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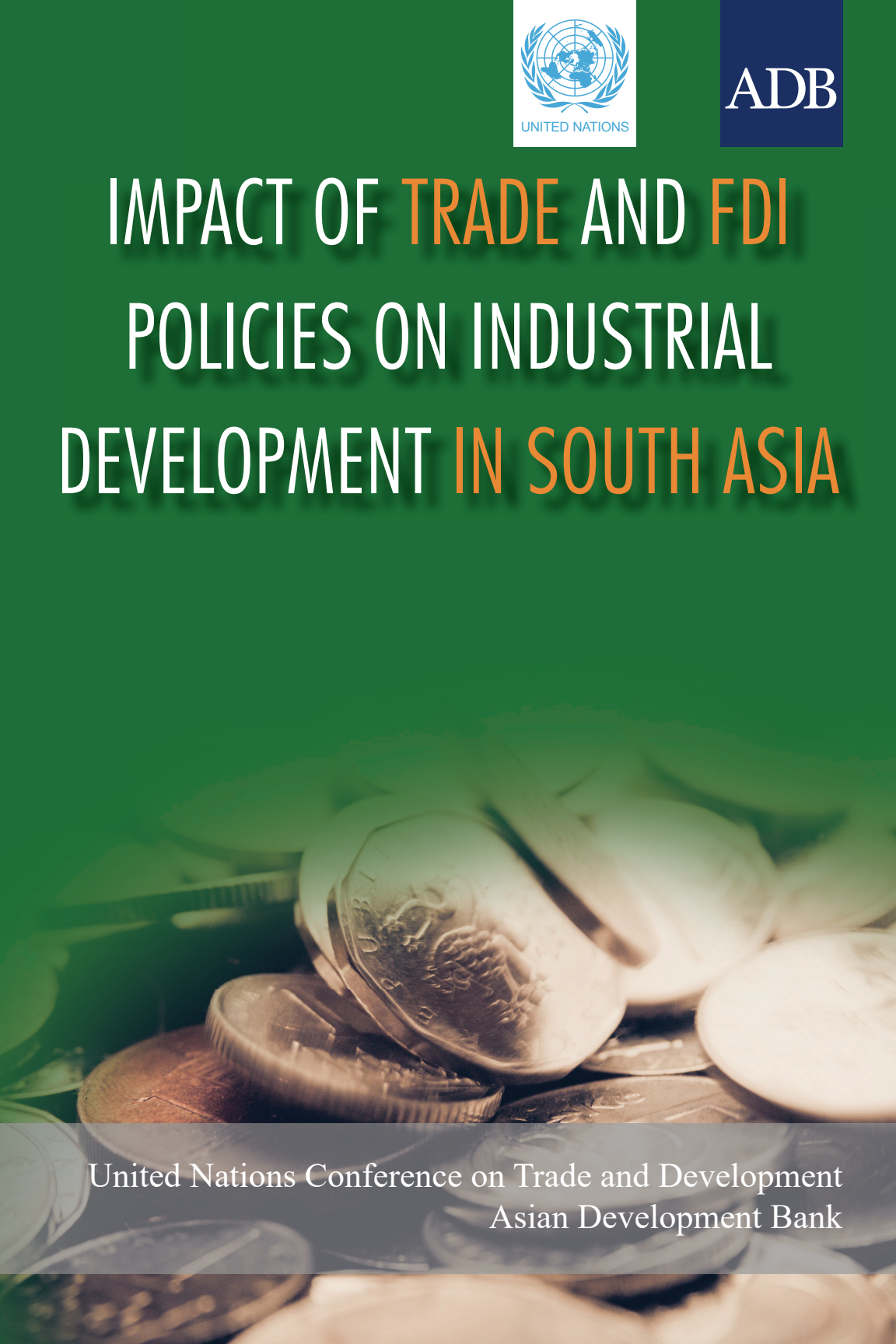
IMPACT OF TRADE AND FDI POLICIES ON INDUSTRIAL DEVELOPMENT IN SOUTH ASIA



United Nations Conference on Trade and Development
Asian Development Bank

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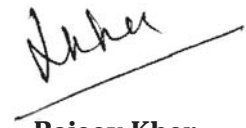
Foreword

Industrial development remains a key area of concern and policy intervention for countries in South Asia. Globalization and the subsequent opening up of the industrial sector by lowering of tariffs and reduction in investment restrictions have further increased the challenges to rapid industrialization in the region. While on the one hand international trade and foreign direct investments (FDI) provide opportunities to increase scale of production and upgrade technologies, on the other hand, they provide fierce competition both in domestic markets as well as in third country markets, which may be difficult for South Asian small and medium enterprises to face. Each country in the region has responded to this challenge through targeted trade and FDI policies. The region has a repository of policies some of which have worked, and some which have not. This study details and analyzes the experiences of countries in the region with respect to trade and FDI policies.

The study traces the evolution of trade and FDI policies in South Asia and uses a rigorous analytical approach to evaluate the success of trade policies in boosting industrial growth in the different countries. It identifies export-led growth models in the region and also uses qualitative analyses to assess the impact of intraregional investments. In this context, the Indian experience in Sri Lanka and Nepal is examined. In so doing, it charts the way forward for regional integration.

The study benchmarks trade and FDI policies in the region and engages policy makers and experts from the region to add value to the analysis. I commend the institutional collaboration and am sure the work will be of immense use to policy makers as well as academia in the region.



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Commerce Secretary
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List of Abbreviations

ADF	Augmented Dickey Fuller
AIMT	Asian Institute of Management and Technology
Annex	Annexure
ANSAB	Asian network for sustainable agriculture and bioresources
AO	Additive Outliers model
ASEAN	Association of Southeast Asian Nations
BEPZA	Bangladesh Export Processing Zones Authority
BIAC	Brandix India Apparel City
BIPPA	bilateral investment promotion and protection agreements
BOI	The Board of Investment
BSCIC	Bangladesh Small and Cottage Industries Corporation
BST	Bhutan Sales Tax
CECA	Comprehensive Economic Cooperation Agreement
CHC	Ceat Holding Company
CIAA	Commission for Investigation of Abuse of Authority
CTC	cut, trimmed and curled
DIPP	Department of Industrial Policy and Promotion
DNPL	Dabur Nepal Private Limited

DOI	Department of Information
DTIS	Diagnostic Trade Integration Strategy
EAC	East African Community
EIF	Enhanced Integrated Framework
ELG	Export-led growth
EOUs	Export Oriented Units
EU	European Union
FDI	Foreign Direct Investment
FEMA	Foreign Exchange Management Act
FICCI	Federation of Indian Chambers of Commerce and Industry
FIEs	Foreign Invested Enterprises
FIML	Full Information Maximum Likelihood
FIPB	The Foreign Investment Promotion Board
FTAs	Free Trade Agreements
FTZ	Free Trade Zones
GEP	Group of Eminent Persons
GOI	Government of India
ICD	Inland Clearance Depots
ICFAI	The Institute of Chartered Financial Analysts of India University
ICSID	International Centre for Settlement of Investment Disputes
IIMOD	International Center for Integrated Mountain Development
IO	Innovational Outliers
ISLFTA	India-Sri Lanka Free Trade Agreement
IT	Information Technology
LDCs	Least Developed Countries
MFA	Multi-Fibre Arrangement
MFAMR	Ministry of Fisheries, Agriculture and Marine Resources
MIFCO	Maldives Industrial Fisheries Company
MNE	Multinational enterprise
MOP	Margin of preference
NAFTA	North American Free Trade Agreement

NAFTA	The North American Free Trade Agreement
NLDCs	Non-Least Developed Contracting States
NTBs	Non-tariff barriers
NTIS	Nepal's Trade Integration Strategy
PSLFTA	The Pakistan-Sri Lanka Free Trade Agreement
QRs	Quantitative restrictions
RMG	The Ready Made Garment
ROO	Rules of Origin
RTA	Regional Trading Agreement
SAARC	the South Asia Association for Regional Cooperation
SAFTA	the South Asia Free Trade Area
SAPTA	SAARC Preferential Trading Agreement (SAPTA)
SEZs	Special Economic Zones
TEPC	Trade and Export Promotion Centre
TRAINS	Trade Analysis Information System
TYHDF	ten year horizon development framework
UN COMTRADE	United Nations Commodity Trade Statistics Database
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UNL	Unilever Nepal
VAR	Vector auto regression
VAT	Value added tax
WTO	World Trade Organisation

Contents

Executive Summary

South Asian countries have experienced unprecedented growth since the beginning of the 21st century. Most of these countries undertook significant reforms during the early 1990s with regard to their trade and foreign direct investment (FDI) regimes. However, in spite of the growth and significant changes in their trade and FDI policies indicating steady liberalization, intraregional trade has remained low and many countries in the region have not experienced the expected rate of industrial growth and development. This study undertakes both quantitative as well as qualitative analyses to assess the extent to which trade and FDI liberalization in South Asian countries have been successful in boosting industrial growth and development.

Briefly reviewing trade and FDI policies in all South Asian countries, the study benchmarks the extent of liberalization these countries have undertaken during 1990–2012. Using advanced econometric techniques the study identifies the extent to which these liberalization policies have been successful in triggering structural changes in the manufacturing sector. Co-integration analysis and causality tests are undertaken to identify countries which have experienced export-led industrialization. The study also assesses the implications of the presence of one of the fastest growing economies in the world, i.e., India, in the region by undertaking case studies of the development impact of free

trade agreements with India (Indo-Sri Lanka Free Trade Agreement) and FDI from India into Nepal. Further, highlighting the changing political economy in the region, the study suggests a way forward for developmental regionalism in South Asia emphasizing the benefits of "One Asia" and its peace dividend.

Sri Lanka is found to be the earliest liberalizer in the region and Nepal is found to be the most liberalized, in terms of trade and FDI regimes. Despite being the first South Asian country to initiate reforms, Sri Lanka has introduced more gradual liberalization compared to the other countries in the region. Bangladesh and Pakistan on the other hand have witnessed more rapid and steeper reductions in their tariffs since the early 1990s. India's reforms have focussed on liberalizing capital inputs for industrial expansion with a more regulated approach toward the import of consumer goods. Nepal and Maldives have maintained a fairly open trading regime over a consistent period. The only country to go slow with liberalization in South Asia has been Bhutan. Although different sectors have been liberalized to different degrees and at varying pace in different countries, the agriculture and automobiles sectors seem to have received much more protection in the entire region.

With respect to intra-regional FDI, India is the largest investor in the region, but compared to its global investments, the share of the region is dismally low. Indian investments have not been able to play the role of "*flying geese*" in the region, in spite of its perceived potential to do so. Most of the Indian FDI in the region is horizontal (market-seeking) in nature thus not causing a slicing of the production process to form regional value chains.

Assessing the success of trade and FDI liberalization in spurring industrial growth and development is very important for any kind of assessment of the development impact of trade and FDI policies. Higher industrial production activities are generally associated with gains in terms of employment generation, technology upgradation and skill development. The study undertakes advanced econometric tests to identify "structural breaks" in industrial growth during 1970–2010. Two kinds of structural breaks are identified—"sudden shift" or instantaneous shock that shifts the mean of the series through the Additive Outliers (AO) model and "gradual shift", i.e.,

when the shock persists and dynamically adds to change the mean of the series over the rest of the period through the Innovational Outliers (IO) model.[1]

Corresponding to structural breaks in growth of manufacturing value added, structural breaks are identified in the growth of real exports and real imports. Comparing the years of major reforms with the identified structural breaks gives a good indication of the extent to which these reforms have been able to lead to structural transformation and industrial growth in the countries. The results show that reforms have led to structural breaks in industrial growth in Bangladesh and India. Pakistan seems to have had more success with its reforms in the first decade of the 21st century as compared to earlier reforms, as made evident by a corresponding sustained structural break in manufacturing value added in 2002. On the other hand, the 1970s reforms seem to have been more successful in Sri Lanka in terms of leading to a sustained structural break in manufacturing value added and real exports. The Least Developed Countries (LDCs) and Small and Vulnerable Economies (SVEs) of the region like Bhutan, Nepal and Maldives do not appear to have succeeded in using trade and FDI policies in making any significant or sustained breaks in their manufacturing value added.

The empirical results with respect to co-integration and causality analyses show the extent to which growth in manufacturing value-added has been interlinked and caused by a growth in exports. It is found that reforms that have been successful in leading to structural transformation in some South Asian countries go much beyond export promotion. Exports alone may not be instrumental in leading to structural changes in the manufacturing sector. In South Asia, exports appear to have led to industrialization only in Bangladesh.

The presence of a fast growing economy in the region can lead to substantive growth spillovers to other countries through enhanced trade and investment opportunities while making the country with

1 See P. Perron. 2006. Dealing with Structural Breaks. In Kerry Patterson, and Terence C. Mills, ed. *Palgrave Handbook of Econometrics Volume 1: Econometric Theory*: Palgrave Macmillan; P. Perron and T. J. Vogelsang. 1992. Nonstationarity and Level Shifts with an Application to Purchasing Power Parity. *Journal of Business and Economic Statistics*, Vol. 10 (No. 3). 301-320 For the underlying models estimated.

the fast growing economy the "growth pole" for the region. In order to assess the developmental role played by India in the region, qualitative analyses have been conducted through case studies which look at the Indo-Sri Lanka Free Trade Agreement (FTA) and its impact on Sri Lanka's economy, and Indian FDI in Nepal's agro-processing industries and its impact on Nepal's economy.

An examination of the development impact of the Indo-Sri Lanka FTA on Sri Lanka's economy shows that there remains considerable scope to intensify this impact. Although, Sri Lanka's exports enjoyed an increase of 107% after the introduction of the FTA, the growth came primarily from a handful of items, including animal fats, vegetable oils, copper and aluminum products, and pharmaceuticals. Indian FDI was attracted to Sri Lanka in vegetable oil, in order to avoid high Indian tariffs. Despite the Board of Investment of Sri Lanka reporting the creation of 5,900 jobs as a result of Indian investment during1993–2007, many of these jobs were simply reallocations of previously existing jobs. The bilateral FTA also led to a surge in bilateral investments with several Sri Lankan information technology (IT) companies venturing into the Indian market, providing internet-related services and mobile phone services including tourism companies. Nonetheless, the development-oriented impact of the Indian FDI in Sri Lanka appears to have been fairly limited.

Indian FDI in Nepal's agro-processing sector has been fairly limited apart from the investment made by Dabur Nepal Private Limited (DNPL). Examining the development impact of DNPL, it is found that the company has not only established its processing plants in Nepal but also initiated several projects. Indian FDI via DNPL has generated direct employment for nearly 2,000 workers and given indirect employment to nearly 20,000 people in Nepal. DNPL has also been one of the largest contributors to merchandize exports from the country. The company has also contributed substantially to government revenue through taxes and import duties. However the extent of indigenization in terms of raw materials sourced from Nepal is found to be limited and hovered around 20% in 2009. On the balance though, the positive contribution of DNPL outweighs the negative, and with some improvement in the modality of operation

as well as greater transparency in operations coupled with a commitment to technological development, DNPL could prove to be a highly useful business venture for Nepal.

The study concludes by highlighting the changing political economy of the region given changes in external factors like a slowdown in advanced economies, decline of hegemonic powers like the US in the realm of global affairs, growing economic power of the People's Republic of China (PRC) and so on. It argues that these changing circumstances have increased the strategic importance of regional cooperation in South Asia. South Asian countries are also realizing the importance of promoting regional cooperation and therefore this is an opportune moment to give a big push to regional integration through various initiatives. Some important steps in this direction have been India's tariff preferential package for LDCs, the list of India's sensitive trading partners getting reduced and Pakistan's commitment to grant India the Most Favored Nation (MFN) status and reduce items on its negative list. Such efforts need to be intensified further. Uniform standards for mutually agreed products which are then synchronized with similar international standards to improve the global competitiveness of South Asian products would help the process immensely.

Regional cooperation can greatly facilitate trade and industrial development in the region through improved infrastructure and transport linkages. Not only will this make trading in the region easier, it will make available other trade opportunities since the region is strategically situated between the oil-rich countries in West and Central Asia and the dynamic economies of East Asia. The resource requirements for infrastructure development in South Asia itself are gigantic. Regional cooperation would create a larger market and offer multilateral agencies and the private sector attractive investment opportunities in developing physical infrastructure in the region. A more integrated South Asia would also have a stronger voice in multilateral standard-setting bodies.

Trust deficit, mutual suspicion and political differences are common in almost all regional relations and not unique to South Asia. A serious commitment to integration, even if encouraged by economic incentives, is more likely to create a forum for the

peaceful resolution of disputes than isolated efforts have done so far. With increased political will and commitment toward integration, the South Asian countries need to mold public opinion, create awareness about the value of increasing regional integration and explore closer economic integration in priority industries to build complementarities, promote industrial development, and improve global competitiveness.

1

Introduction

Trade and FDI policies are becoming important in the globalized world as they are frequently being used to spur growth and development in an economy. However, country experiences show that higher openness of an economy may not necessarily lead to growth and growth may not necessarily be accompanied by development. In fact, the relationship may run in the opposite direction and faster growing economies may tend to be more open and derive higher gains from integrating with the global economy.

South Asia as a region has grown rapidly in the last decade and a half. The region grew at an average annual growth rate of 7.4% during 2000–2010, as compared to 5.5% in the 1990s. The percentage of people living on less than $1.25 a day declined from 45% in 1999 to 36% in 2008.[1] Although India enjoyed the highest average annual growth in the region in the first decade of the 21st century (8%), almost all South Asian countries experienced a higher average annual growth in the same decade as compared to the 1990s. Further, India became the second fastest growing economy of the world in 2010. The changing circumstances of the region provide an opportune moment for its countries to revisit their trade and

1 World Development Indicators. 2012. *The Millenium Development Goals Report*. New York: United Nations.

FDI policies and use them for strengthening regional integration, growth and development. The existence of an emerging economy like India has provided further opportunity to the region to avail of a "growth pole."

However, in spite of growth in almost all countries in the region and the existence of an emerging economy, South Asia (which comprises Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka), remains the least integrated region in the world. The regional trade in South Asia is dismally low at 8.3% in 2012, as compared with the regional trade of the European Union at 63%, the North American Free Trade Agreement (NAFTA) at 48.5%, the Association of Southeast Asian Nations (ASEAN) at 26% and the East African Community (EAC) at 21%. Despite the common heritage, history, linguistic, cultural and social practices shared by these nations, the region is distinctly characterized by complex security issues, multiple interstate disputes and political issues and conflicts which have not allowed economic and strategic interests to take precedence in matters of policy and development. Cooperation and collaboration in trade and FDI policies is required to help the countries in the region to tap into their high economic potential.

Inspired by the success of economic integration agreements in other parts of the world South Asian countries decided to create the South Asia Association for Regional Cooperation (SAARC). The charter of the SAARC was accepted by all the seven members in mid-1985. A regional trading block among these members was formed in April 1993 with the signing of the SAARC Preferential Trading Agreement (SAPTA) for giving preferential market access to the exports of the member-countries in a limited way. These countries moved further to achieve the South Asia Free Trade Area (SAFTA), and signed the SAFTA Pact in 2004. The agreement came into force on 1 January 2006 and the trade liberalization process commenced from 1 July 2006. It has resulted in considerable liberalization of trade within the region leading to an increase in intraregional trade. But long lists of sensitive items which are removed from preferential trade have kept the level of intercountry trade under SAFTA far below its potential.

There is a divergence of opinions on the prospect of increasing economic integration in South Asia. Some authors argue that unilateral liberalization as is currently underway in South Asia offers greater benefits than regional integration would.[2] Others argue that regional integration will create exciting opportunities and will allow countries to develop comparative advantage, coordinate programs to address challenges in governance, environment, social development, and other areas that most often spill over national boundaries.[3] Although, conventional wisdom based on standard trade theory holds that there is little room for fostering intraregional trade through collective action, given the similarities of these countries in terms of resource endowments, it has been strongly contested. The proponents of regional economic integration argue that the static comparative advantage argument based on existing patterns of economic integration should not be treated as a guide to policy, and there is ample room for creating economic complementariness through further trade and investment policy reforms. The ongoing process of global production sharing has provided opportunities for South Asian countries to integrate and form regional supply chains to become globally competitive.[4] Vertical FDI and trade integration can add new dimensions to regional trade leading to gains for all countries in the region.

It is also argued that the existence of a fast growing economy like India in the region can provide additional opportunities for spurring growth and development. The theory of growth poles leading to regional development dates back to the 1950s when Perroux put forward his theory of active units which assumed that under certain conditions actors have the capacity to change their

2 J. S. Bandara and W.Yu. 2003. How Desirable is the South Asian Free Trade Area? A Quantitative Assessment, *The World Economy*. 26 (9).

3 UNCTAD and ADB. 2008. Quantification of Benefits from Regional Cooperation in South Asia.

4 UNCTAD and ADB. 2013a. Intraregional Trade in Leather and Leather Products in South Asia: Identification of Potential Regional Supply Chains.
UNCTAD and ADB. 2013b. Identifying and Promoting Potential Regional Supply Chains in Food Processing Industry in South Asia.

environment.[5] Perroux argued that the poles of development, which are centers of the most intense activity, could produce polarization in leading sectors determined by proximity in economic space and resulting in growth in these sectors. Friedman applied these ideas to physical space as opposed to economic space to arrive at the much discussed "core-periphery model."[6] Since then there has been considerable interest generated in regional growth models, which are based on the fundamental condition of geographical proximity.

This study aims to review the existing trade and FDI policies in all South Asian countries, benchmark their extent of liberalization, asses the success of these policies in triggering structural transformations in the economies, estimate their impact on industrial development and suggest ways to link these policies across national boundaries so as to smoothen the process of regional integration and increase global competitiveness of the region. The study proposes regional integration as an instrument to build industrial capacity and boost industrial growth and development in South Asian countries.

5 F. Perroux. 1950. Economic Space: Theory and Application. *Quarterly Journal of Economic*., 64. pp. 89–104. F. Perrox. 1970. Note on the Concept of Growth Poles in McKee D, Dean RD, Leahy WH, eds. *Regional Economics: Theory and Practice*. New York: The Free Press. pp. 93–104.
F. Perroux. 1988. The Pole of Development's New Place in a General Theory of Economic Activity. In B. Higgins and D. Savoie, eds. 1988. *Regional Economic Development: Essays in Honour of Francois Perroux*. Boston. pp. 48–76.

6 J. Friedmann. 1966. *Regional Development Policy: A Case Study of Venezuela*. London: MIT Press.
J. Friedman. 1972. A General Theory of Polarized Development. In N.M. Hansen, ed. *Growth Centers in Regional Economic Development*. New York: Free Press

2

Review of Trade Policies in South Asia: Benchmarking Extent of Trade Liberalization

2.1 Trade and Development Debate

Trade has been long regarded as an "engine of growth" and this role of trade has been supported by both theoretical as well as empirical literature. But the net effect of trade openness on economic growth has been, and remains, a subject of controversy. On the theoretical side, since the time of Smith through Ricardo and Solow, trade has been shown to help a country reach a higher level of income since it permits better allocation of resources. The growth effects of trade openness are made much more explicit by the use of the new growth theory led by Romer and Lucas.[1] Within such framework, trade allows intensification of capacity utilization that increases production and consumption. Openness offers a larger market for domestic producers, allowing them to operate at a minimum required scale whilst reaping benefits from increasing returns to scale.

However, with the growing volume of trade in the world in the last three decades, doubts have been raised not only about whether trade leads to growth but also about the direction of

1 Paul M. Romer. 1986. Increasing Returns and Long-Run Growth. *The Journal of Political Economy.* pp. 1002–1037; Robert E. Lucas Jr. 1988. On the Mechanics of Economic Development. *Journal of Monetary Economic.* 22 (1). pp. 3–42.

the relationship. It has been argued by some that faster growing economies trade more and therefore the relationship between trade and growth may not be one way. New developments in growth theory provide an explanation for questioning the growth regression framework to deal with complex relationships like the openness-growth nexus. The effect of openness on growth depends on a country's structural and institutional conditions.[2] Winters et al identify four main channels through which trade shocks, including trade liberalization, are transmitted into poverty impacts.[3] These include impact on wages and employment; prices of the tradable; taxes and spending; shocks, risks and vulnerability; and economic growth and technology. These impacts are transmitted through four groups of institutions, i.e., households, enterprises, distribution channels, and government.

Some of the empirical studies in the last two decades that support the role of trade in boosting growth include David Dollar and Aart Kraay.[4] Using data for 80 countries over four decades their study reiterates the fact that openness boosts economic growth and that incomes of the poor rise one for one with overall growth. Frankel and Romer use data for 100 countries since 1960 and conclude that openness does have a statistically and economically significant effect on growth.[5] Sachs and Warner find that developing countries with open economies grew by 4.5% per annum in the 1970s and 1980s, while those with closed economies grew by 0.7% per annum in the same period.[6] According to this study, open economies double in size in 16 years, whereas closed ones take 100 years. Winters et al find evidence that trade liberalization in Viet Nam reduced poverty substantially during 1993–1998.[7]

2 R. Chang, L. Kaltani, and N. Loayza. 2005. Openness can be Good for Growth: The Role of Policy Complementarities. DEGIT Conference Papers. DEGIT (Dynamics, Economic Growth, and International Trade). David N. DeJong and Marla Ripoll. 2006. Tariffs and Growth: An Empirical Exploration of Contingent Relationships. *The Review of Economics and Statistics*. 88 (4). pp. 625–640. MIT Press.

3 L. Alan Winters, Neil McCulloch and Andrew McKay. 2004. Trade Liberalization and Poverty: The Evidence So Far. *Journal of Economic Literature.* 42 (1). pp. 72–115.

4 D. Dollar and A. Kraay. 2001. *Trade, Growth, and Poverty*. World Bank, Development Research Group. Macroeconomics and Growth.

5 Jeffrey A. Frankel and David Romer. 1999. Does Trade Cause Growth? *American Economic Review*. pp. 379–399.

6 Jeffrey D. Sachs and Andrew M. Warner. 1997. Sources of Slow Growth in African Economies. *Journal of African Economies.* 6 (3). pp. 335–376.

7 Winters et al. 2007. Trade Liberalization and Poverty Dynamics in Vietnam. *Journal of Economic Integration.* 22 (4). pp. 819–851.

Studies that question the growth-enhancing role of trade include Harrison, Barro, Rodriguez and Rodrik, Nye, Reddy and Watkins, Rodrik and Rigobon and Rodrik.[8] These studies are critical of those which establish links between trade and growth for their alleged lack of control for "other" economic policies and use of largely unsatisfactory trade policy indicators. Rodrik debates the use of instrument-variable strategy in regression analysis to arrive at the effects of government policies,[9] with respect to trade, on growth. First, in this area of inquiry it is genuinely hard to find credible instruments, which satisfy both the erogeneity and exclusion requirement, and second, these regressions do not indicate how effective the *purposeful* policy interventions have been. Easterly emphasizes that the large policy effects uncovered in growth regressions are typically driven by outliers, which represent instances of extremely "bad" policies.[10]

Further, Rodriguez and Rodrik observe that most studies make use of complex indices to establish the relation between trade and economic growth.[11] For example, they are skeptical about the index constructed by Sachs and Warner which includes information on average tariffs, nontariff barriers, adoption of central planning, state monopolies of exports and the black-market premium.[12] According to Rodriguez and Rodrik, the link of the last two components to trade policy is questionable.

On the other hand, Frankel and Romer have constructed a variable—trade caused by geographical factors—to use as an

8 A. Harrison. 1996. Openness and Growth: A Time-Series, Cross-Country Analysis for Developing Countries. *Journal of Development Economics.* 48 (2). pp. 419–447; Robert J. Barro. 1999. Inequality, Growth, and Investment. *NBER Working Papers*. No. 7038: National Bureau of Economic Research, Inc.; F. Rodriguez and D. Rodrik. 1999. Trade Policy and Economic Growth: A Skeptic's Guide to Cross-national Evidence. *NBER Working Papers*. No. 7081: National Bureau of Economic Research, Inc.; H.L.M. Nye, S. Reddy and K. Watkins. 2002. *Dollar and Kraay on Trade, Growth and Poverty : A Critique*. Columbia University; D. Rodrik. 2000. Comments on '*Trade, Growth, and Poverty*' by D. Dollar and A. Kraay. Cambridge, MA: Harvard University and R. Rigobon and D. Rodrik. 2004. Rule of Law, Democracy, Openness, and Income. *Economics of Transition*. 13 (3). pp. 533–564.

9 D. Rodrik. 2005. *Why We Learn Nothing From Regressing Economic Growth on Policies*. Mimeo: Kennedy School of Government.

10 William Easterly. 2004. National Economic Policies and Economic Growth: A Reappraisal. In P. Aghion and S. Durlauf, eds. *Hand-book of Economic Growth*. North Holland.

11 Francisco Rodriguez and Dani Rodrik. 2001. Trade Policy and Economic Growth: A Skeptic's Guide to the Cross-National Evidence. *NBER Macroeconomics Annual 2000.* MIT Press. 15. pp. 261–338.

12 Jeffrey D. Sachs and Andrew M. Warner. 1995. *Economic Convergence and Economic Policies*. No. w5039. National Bureau of Economic Research.

instrument for trade/GDP ratios in a regression in which income levels are dependent.[13] Although, using this trade share in the regression gives significant results, this approach has also been questioned on the grounds that the trade share may be acting as a proxy for geography's direct effect on growth, say effect of climate on disease, international technology transmission, etc.

An interesting result by Warner shows that the unweighted average tariff rate on capital and intermediate goods did display a simple negative correlation with growth.[14] However, by using different data sets for growth, Rodriguez and Rodrik found that the Warner's results could not be replicated. The results were consistent with the idea that there is a weak, insignificant statistical relationship between growth and tariffs. Rodrik argues that poor countries need to design policies as per their unique situations to overcome their own specific constraints to benefiting from trade.[15]

It is thus hard to arrive at a consensus on whether trade policies can be used as an instrument for spurring growth and development in a country. Nevertheless, trade policies have gained prominence with the onset of regional and multilateral trade agreements. Guided by their commitments in different forums, be it bilateral free trade agreements, regional trade agreements or multilateral trade agreements, countries have pursued active trade liberalization policies.

2.2. Extent of Trade Liberalization in South Asia

Compared to other developing regions of the world, South Asia seems to have initiated trade liberalization in a more conservative manner, although there are variations among countries within the region. Latin America started its reform process in the 1980s, much before South Asia, and at a faster pace. Reform in Latin America was led initially by the policies dictated by international financial institutions and gathered pace and momentum after the

13 Jeffrey A. Frankel and David Romer. 1999. Does Trade Cause Growth? *American Economic Review*. pp. 379–399.
14 A. Warner. 2003. Once More into the Breach: Economic Growth and Integration. Center for Global Development. Working Paper 34.
15 D. Rodrik. 2007. *Normalising Industrial Policy*. Cambridge, MA: Harvard University

Washington Consensus. East Asia, on the other hand, introduced gradual reforms starting much earlier, around the 1960s. However, the rapid trade liberalization in East Asia, took place only after the 1970s. It must be noted that there may be large variations in the liberalization trends of various East Asian countries. Trade policies of South Asian countries with respect to the lowering of tariffs followed a similar trend after the 1990s; however differences are stark when this is compared across sectors.

2.2.1 Average Tariffs in South Asia

South Asian countries started late with trade liberalization only in the early 1990s by primarily lowering their import tariffs. By 2009, most of the countries had substantially reduced their MFN tariffs. The average tariff for all South Asian countries taken together declined from 75% in 1990 to around 17% in 2009. However, average tariffs differed substantially in the early 1990s amongst South Asian countries with the highest tariffs in Bangladesh (113%) and the lowest in Sri Lanka (28%). Although varying methods of calculation might sway the number by a percentage point or so it does give some indication of the extent of trade liberalization that has taken place in the region. [16] Of the seven countries analyzed, only Bhutan's average MFN tariff exceeded 25%, while all the remaining countries' averages varied between 10% and 15% in 2011 (Figure 2.1). [17] In 2011, Afghanistan had the lowest average tariff (5.5%), followed by Sri Lanka (9.2%) and Nepal (12%).

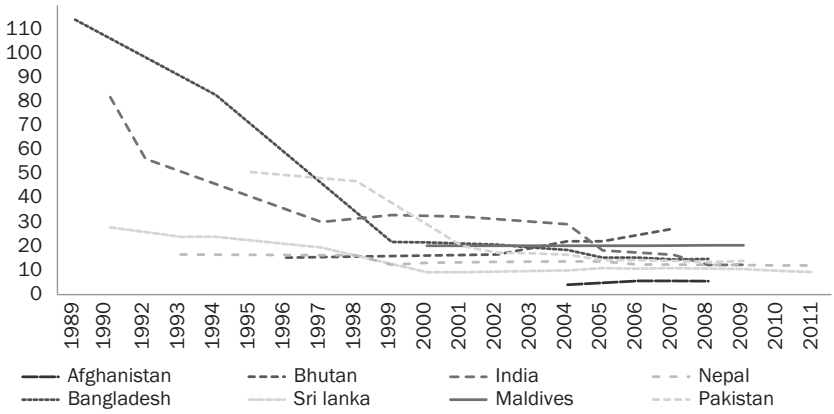
Lowering of tariffs and other reforms in the early 1990s led to a rise in trade openness in all countries of the region. In 2011, trade to GDP ratio was as high as 205% for Maldives followed by 127% in Bhutan. Average trade openness for SAARC increased from 20% in 1980 to 31% in 2000 and further to 52% in 2011. Trade openness spiked in Maldives, Bhutan, and Sri Lanka but did not increase much in Pakistan (from 36% in 1990 to 37% in 2011). India and Bangladesh

16 For instance, if data for one year for a country are not available, WITS uses the nearest available year as a proxy.

17 The data on Afghanistan are fairly scant, particularly for the years before 2001. The missing values could not be accounted for and therefore, only seven countries were used for calculating the overall averages.

have experienced high growth in their trade openness with a rise of 30 percentage points since 1990.

Figure 2.1: Average Tariffs in South Asian Countries: 1989–2011



Source: UNCTAD STAT

Table 2.1: Trade Openness: Trade in Goods and Services to GDP Ratio: 1980–2011

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	SAARC
1980	23	-	15	284	32	33	82	20
1985	21	81	14	154	32	29	64	18
1990	21	78	16	171	33	36	64	20
1995	32	71	23	158	59	34	79	27
2000	37	79	28	146	54	31	87	31
2005	44	97	40	180	48	44	74	42
2006	49	101	44	199	46	44	71	46
2007	49	102	43	200	46	42	69	44
2008	54	113	53	208	52	50	63	54
2009	45	99	44	149	52	37	49	44
2010	51	104	46	151	47	39	53	46
2011	60	127	52	205	46	37	61	52

Source: UNCTAD STAT

2.2.2 Lowering of Agricultural and Industrial Tariffs

Agricultural Tariffs

The agriculture sector has remained more protected than the industry sector in the region. Interestingly, the average tariff for agricultural products for the region increased from 19% in 2000 to around 21% in 2009 as compared to a lowering of tariffs in nonagricultural products from 16% in 2000 to 13% in 2009. The highest average agricultural tariffs in 2009 were in Bhutan (41%), followed by India (32%) and Sri Lanka (22%) and the lowest tariffs in the same year were in Afghanistan (6%) followed by Nepal at 13%.[18] However, the most drastic cuts in agricultural tariffs have been undertaken by Bangladesh where they reduced from 91% in 1989 to 17% in 2008. While average agricultural tariffs increased in Bhutan from 15.5% in 1995 to 41% in 2007, Pakistan lowered its tariffs from 22% to 17% in that period.

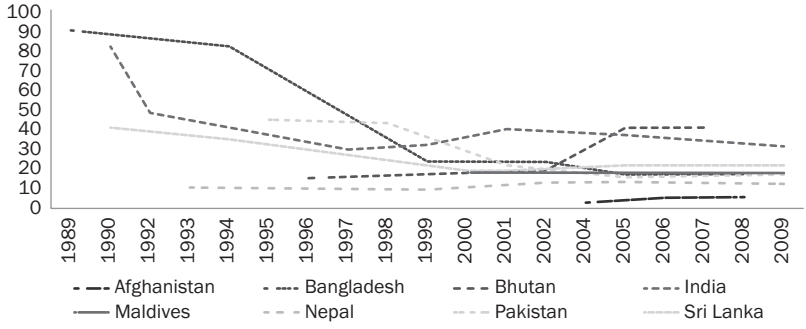
For most countries in South Asia, agricultural tariffs first show a decreasing trend from the mid-1990s to late 1990s,then they rise around 2000, only to fall again more recently. For instance, the average Indian tariffs declined from around 83% in 1990 to 30% in 1997 before rising to 40% in 2001 and eventually decreasing to its current rate of 31.9%. Similarly, in Sri Lanka, the average tariff dropped from 35.4% in 1994 to 19.4% in 2000 but rose again to 22.1% in 2005 and has remained around the same. In Nepal as well, the average rate fell from 10.7% in 1993 to 9.7% in 1999, then rose to 13.2% in 2002 before eventually reaching the current 12.6%. Pakistan also showed a liberalizing trend until 2005 when the average tariff was reported at 16% as compared to45.5% in 1995. However, it has risen slightly to 17.4% in 2009 (Figure 2.2). In the case of Maldives, the average agriculture tariff has remained consistent since 2000 at around 18%, while Bhutan is the only country in South Asia that has shown a protective tendency over time. The average tariff in Bhutan rose consistently from 15.5% in 1996 to 41.4% in 2007.

18 Simple averages have been taken for the years for which tariffs are available for most of the countries.

Agricultural Tariffs at Two-Digit Level

Annex 1 reports the average agricultural tariffs in different countries. A comparison across different chapters of HS shows that among agricultural products, Chapter 22 (beverages, spirits and vinegar) is the most protected sector across almost all South Asian countries. India has the highest average tariff of 114% for this sector, followed by Bhutan (87.5%) and Pakistan (75%). In terms of the most open or low tariff products, there is no consistent trend across countries. Sri Lanka's tariffs on Chapter 22 are 25% on average but those are also among the highest for the country. The highest tariff in Sri Lanka appears on Chapter 24 (tobacco and tobacco products) at 80%. For Bangladesh and Pakistan, Chapter 10 (cereals) and Chapter 12 (oilseeds, miscellaneous grain, etc.) have lowest average tariffs. For Bangladesh, the figures are 3.8% and 5.7% respectively. For, Pakistan they stand at 2.9% and 5.9% respectively. In case of Bangladesh, Chapter 23 (residue and waste from food, etc.) has only 1% average tariff. In case of India, Chapter 15 (animal/veg fats and oils, etc.) with an average tariff of 15% is the only chapter with tariffs less than 20%. Sri Lanka's least protected products are in Chapter 14 (vegetable plaiting materials) at 6.3%.

Figure 2.2: Tariffs on Agricultural Products: 1989–2009



Source: UNCTAD, TRAINS

As far as liberalization with regard to agricultural products is concerned, the four large countries have made significant

changes.[19] In India, Chapter 15 (animal/vegetable fats and oils, etc.) has again been found to be the most rapidly liberalized sector over time. Its average tariff went from 104% in 1990 to 15% in 2009. In Pakistan, Chapter 1 (live animals) and Chapter 3 (fish and fish products) have seen a similar trend. The tariff on Chapter 1 went down from around 49% in 1995 to 7% in 2009, while in Chapter 3, it reduced from 68% to 9% over the same period. For Bangladesh, rapid liberalization has taken place in Chapter 9 (coffee, tea mati and spices), Chapter 15 (animal/vegetable fats and oils, etc.) and Chapter 18 (cocoa and cocoa preparations). Tariffs went down from 146% in 1990 to 23% in 2008 (Chapter 9), 107% to 14% (Chapter 15) and 140% to 16% (Chapter 18). For Sri Lanka, a similar trend is seen with regard to Chapter 13 (lac; gums, resins and other vegetable saps) and Chapter 14 (vegetable plaiting materials and vegetable products). Tariffs for these sectors reduced from 56% and 43% in 1990 to 10% and 6% in 2009 respectively.

For the remaining countries, the trends are quite different. In the case of Nepal, tariffs in the 1990s were quite low and have gone down further after slight increases around 2000. In general, barring Chapters 22 and 24, Nepal's average tariffs at 2-digit level are below 20%. In case of Maldives, data is available from the year 2000, and since then the tariffs have declined consistently. No radical changes of trend have been seen with regard to any product. As mentioned earlier, Bhutan has shown a protectionist trend over time. In certain cases, tariffs in Bhutan have gone up from 0% in 1993 to 50% in 2007. This trend is consistent across all chapters except 22 and 24 where the tariffs have always been high. In Afghanistan, it is difficult to determine a trend as no data are available before 2004–2005.

Table 2.2 provides a list of agricultural products which have seen maximum liberalization, and those which have seen the least, across all the countries of South Asia.

19 In terms of economic size and trade volumes, India, Pakistan, Bangladesh, and Sri Lanka are the largest South Asian countries.

Table 2.2: Most and Least Liberalized Agricultural Products in South Asian Countries

	Most Liberalized	Least Liberalized
Bangladesh	Cereals; Oil seed, oleagi fruits; miscell aneous grain, seed, fruit; Residues & waste from the food industry; Live animals	Coffee, tea, matï and spices; Cocoa and cocoa preparations; Animal/veg fats & oils & their cleavage products
Bhutan	Sugars and sugar confectionery.	Beverages, spirits and vinegar; Tobacco and manufactured tobacco substitutes
India	Animal/veg fats & oils & their cleavage products; Residues & waste from the food industry; Oil seed, oleagi fruits; miscellaneous grains and seeds	Beverages, spirits and vinegar; Coffee, tea, matï and spices; Miscellaneous edible preparations; Preparation of meat, fish or crustaceans, molluscs
Nepal	Animal/veg fats & oils & their cleavage products; Fish & crustacean, molluscs& other aquatic invert Prod. mill. indust; malt; starches; inulin; wheat?	Beverages, spirits and vinegar. Preparation of vegetable, fruit, nuts or other parts of Tobacco and manufactured tobacco substitutes Preparation of cereal, flour, starch/milk; pastrycooks'
Maldives	Animal/veg fats & oils & their cleavage products; Dairy products; birds' eggs; natural honey; edible produce	Beverages, spirits and vinegar; Residues & waste from the food industry; preparation of meat; Live animals; Vegetable plaiting materials; vegetable products; Tobacco and manufactured tobacco substitutes

	Most Liberalized	Least Liberalized
Pakistan	Cereals; Oil seed, oleagi fruits; miscellaneous grain, seed; Coffee, tea, matï and spices; Edible vegetables and certain roots and tubers; Products of animal origin, nes or included; Live animals	Beverages, spirits and vinegar; Preparation of cereal, flour, starch/milk; pastrycooks' Preparation of vegetable, fruit, nuts or other parts of edible fruit and nuts; peel of citrus fruit or me
Sri Lanka	Vegetable plaiting materials; vegetable products; Products of animal origin, nes or included. Oil seed, oleagi fruits; miscellaneous grain, seed, fruit	Beverages, spirits and vinegar; Tobacco and manufactured tobacco substitutes; Edible fruit and nuts; peel of citrus fruit or me Coffee, tea, matï and spices; Edible vegetables and certain roots and tubers;

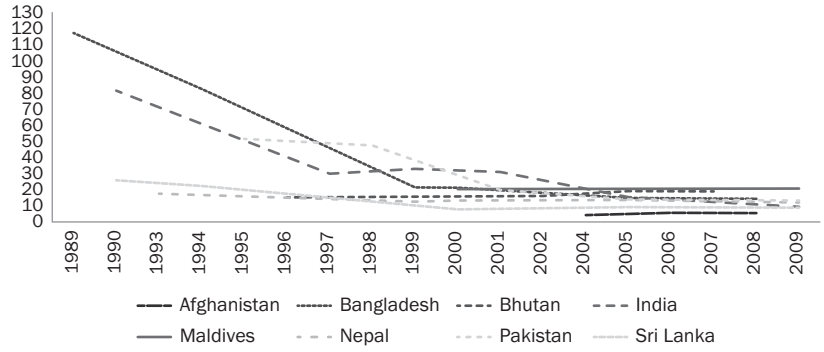
Industrial Tariffs

Averages tariffs for industrial products are overall much lower than those for agricultural products. Among the South Asian countries, Maldives recorded the highest average industrial tariffs in 2009 at 21% while Sri Lanka recorded the lowest at 9%. Bangladesh has made the most substantial cuts in industrial tariffs from an average of 117% in 1989 to 14% by 2008. Nepal's average industrial tariff has remained almost consistent over the years with only a minor reduction from 17.5% in 1993 to 12% in 2009 (Figure 2.3).

As opposed to the agriculture sector, there is no trend showing a rapid initial decline and slight increase later in tariffs of industrial products. Only in the case of Sri Lanka, the average tariff dropped from 22% in 1994 to around 7% in 2000 only to rise to 9% in 2005 and settle at 8% in 2009. The remaining countries show a consistently declining trend, except in Bhutan, where average tariffs showed marginal changes over the years. There is no general trend among

tariffs on industrial products across South Asian countries. However, the Automobiles sector (Chapter 87) faces the highest tariffs in several countries, followed by Clothing (Chapters 61, 62 and 63), and Furniture (Chapter 94). The highest tariff among industrial products across all countries and sectors is 55% in Maldives on Automobiles. Among the least protected sectors are fertilizers, base metals, and ores and leather products (Chapters 41 to 43).

Figure 2.3: Average Industrial Tariffs in South Asian Countries: 1989–2009



Source: UNCTAD, TRAINS

In 2009 the fastest decline in percentage points in industrial tariffs was experienced by India, of almost 22 percentage points. Bangladesh and Sri Lanka experienced a decline of around 7% and 6% respectively at the same time. As Figure 2.3 makes clear, Sri Lanka, Afghanistan, Bhutan, Maldives and Nepal did not witness much change in their industrial tariffs during 2000–2009.

Table 2.3: Industrial Tariffs: 2000–2009

	2000	2005	2009
Afghanistan	4.2	4.2	5.5
Bangladesh	21.2	14.9	14.4
Bhutan	16.1	19.2	18.9
India	31.0	15.3	9.4
Maldives	20.5	20.5	20.7
Nepal	13.2	13.7	12.1
Pakistan	19.8	13.9	13.4
Sri Lanka	7.7	9.3	8.8

Source: UNCTAD, TRAINS

2.3 Highlights of Trade Policies of South Asian Countries

2.3.1 Trade Policy of Bangladesh

Bangladesh has experienced trade policy reforms and import liberalization since the early 1990s. This has been accompanied by promotional measures for exports, including a reduction of the anti-export bias and setting up of facilities such as bonded warehouses and duty drawback, subsidized interest rates on bank credit, cash compensation schemes, duty-free import of machinery, and intermediate inputs and exemption from income tax and other taxes. A recently devised Vision 2021 targets an annual GDP growth rate of at least 8% for Bangladesh by 2015, driven by accelerated growth in the industry and service sectors, through diversification of the export base and markets.

So far, manufacturing has been narrow-based in Bangladesh with the concentration of growth in a few sectors—textiles, wearing apparel and leather, and frozen food and beverages. Almost 75% of the country's exports come from woven and knitted garments. Recently emphasis has been laid on export diversification by plugging itself into regional supply chains and diversifying its manufacturing base. The Sixth Five-Year Plan contains detailed strategies for "thrust manufacturing sectors": notably the (RMG) sector, non-RMG textiles, jute, footwear and leather, light engineering,

pharmaceuticals, agro-processing, shipbuilding, electronics, steel and engineering, software and ICT products, home textiles, ocean-going shipbuilding industries, toiletry products, chemicals, and small and micro enterprises across different sectors. A relatively recent development is private investment in the construction and export of small ships, a segment where Bangladesh appears to enjoy a competitive edge.

An important initiative in recent years is the establishment of economic zones. The government of Bangladesh expects that the new economic zones could be a major driver of economic growth and job creation. The 20 planned economic zones are expected to generate 1.5 million new jobs and attract new investments worth up to $2.5 billion. Exports of agricultural products account for 4% of total export earnings. In addition to the exports of main agricultural commodities, such as raw jute, jute goods, tea, and frozen foods, the government has taken steps to increase exports of nontraditional agricultural commodities. However, food imports account for nearly 13% of total imports, making Bangladesh a net food-importing country.

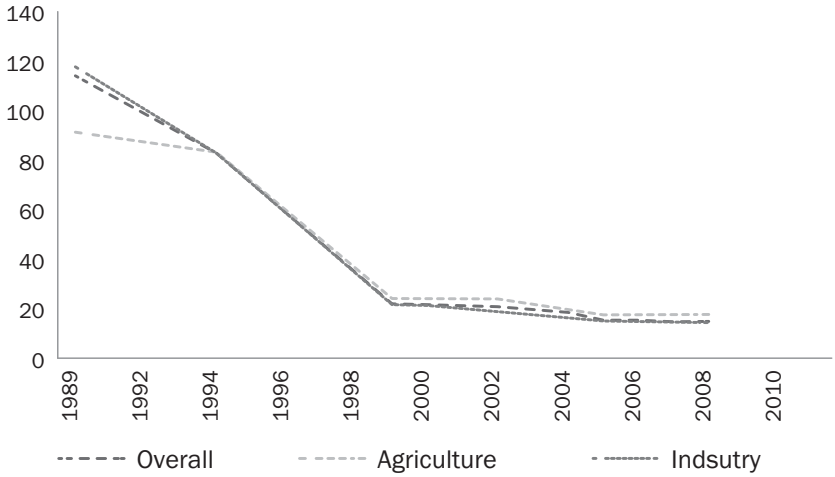
A key component of export policy from 2004-2014 has been the use of cash incentives for the promotion of export of certain agricultural products. The government has recently increased the rate of cash incentives/subsidies for jute goods, leather goods and frozen shrimp. While agricultural share in total exports has fallen from 37% in the 1970s to 6% in 2011, recent growth in shrimp exports, which now has a 65% share of agricultural exports, has been driven to a large extent by the cash incentives and by subsidized freight charges.

Services represent almost half of Bangladesh's GDP and have been the fastest growing component of the economy in the last decade (average growth rate per year 6%–7%). Within the services sector, wholesale and retail trade is the largest component, accounting for about 15% of GDP, followed by transport, storage and communication.

Since 1992, Bangladesh has continued making efforts to simplify and rationalize its trade regime. The customs tariff is now Bangladesh's main trade policy instrument. Nominal applied most-

favored-nation (MFN) tariffs fell rapidly from 1992 to 2000 and the number of trade-related quantitative restrictions was also reduced. Showing similar trends to Pakistan with even more pronounced cuts, the average MFN tariff in Bangladesh went down over five years from 83% in 1994 to 24% in 1999 (Figure 2.4).

Figure 2.4: Bangladesh's Tariff Liberalization in different sectors



Source: UNCTAD, TRAINS

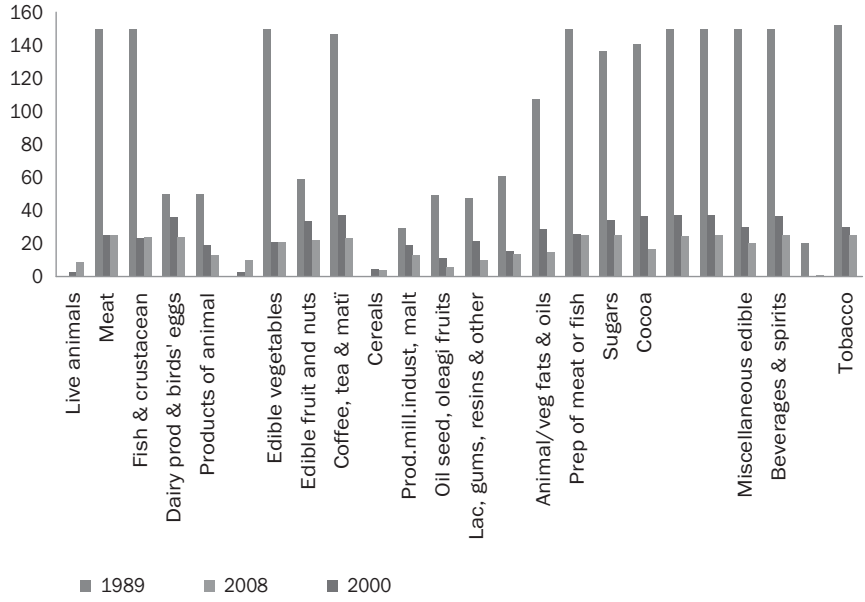
Among agricultural products, Chapter 10 (cereals) and Chapter 12 (oilseeds, miscellaneous grain, etc.) have lowest average tariffs at 3.8% and 5.7% respectively. Also, Chapter 23 (residue and waste from food, etc.) has only 1% tariff. The most extensive liberalization has taken place in Chapters 9 (coffee, tea mati and spices), 15 (animal and vegetable oils) and 18 (cocoa and cocoa preparations). Tariffs went down from 146% in 1990 to 23% in 2008 (Chapter 9), 107% to 14% (Chapter 15) and 140% to 16% (Chapter 18).

Among industrial products the import tariffs went down from 60% straight to 0% on two occasions, i.e., fertilizers (Chapter 31) and wood (Chapter 47). Other products currently at very low tariff (5% or less) include pharmaceuticals (Chapter 30), nuclear reactors (Chapter 84) and aircraft (Chapter 88).

The extent of liberalization can be gauged from the fact that

none of the chapters in the Bangladesh tariff profile have tariffs higher than 25%. Those at or around 25% include most textile fibers and products falling between Chapters 57 and 67 except Chapter 59 (laminated fabrics, etc).

Figure 2.5: Bangladesh's Tariff Liberalization in Different Products



Source: UN COMTRADE

2.3.2 Trade Policy of Bhutan

Despite a rise in overall tariffs witnessed in recent years, Bhutan appears to be making attempts to create a relatively open economy. Bhutan's export activity is, however, concentrated essentially in a single market, i.e., India. The royal government has made attempts in the past several years to reduce the dependence of the external sector on India and the South Asia region by promoting trade with other countries but in order to effect this change, the government in Bhutan must also focus on product diversification. An Economic Development Policy (EDC) has been drafted and is under consultation by the government.

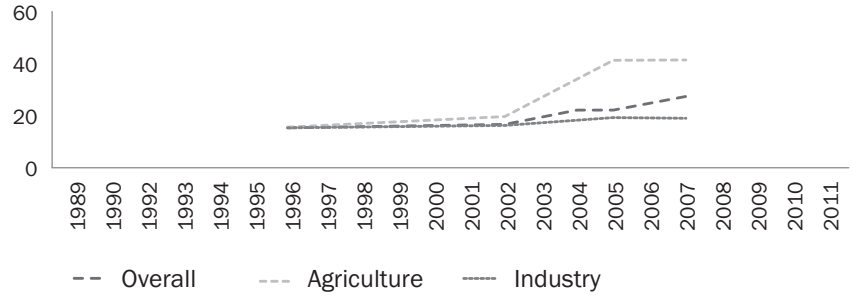
Bhutan's largest export is electricity, followed by steel. Electrical energy, in 2009, accounted for 42% of total exports of around $500 million. This was followed by iron and steel accounting for about 25% of exports. The manufacturing sector is also an important contributor, which typically imports raw materials from India and exports finished products back to India. Other relevant exports are related to mineral industries (e.g., cement).

The government protects the agriculture sector, which has just over twice the average applied tariff of the nonagriculture sector. Within the top selected commodities exported, potatoes, oranges and apples are identified as the main cash crop exports.

Bhutan's accession process to the World Trade Organization (WTO) began in September 1999 when the Royal Government of Bhutan applied for accession under Article XII of the WTO Agreement. Applying as an LDC, Bhutan hopes to strengthen its economy by integrating into the global trading system. However, these reforms have not led to a perceivable liberalization of the tariff regime as yet.

Bhutan is the only country in South Asia that has shown a protective tendency over time. The average tariff in Bhutan has risen consistently from 16% in 1996 to 27% in 2007. On the agriculture side the increase in tariffs has been more pronounced with the average tariff rising from 15.5% to 42%. In the industry sector, tariffs increased marginally from 15% to 18% over the same period.

Figure 2.6 Bhutan's Tariff Liberalization in Different Sectors



Source: UNCTAD, TRAINS

In certain cases, tariffs in Bhutan have gone up from 0% in 1993 to 50% in 2007. Among the highly protected products are tobacco and beverages with tariffs approaching 100%. In industrial products the highest tariff is 50% with fur skins, arms and ammunition, and furniture all falling in that category. Several products appear close to the lower limit which is 10% in the case of Bhutan. Examples include explosives, musical instruments, chemicals, and railway locomotives.

2.3.3 Trade Policy of India

The Indian Government initiated a major program of economic reform and liberalization in 1991. Reforms in the manufacturing sector have been widespread, including reductions in average tariff rates, import licensing restrictions for industrial inputs and capital goods, and compulsory industrial licensing. The agriculture sector and consumer goods trade have, as yet, been relatively untouched by government reform efforts. The policy focus was principally on the liberalization of capital goods and inputs for industry to encourage domestic and export-oriented growth: by and large, imports of consumer goods remained regulated.

The structure of India's economy has not changed significantly since 2007. The services sector, which has been the most dynamic sector during the period under review, continues to be the largest contributor to GDP (and employment) and has emerged resilient to the negative effects of the global crisis.

India's exports increased from $63 billion in 2003–2004 to $185 billion in 2008–2009 and stood at around $287 billion in 2011–2012. India's share in global merchandise trade has been consistently increasing and the export basket has become much more diverse over the years since the reform process started in the 1990s. The list of top 10 items of export today is similar to that in the early 1990s. Overall, some of the biggest contributors to India's export earnings remain precious stones (Chapter 71), mineral fuels and oil (Chapter 27), textiles (particularly Cotton, Chapter 52), and readymade garments (Chapters 61 and 62)). Oil and precious stones alone accounted for almost one-third of India's exports in 2011.

The statistics for rise in exports of other sectors and areas are more revealing. In 1996, India exported only $7 million and $41 million worth of aircraft parts (Chapter 88), and shipping parts (Chapter 89) respectively. In 2011, the two figures stood at $2 billion and $7 billion respectively. This shows a dramatic shift in priorities toward higher value added and higher technology manufactures. Other nontraditional sectors where exports have shown significant increase over the last decade or more are products in Chapters 78 and 79 (manufactures of lead and zinc respectively), Chapter 84 (nuclear reactors and their parts), Chapter 85 (electrical machinery and equipment), and Chapter 94 (furniture and bedding).

Among agricultural products as well, there seems to be a shift from products in their primary form toward higher value addition. Most significant has been an increase in the exports of products in Chapters 16 (preparations of meat, etc.), Chapter 19 (preparations of cereals), and Chapter 20 (preparations of vegetables, fruits and nuts). India is a net exporter of agricultural products. Its agricultural support policies promote domestic production at the expense of imports. Agricultural imports are relatively low (4.4% of total merchandise trade) and are concentrated in a few commodities, including vegetable oils, pulses, and wood products. In 2009–2010, agricultural exports accounted for 10.6% of the total merchandise exports; they increased from $13.7 billion in 2006–2007 to $18.8 billion in 2009–2010 (9.3% of the foreign exchange). Basmati rice has become India's leading agriculture export product, followed by marine products and cotton.

India remains a net exporter of services; its services balance showed a surplus of $35,726 million in 2009–2010 (equivalent to 2.7% of GDP), $6,257 million higher than in 2006–2007. India is a leading exporter of computer and related services, including software installation and data processing, and a major supplier of back office processing services, such as abstracting and indexing, data processing, legal transcription, telemarketing, and website design.

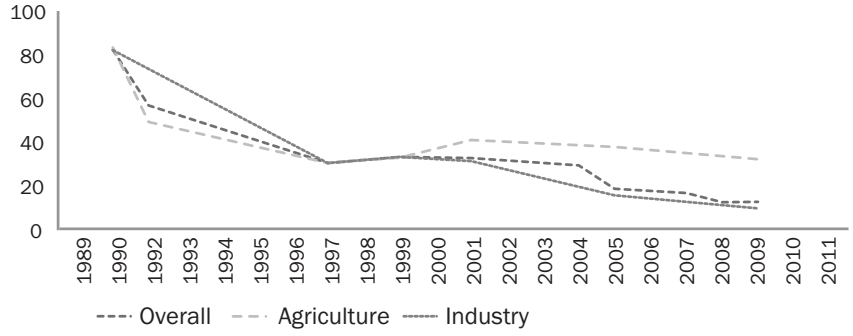
Export taxes are used as a policy instrument to, among other things, ensure domestic supply of raw materials for higher value added industries, promote further processing of natural resources, ensure an "adequate" domestic price, and preserve natural resources.

Exports in India are encouraged through the establishment of special economic zones (SEZs) and expor toriented units (EOUs). SEZs may be set up by the central or state governments or by private developers (including foreigners) as joint ventures with the State or as fully private entities. The Export Oriented Units (EOUs) Scheme, introduced in early 1981, complements the SEZ scheme. EOUs are regulated by the Foreign Trade Policy. Initially, EOUs were concentrated mainly in manufacturing (e.g., textiles, food processing, and electronics) but currently agribusinesses and firms supplying services also operate under the EOU Scheme.

Furthermore, the Department of Commerce through 'The Assistance to States for Development of Export Infrastructure and Allied Activities Scheme' provides assistance for, among other things, setting up new export promotion industrial parks/zones (including SEZs), and supporting infrastructure (e.g., road links to ports, inland container depots, container freight stations, and power supply).

The average MFN tariff for India is around 15.47% from complete data available up to 2009. The tariffs were reduced consistently after 1990 (from 81.7%) and fell to an average of 30% by 1997. They witnessed a slight increase in 1999 going up to 34% and have since then been reduced again to their current levels.

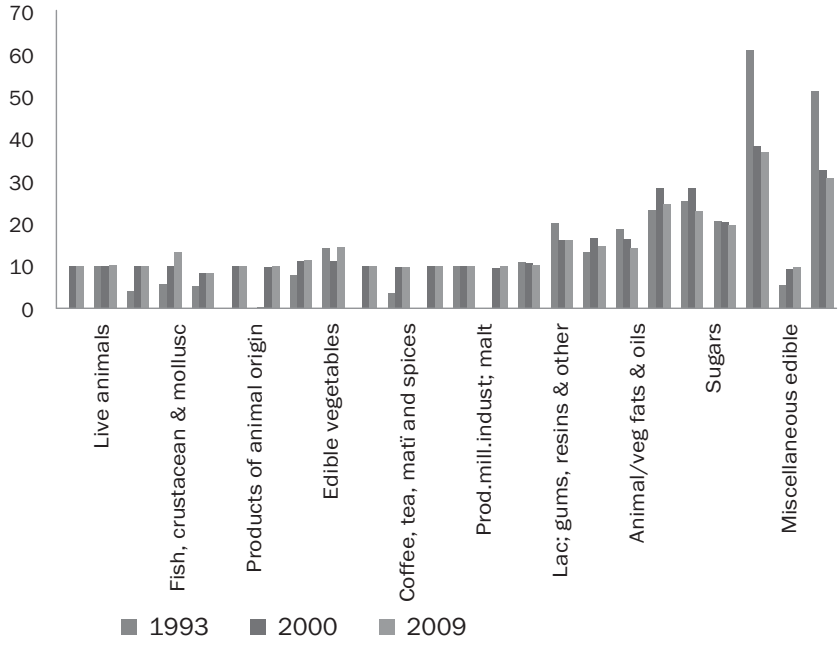
Figure 2.7 India's Tariff Liberalization in Different Sectors



Source: UNCTAD, TRAINS

Among agricultural products, Chapter 15 (animal/vegetable fats and oils, etc.) with an average tariff of 15% is the only chapter at less than 20%. It is also the most rapidly liberalized over time. The average tariff has gone down from 108% in 1990 to 15% in 2009.

Figure 2.8 India's Liberalization in Agricultural Products



Source: UNCTAD, TRAINS

With an average tariff of around 9% in 2009, India has come a long way in liberalizing its industry sector. Metals, ores and fur skins, etc., are among those products with the lowest tariffs around 5%. In 1990, India's tariffs for the textiles and clothing sector were around or in excess of 100%. These tariffs have dramatically reduced during 1990–2010 to around 10%. Automobiles are the only nonagriculture sector product with tariffs above 20%. Among the remaining products, modified starches (Chapter 35) and silk (Chapter 50) had the highest tariffs in 2009. However, with less than average tariffs at the time, these products were not the most protected in the 1990s, indicating a change in priorities over time.

While agriculture sector tariffs in India remain relatively high, a couple of products have shown trends inconsistent with the rest of the products. For example, the tariff on cereals (Chapter 10) was 0% throughout the 1990s until a substantial increase to 50% in 2001. Also, in the case of fish (Chapter 3), tariffs went down from 55% in 1990 to 0% in 1992, only to be raised again through the years to 35% in 2001, and then reduced to 30% in 2005 where they have stayed till 2014.

2.3.4 Trade Policy of Maldives

The Maldives remains an open economy but with a very narrow export base and a large dependence on tourism and services.

Fisheries account for almost all merchandise exports of the Maldives and the state-owned Maldives Industrial Fisheries Company (MIFCO) remains dominant in the sector. It accounts for nearly all merchandise exports (97%). Fishing and fish processing is characterized by very little product diversification and low value added products. The Maldives has no comprehensive fisheries management policy. The Ministry of Fisheries, Agriculture and Marine Resources (MFAMR) is responsible for regulating the sector as well as formulating policy.

Following the expiry of the Multi-Fibre Arrangement (MFA), five garment factories closed in 2005 but this did not have a particularly harsh effect on the industry, as most of the profits were repatriated and most of the labor was expatriate.

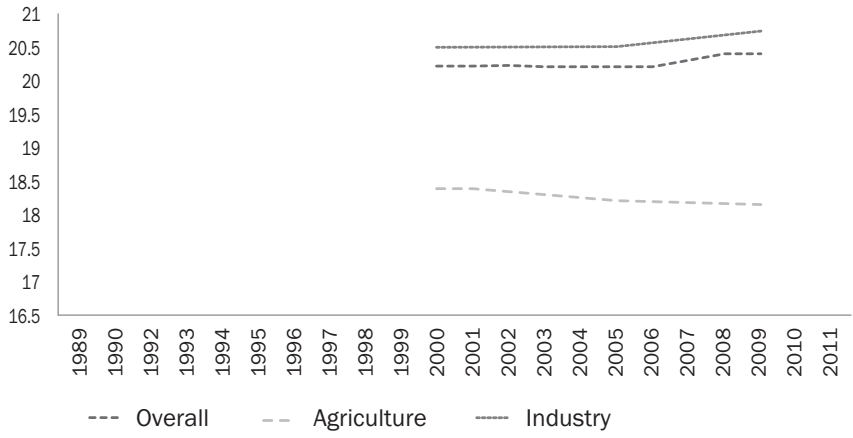
Services account for around 80% of GDP and 68% of total exports (goods and services). Tourism is the most important services subsector, followed by transport and communications.

The Maldives embarked on a process of reform in the year 2000. The Sixth National Development Plan, the first plan that extends for five years instead of three (2001–2005), embodies the long-term vision of the Maldives becoming a top ranking middle-income nation by 2020 (Vision 2020).

In the case of the Maldives, complete data are available only from 2000 onward. Since then, the tariff profile has remained fairly consistent with no major changes. The average overall tariff has

remained at 21%, with agriculture sector products averaging at 18% and industry sector products at 21%. No product has shown any major changes in tariffs either.

Figure 2.9 Maldives' Tariff Liberalization in Different Sectors



Source: UNCTAD, TRAINS

Among products with the highest tariffs are automobiles (Chapter 87) and tobacco (Chapter 24) at 50% or more. Other highs include beverages and spirits (Chapter 22), explosives (Chapter 36), and rubber (Chapter 40) with tariffs at 30% or more.

Pharmaceutical products (Chapter 30) currently have the lowest tariff at 5% with some others at 10% including musical instruments (Chapter 92), fertilisers (Chapter 30), and dairy products (Chapter 4).

2.3.5 Trade Policy of Nepal

Nepal started economic reform measures in the mid-1980s in pursuance of the Structural Adjustment Program in cooperation with the IMF and the World Bank. This process was further intensified in 1992 when the newly elected democratic government brought a substantial change in the economic and trade policies. Nepal undertook several measures in improving and facilitating trade

along with pursuing more liberalized policies, like streamlining tariff commensurate to commitments; the development and operation of trade-related infrastructure, such as Inland Clearance Depots (ICD) at four major customs points; and more importantly, obtaining the membership of the WTO in 2004, which is a milestone toward liberalizing and mainstreaming Nepal's trade into the global trading system.

Agriculture, forestry and fishing remain the mainstay of the Nepalese economy accounting for around 35.7% of Nepal's real GDP in 2010–2011. The sector employs around two-thirds of the labor force, mostly in subsistence farming, provides livelihood for 76% of the population, and contributes around 25% to export earnings.

Nepal's major export items comprise basic agricultural products, such as maize, mustard, ghee, ginger, pulses (lentil and gram), broom grass, live animals, wheat flour, oil cake, jute, fresh vegetables and vegetable seeds, orthodox tea, hide and skin, rice bran, vegetable oil, spices, large cardamom, coffee, and fruits.

Nepal levies export duties on some agricultural products, including margarine and molasses. The purpose of these export duties is to discourage environmental degradation, to ensure food security, and to discourage trade diversion to neighboring countries. Manufactured exports account for almost 70% of the total merchandise exports, and consist mainly of textile and clothing products (40% of total merchandise exports).

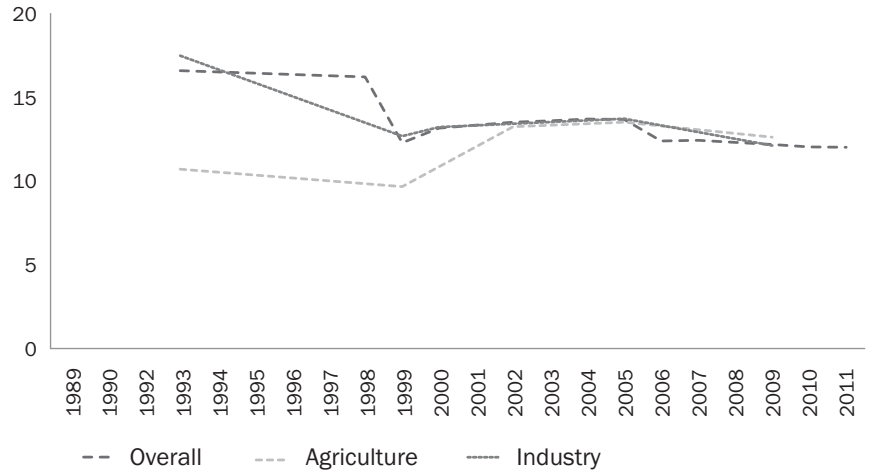
Under Nepal's Trade Integration Strategy (NTIS) 2010, 19 priority economic activities with export potential have been identified, including certain manufacturing industries such as medicinal herbs/essential oils, handmade paper, silver jewelery, iron and steel, pashmina, and wool products. Other potential export activities are cement, dairy products, and transformers.

Recently the exports of chemicals and pharmaceutical products have picked up significantly and with the government's push to these sectors, the trend may prove useful for diversifying the export base of the country.

Nepal's tariff regime has been the most liberal in South Asia. Starting at an average tariff of 17% in 1993, Nepal liberalised further to an average of 13% tariff in 2009. The industrial average has also

gone down similarly from 17% to 12% in the same period. In the case of agriculture, however, the tariffs have witnessed a slight increase from 10% in 1990 to 12% in 2009.

Figure 2.10 Nepal's Tariff Liberalization in Different Sectors



Source: UNCTAD, TRAINS

In general, barring Chapter 22 (alcoholic beverages) and Chapter 24 (tobacco), most of Nepal's average tariffs at 2-digit level are 25% or below. In some cases, the tariffs have actually gone up from a very low level in 1993. In the case of fertilisers (Chapter 31) the tariff rose from 0% to 25% between 1990 and 2009. Tariffs on live animals (Chapter 1), live trees (Chapter 6), and cereals (Chapter 10) rose from 0% to 10% in the same period. Raw hides (Chapter 41), musical instruments (Chapter 94), nuclear reactors (Chapter 84), and zinc (Chapter 79) are among the products with the lowest tariffs at 6% or less.

2.3.6 Trade Policy of Pakistan

Pakistan initiated a comprehensive macroeconomic and structural reform program in 1990. This included measures to liberalize both domestic activity and the payments system. The levels of

tariff and nontariff protection, and of state intervention in trade, were reduced significantly. In 1993–1994, Pakistan intensified its medium term (between 1993–1994 and 1996–1997) adjustment and structural reforms. The trade-related reforms included a cut in the average statutory tariff from 77% to 50%with further reduction to a maximum of 35% by 1997; the integration of "paratariffs" into the single tariff rate by mid-1994; and reduction, followed by elimination, of import licensing.

Pakistan's exports have shown a modest increase since the 1990s when the reform process was initiated. Textiles and clothing remain Pakistan's single most important industry; its recent growth has been aided by several assistance packages, including research and development grants tied to exports, and freight subsidies, but minimal market diversification away from the traditional EC and United States' markets has occurred.

However, export diversification, both in terms of markets and products remains a major government priority. Several incentives such as freight subsidies for new markets and products were introduced during the previous decade, but so far the results have been modest. In the early 1990s, cotton and cotton-based manufactures accounted for about 60% of merchandise exports. Other significant exports were leather products, rice, fish, and carpets. In recent years, the trend has shifted only slightly. Exports of textiles still make up more than 50% of the export basket.

Some changes have taken place in the distribution within the textile group. A significant move has been seen toward the export of Chapter 55 (man-made staple fibers) after 2001. Of prime importance among these is polyester staple fiber. The exports of Chapter 55 products increased from less than $70 million in 2002 to $605 million in 2011. This is attributable to special incentives given to the polyester industry during the late 1990s that continue to date.

A significant change was also seen in Chapter 57 (carpets) where Pakistan has seen a consistent decline in export earnings after 2004–2005 from a high of almost $300 million. Recent figures of 2011 report carpet exports at just $108 million.

Other than the traditional items, Pakistan seems to have

experienced an increase in exports in ores (Chapter 25), precious Stones (Chapter 71) and metal products; in particular, Chapter 74 (copper), 78 (lead), 79 (zinc), and 80 (tin) have seen major increases. Overall, export diversification still remains a challenge for Pakistan, where textile products along with leather and cereals remain the mainstay of export earnings.

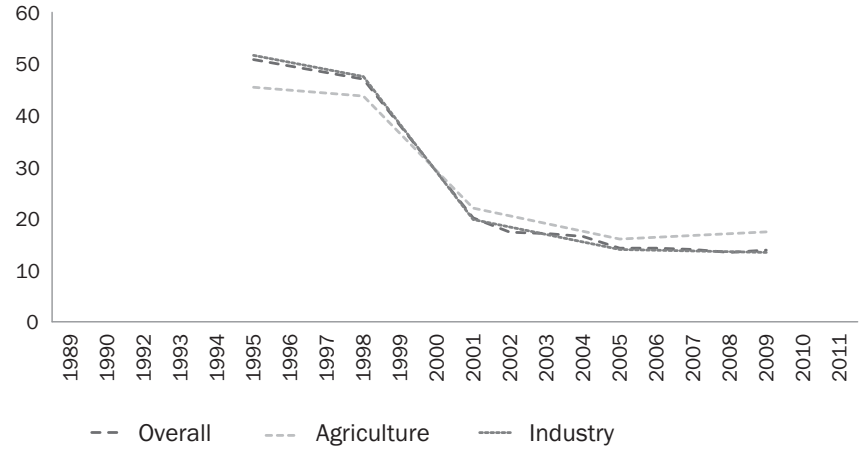
Agriculture remains a designated government priority. Reforms since 2001–2002 have been directed at increasing the role of the private sector, particularly in marketing; supplying farm inputs; wheat procurement; construction of silos; establishing cold-chain facilities to collect, store, and transport perishable animal products; operating international standard export abattoirs improving farm extension services and enhancing pest and disease eradication.

Food (and beverages) processing, one of Pakistan's major industrial sectors consists mainly of fresh (fruit juice and pulp) and processed (dried) fruits (mango, citrus fruits, apples, and guavas) and vegetables (potatoes, onions, and mushrooms), confectionery, cereals, biscuits, and bread. Initiatives to increase agribusiness and export of processed foods have been introduced recently.

Wholesale and retail trade, transport, storage, and communications have remained by far the leading service activities in Pakistan. The country incurs a substantial deficit on the services trade, mainly due to negative receipts on transportation (freight), travel (personal), business services, construction, and insurance.

While Indian tariffs have shown a steady and gradual reduction over time, Pakistan's import regime has been liberalized more radically. The year 2001 saw Pakistan reduce its average MFN tariff to less than half from 48% to 20%. Some of the products saw their tariffs slashed substantially (e.g., from 42% to 8% in the case of Chapter 43, i.e., fur skins; 63% to 10% in the case of Chapter 3, i.e., fish and fish products; and 54% to 17% in the case of Chapter 72, i.e., iron and steel).

Figure 2.11 Pakistan's Tariff Liberalization in Different Sectors



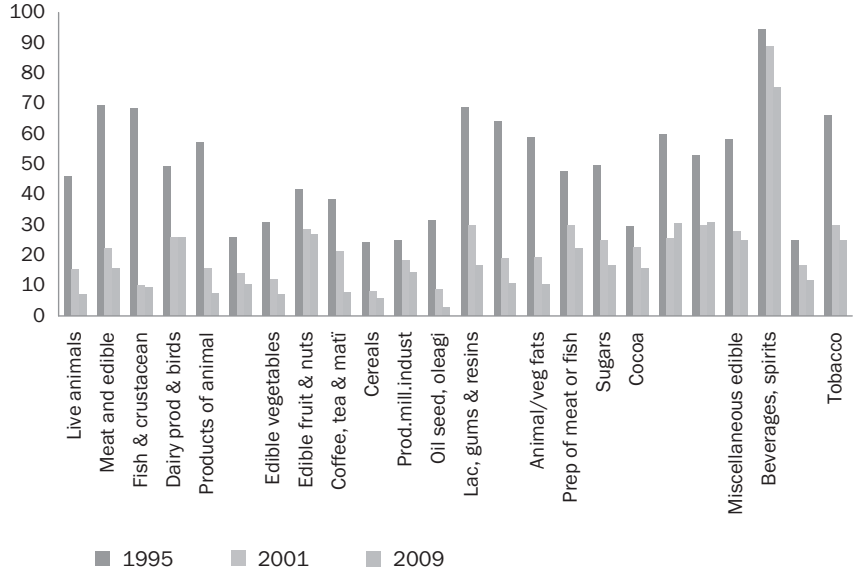
Source: UNCTAD, TRAINS

In Pakistan, as in other South Asian countries, the agriculture sector is currently more protected than the industry sector. This was not the case before 2000. Until 1998, the average tariff for industrial products was closer to 50% while that for agricultural products was around 40%. After 2001, the industry sector was liberalized much faster resulting in an average of 13.4% in 2009 while the average for the agriculture sector is 17%.

Among the most protected products in Pakistan from the industrial sector are textiles and clothing (Chapters 61–63), automobiles (Chapter 87), ceramics (Chapter 69), furniture (Chapter 94), and essential oils (Chapter 33). These products face a tariff of around 25% or more. In the agriculture sector, beverages and spirits are most protected with a 75% tariff. Other products with tariffs of 30% or more are Chapter 19 (preparations of cereals, etc.) and 20 (preparations of vegetables, etc.).

The products with the lowest tariffs (at 5% or less) include cereals (Chapter 10), oilseeds, miscellaneous grain, etc. (Chapter 12), raw hide (Chapter 41), wood (Chapter 47), precious stones (Chapter 71), base metals (Chapter 81), and aircraft (Chapter 88).

Figure 2.12 Pakistan's Tariff Liberalization in Agricultural Products



2.3.7 Trade Policy of Sri Lanka

For over three decades, Sri Lanka has pursued an export-oriented strategy aimed at diversifying the industrial base. The structure of the economy has not changed significantly since 2004. The services sector continues to be the largest contributor to GDP and employment; the share of the manufacturing sector in GDP has seen a slight decline, and that of agriculture has remained virtually unchanged, ending a long period of progressive decline.

Sri Lanka maintains a policy aimed at diversifying its industrial base and promoting regional industrialization. Readymade garments remain the mainstay of the Sri Lankan export base along with fisheries and some electrical machinery and equipment. The government favors an industrial policy that strengthens the existing export-oriented industries, while promoting a gradual shift from import-based industries to higher value-added industries with backward linkages.

The readymade garments industry has faced significant

challenges over the past few years, following the end of the MFA quota system and, more recently, weakening demand in the United States and the EU, which receive 90% of its exports. Nevertheless, it retains its position as the leading foreign exchange earner and ranks second-largest in terms of output.

The chemical, petroleum, rubber and plastic industry, which is dominated by rubber-based products, is the second largest export industry. Together, the three largest subsectors generate around 90% of the total manufacturing output. As a whole, the manufacturing sector accounts for 67.1% of Sri Lanka's merchandise exports. Besides apparel and rubber products, other export-oriented industries include electronic equipment, diamond products, leather, paper and wood products, ceramic products, and jewelry.

Although Sri Lanka now produces a substantial proportion of its staple foods, in particular rice, it remains a net food importing country. The share of agricultural exports in total merchandise exports has been consistently rising and has now gone past 25%. Of these, three commodities—tea, coconut, and rubber—make up the bulk of agriculture-based exports. Other export crops include cinnamon, cardamom, cloves, pepper, cocoa, and coffee.

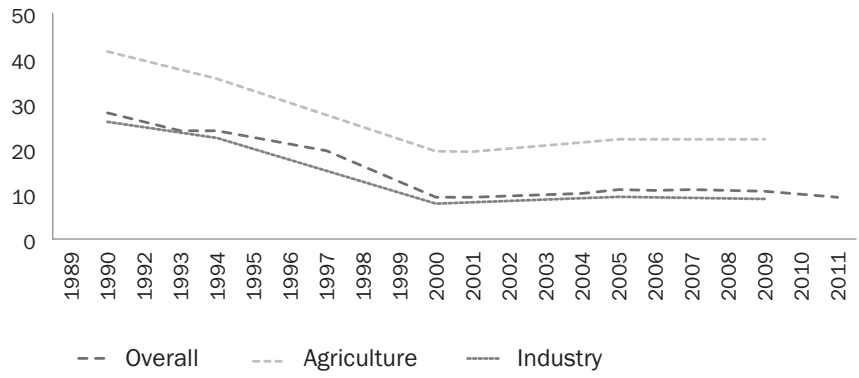
According to the government's 2006–2016 development plan (TYHDF), the country's agricultural policy is aimed at increasing production to ensure food and nutritional security and raising small farmers' incomes, by improving competitiveness through modern technology, shifting to commercial agriculture, and promoting diversification into higher-value products (e.g., fruits, vegetables, fisheries, etc.).The plan also envisages the continued use of trade policy instruments (i.e., import duties and safeguard measures) to protect local farmers. While government strategy has allowed some diversification of the country's export structure from traditional plantation crops into labor-intensive manufactured exports, manufacturing remains concentrated in a few products and export markets.

A major step in tariff rationalization was taken by Sri Lanka in 1985 when the maximum nominal rate was reduced from 100% to 60%. Subsequently, a major reform was undertaken by the Sri Lankan

government on recommendations of the Tariff Commission resulting in a four-band tariff structure with rates of 50%, 35%, 20% and 10% in 1992. Subsequent liberalization ensured reduction of tariffs with accompanying liberalization of items under import control. Tariffs were further reduced by the 1995 budget by introducing a three-band tariff system with rates of 35%, 20% and 10%.

Sri Lanka has introduced tariff liberalization gradually as compared to India, Pakistan, and Bangladesh. This is because Sri Lankan tariffs were already quite low in the 1990s. The overall average tariff in 1990 was only 33% which has steadily reduced to 14% in 2009. The difference between agriculture and industrial goods has always been high and is remains so even after liberalization. The average tariff for agricultural products was reduced from 41% in 1990 to 22% in 2009. On the other hand, industrial tariffs were brought down from 26% to 8% in the same period.

Figure 2.13 Sri Lanka's Tariff Liberalization in Different Sectors



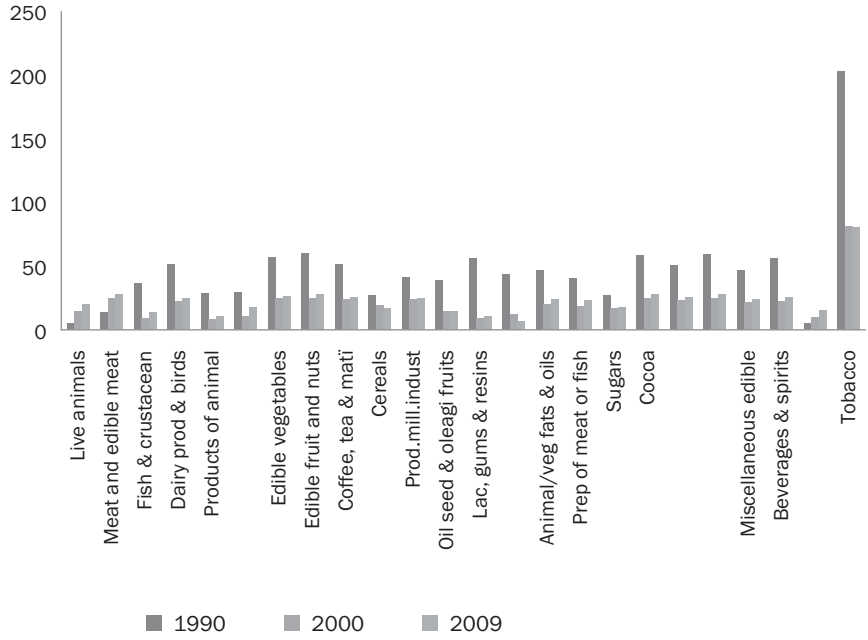
Source: UNCTAD, TRAINS

There are no instances of a drastic slashing of tariffs in the Sri Lankan regime. However, some agricultural products showed significant changes. In the case of Chapters 13 (lac, gums, resins and other vegetable saps) and 14 (vegetable plaiting materials and vegetable products), tariffs were reduced from 56% and 43% in 1990 to 10% and 6% in 2009 respectively.

In some cases, tariffs have actually gone up from the 1990 levels. For example, in the case of live animals (Chapter 1), food residue and waste (Chapter 22), railway locomotives (Chapter 89), and works of Art (Chapter 97), the starting tariff was 5% in 1990. It increased to 15% or more by 2009.

The highest tariff in Sri Lanka appears in the case of Chapter 24 (tobacco and tobacco products) at 80%.Among the remaining items none exceeds 28% with several products falling between 25% and 27%. Examples of the latter include clocks and watches (Chapter 91), furniture (Chapter 94), headgear (Chapter 65), articles of leather (Chapter 42), and straw manufactures (Chapter 46).

Figure 2.14 Sri Lanka's Tariff Liberalization in Agricultural Products



Source: UNCTAD, TRAINS

There are also several products with very low tariffs. Most textile fibers, yarns and fabrics have tariffs at 0%. Tariffs for base metals and their products, pharmaceuticals, and mineral ores are all around 2.5% or less.

2.4 Conclusion

The jury still seems to be out on the direct linkage between trade liberalization and economic growth. The discussion on the impact of trade openness on economic development of poor countries has been even more contentious. Nevertheless, trade policy reform has gathered significant momentum in recent decades under various countries' global commitments at multilateral as well as bilateral levels.

In South Asia, liberalization has occurred at a moderate speed, since reforms were initiated around the 1990s. In terms of depth, however, reform has been quite extensive in most countries of the region. Different sectors have been opened to different degrees and at varying pace, with agriculture generally receiving much more protection along with automobiles in the industry sector. Even during the liberalization phase, average agricultural tariffs witnessed a protectionist tendency between 2007 and 2011 for most of South Asia.

Sri Lanka was the first South Asian country to initiate reform in the mid-1980s. Yet, it has liberalized more gradually compared to other countries in the region. This seems to be in keeping with Sri Lanka's stated objective of pursuing an industrial policy aimed at promoting a shift from import-based industries to higher value-added sectors with export orientation. Pakistan and Bangladesh, on the other hand, have witnessed more rapid and steeper reductions in their tariff profiles since the reforms began. Both countries rely heavily on textiles and clothing as a mainstay of their economy and see export diversification as one of their major challenges.

India's reform has coincided with a period of very high growth and rapid increase in exports owing to well-targetted reform policies. A focus on liberalizing capital inputs for industrial expansion with a more regulated approach toward import of consumer goods seems to have had results. Nepal and the Maldives seem to have maintained a fairly open trading regime over a consistent period. Maldives remains heavily reliant on services and fisheries, and maintains moderate tariffs uniformly across all sectors. Nepal, in terms of tariffs, is the most open South Asian country, though

its heavy dependence on agriculture seems to have prompted a slight increase in agriculture-sector tariffs as compared to tariffs on industrial goods.

The only country to go against the liberalizing trend in South Asia over the recent years has been Bhutan. Nevertheless, its accession process with the WTO signals a commitment toward creating a relatively open economy. Its concentration in a single export market (India) will however remain a concern.

3

Review of FDI Policies in South Asia: Benchmarking Extent of FDI Liberalization

3.1 Regional Integration and Foreign Direct Investment

Regional economic integration is expected to promote FDI through reduction in trade cost,[1] market enlargement and improving policy credibility. However, for the purpose of analyzing the impact of regional economic integration on the FDI-trade nexus, it is important to distinguish between horizontal investment (or market-seeking) FDI (HFDI) and vertical (efficiency-seeking) (VFDI). HFDI takes place when a multinational enterprise (MNE) produces the same goods (and services) in order to avoid trade costs of exporting goods from one country to another, while retaining its firm specific advantages in production. By contrast, VFDI takes place when an MNE geographically fragments the production process (value chain) of a given product into stages, in order to take advantage of location-specific advantages such as lower factor prices in other countries. Thus, VFDI is more likely to occur for firms with production processes that can be easily fragmented into several stages characterized by different factor intensities and between countries with different factor endowments.

1 The term 'trade cost' is used here in a broader sense to encompass all costs that are incurred in conducting international trade and include transport costs, tariffs, and other transaction costs.

In both cases, the MNE faces trade-offs in its investment decision: avoiding trade cost through HFDI implies foregoing economies of scale, as production is distributed across several plants located in different host countries, whereas VFDI involves costs of coordinating fragmented activities in several locations ("services link cost", *a la* Jones and Kierzkowski).[2] Some of the factors that are important in these trade-offs are firm- or industry-specific (e.g., the importance of economies of scale), and some depend on country characteristics such as market size, factor price differences, and various aspect of the trade and investment policy region. VFDI is predicted to occur when factor cost savings are large relative to the costs of coordinating fragmented activities in several locations.[3]

In the context of regional economic integration, HFDI can take two forms, tariff-jumping investment or investment triggered purely by tariff preferences, and investment driven by the market enlargement effect. Tariff-jumping investment would contribute to trade diversion, shifting the location of production from a low-cost source of supply outside the region to a higher-cost source in a member country. The attractiveness of the region for tariff-jumping investment depends on the magnitude of the "margin of preference", the difference between the preference tariff among the member countries and the tariff applicable to trade with third parties. Differences in members' tariffs may be important in procuring low-cost imported inputs, which could influence the location of investment in relatively low tariff countries in the region from third countries as well as from high tariff countries within the region. This influence would be magnified if there are significant differences among member countries in nontariff barriers to third-country trade.

In the early literature on the investment effect of regional economic integration, it was generally believed that, apart from the contemporaneous influence of the existing (initial) preference margins, the formation of a regional trading agreement (RTA) can affect investment decisions of the tariff-jumping variety by creating a (perceived or real) threat of protection for extra-regional trade. The

2 Jones and Kierzkowski. 2001.
3 G. Navaretti, A. Venables et al. 2005. *Multinational Firms in the World Economy*. Princeton University Press.

simple point here was that the creation of a wider regional market may foster a more protectionist approach toward extra-regional trade.[4] However this theory is of limited relevance for analyzing the investment effects of modern RTAs because most (if not all) partners to RTAs pursue regional trade liberalization as an integral part of their commitment to unilateral and multilateral (TWO-based) trade liberalization.

Horizontal FDI driven by the market enlargement effect has the potential to promote intraregional trade. The removal of tariff barriers on intraregional trade leads to an increase in the size of the "domestic" market, enabling plants that are large enough to exploit economies of scale to be built. The market enlargement effect would be greater if the member nations have similar income levels and demand structures, but diverse preferences for varieties of goods (a condition which is generally met by developed, rather than developing, countries). The formation of an RTA could allow producers to "exchange" scale economies in the provision of differentiated goods. In an enlarged market, economies of scale may be achieved through the construction of large plants that produce a single product (economies of scale in the traditional sense), through the reduction in the number of product varieties in individual plants (horizontal specialization), and through the manufacture of parts, components, and accessories of a particular product in separate locations (vertical specialization). The first type of scale economy is particularly important in heavy industry, such as steel, chemicals, petroleum refining, and pulp and paper.

Even in a context of significant and continuous decline in the margin of preference (as part of the ongoing multilateral trade liberalization process), the formation of an RTA can have a significant impact on FDI inflows. For the same reasons emphasized in the traditional literature on economic integration (such as scale and scope economies, spill-over externalities, etc.), liberalization among neighbors would expand markets and thus induce better utilization of resources, creating incentives for new investments. If transport and transaction costs

4 There is, in fact, evidence that one of the principal factors behind the massive increase in FDI inflows to countries in the EC since the late 1980s was the concern that the single market would be heavily protectionist: that the existing structure of protection with national quotas would give way to EC-wide quotas and a tougher trade regime (Balasubramanyam and Greenaway 1993, p. 157).

associated with trade with the rest of the world are substantial, expansion of the market following the formation of an RTA could be more important for the exploitation of scale economies compared to integration with the global economy.

From about the late 1960s, VFDI has shown phenomenal growth as an integral part of the ongoing process of global production sharing (international production fragmentation).[5] This phenomenon has been the outcome of the growing ability of modern industry to 'slice up the value chain' of goods traditionally viewed as skill-, capital- or technology-intensive and shift the labor-intensive slices to low-wage locations. Assembly activities related to electronic industries, assembly of semiconductor devices in particular, are by far the most important. The other industries with significant assembly operations located in developing countries are electrical appliances, automotive parts, electrical machinery, and optical products. However, there is evidence from recent studies of trade patterns of standard light manufactured goods such as clothing, footwear and wood products that, even in these industries, there are growing opportunities for countries to specialize in different tasks within the global value chain (such as designing, providing technical and managerial expertise, producing accessories, marketing/distribution), rather than producing the good from start to finish within its own national borders.[6]

It is generally believed that RTAs among developing countries (South-South RTAs) are unlikely to have a significant impact on intraregional VFDI flows. This effect depends on members having complementary economic structures (dissimilar patterns of production) which provide scope for intra-industry specialization. If the members of the RTA are very similar in terms of factor endowments (e.g., their greatest resource is their large labor force), the scope for the relocation of production processes among countries based on "true" competitiveness will not be large.[7] Compared to RTAs among

5 R.W. Jones and H. Kierzkowski. 2001. A Framework for Fragmentation. In S.W. Arndt and H. Kierzkowski. *Fragmentation: New Production Patterns in the World Economy*. Oxford: Oxford University Press; Robert C. Feenstra. 2011. *Offshoring in the Global Economy*. Cambridge, MA: MIT Press; Prema-Chandra Athukorala. 2010. Production Networks and Trade Patterns in East Asia: Regionalization or Globalization? *Working Papers on Regional Economis Integration*. No. 56. Manila: Asian Development Bank.

6 G. Gereffi, J. Humphrey, and T. Sturgeon. 2005. The Governance of Global Value Chains. *Review of International Political Economy.* 12 (1). pp. 78–104.

7 W. J. Ethier. 1998. The New Regionalism. *The Economic Journal.* 108 (449). pp. 1149–1161.

developing countries, those involving both developed and developing countries (such as NAFTA and the enlarged EU) are, therefore, likely to have a greater impact on FDI.

However, even in the case of South-South economic integration, one can still expect VFDI to occur depending on differences among the member countries in terms of stage of development, even though such differences do not appear significant in the standard developed-developing country comparison. The geographical proximity among member countries, combined with such differences, could play a role in facilitating the restructuring of production across countries. Geographical proximity reduces transaction costs associated with transportation and communication.[8] Moreover, the country-specific advantages required for vertical specializations such as the skill-composition of the labor force, entrepreneurial talents, the quality of trade-related logistics are not static but endogenous to the reforms process. Also, over time firms can develop their own specific "assets" (firm characteristics) required for success in vertical specialization through their exposure to foreign competition and links forged with foreign buyers.[9] Further, country-specific FDI policies can play an important role in influencing intraregional as well as extraregional VFDI. In this context, we examine the evolution of FDI policies in South Asian countries and benchmark the extent of liberalization achieved by these countries by the end of the first decade of the 21st century.

3.2 Evolution of FDI Policies in South Asian Countries

From the inception of their independent nationhood and well into the 1970s, countries in South Asia have pursued import substitution (IS)—the promotion of industries oriented toward the domestic market by using import restrictions, or even import prohibition, to encourage the replacement of imported manufactures by domestic products—as the foundational tenet of the national development strategy. During the import-substitution era these countries were not very receptive, if not completely hostile, to foreign direct

8 M. W. Schiff and L.A. Winters. 2003. *Regional Integration and Development*. World Bank.
9 R. Alvarez, 2007. Explaining Export Success: Firm Characteristics and Spillover Effects. *World Development.* 35 (3). pp. 377–393.

investment. They did not rule out FDI, but wanted it on their own terms. The regulatory mechanism governing the entry of MNEs was characterized by an explicit preference for technical collaboration agreements as opposed to FDI; a policy stance dictated by the desire to achieve the (conflicting) twin objectives of minimizing foreign control on business operation and gaining access to foreign technology. Foreign investment applications were generally considered on a case-by-case basis and that too favoring majority local ownership. From about the late 1960s, countries in the region began to encourage export-oriented FDI by offering tax incentives and in some cases full foreign ownership. Naturally, these policies had little success given the anti-export bias in the overall incentive structure.

Policy regimes relating to outward FDI were even more restrictive in all countries. In India, the only country in the region that had some local firms with the capacity to venture overseas, government policy toward overseas investment was formulated on the basis of the foreign exchange earning capacity of proposed ventures. As part of the highly restrictive foreign exchange monitoring process, every proposal had to be placed before an interministerial committee on joint venture for approval. Overseas investment was normally permitted only in minority-owned joint ventures. As regards financing of the proposed project, the government severely restricted cash remittances for equity participation and encouraged the export of capital equipment and technology from India for the purpose. It was stipulated that 50% of declared dividends should be repatriated to India. All project proposals were screened on a case-by-case basis, approving only those that promised quick payoffs in the form of exports.[10]

Sri Lanka led the way in breaking away from the protectionist past, by embarking on a decisive process of economic opening in 1977. Following some hesitant and sporadic attempts to dismantle trade barriers at various points in time in the 1970s, the other countries embarked on significant liberalization reforms starting

10 R.B. Lall. 1986. *Multinationals from the Third World: Indian Firms Investing Abroad*. Delhi: Oxford University Press.

in the late 1980s. In India the liberalization of commodity markets started with partial trade liberalization in the early 1980s, but followed a tortuous route through the decade. In 1991 India initiated a decisive break away from the strong inward-oriented policy regime, following a massive balance-of-payments crisis, which severely constrained its ability to continue with past policies. While there are vast intercountry differences in terms of the degree of liberalization achieved during the ensuing years and the comprehensiveness of reforms, by the mid-1990s all these countries seemed to have moved into a seemingly irreversible process of economic liberalization.

Market friendly reforms sustained over three decades have brought about a high degree of commonality relating to the institutional framework among these countries. Tariff levels have come down. All South Asian countries other than Bhutan had achieved IMF Article 7 status for current account liberalization by the turn of the last century (Table 3.1). In addition to trade liberalization, South Asian countries have substantially removed many other restrictions on foreign trade and operation of the private sector, and rationalized their earlier system of dual or multiple exchange rate systems, permitting market forces to play a greater role in determining exchange rates.

As part of liberalization reforms all countries in the region have become more receptive to FDI. Sri Lanka is unique in the region for concurrent liberalization of both trade and investment policy regime.[11] In other countries, investment liberalization followed trade liberalization with a substantial time lag. In addition to FDI liberalization, a range of measures have been introduced by all countries to entice FDI. These include procedural simplifications, increasing caps on equity participation, and bringing more sectors under automatic approval, various financial incentives, relaxing restrictions on repatriation of profits and capital, fast tracking of FDI approvals, guarantees against nationalization and expropriation, and signing investment protection agreements with source countries of FDI.

11 P. Athukorala and S. Rajapatirana. 2000. Liberalization and Industrial Transformation: Lessons from the Sri Lankan Experience. *Economic Development and Cultural Change.* 48 (3). pp. 543–572.

Despite recent reforms, India's foreign investment regime still reflects the tension between the traditional aversion to foreign investment and the current recognition of its importance to economic development.[12] For example, FDI is still not permitted in pure retailing; global retailers can only participate in India's retail sector trough wholesale trade or by operating retail outlets through local franchises. In apparel and other light consumer goods producing industries, which are important in export expansion and job creation at the current stage of economic development of the country, FDI is limited to 24% of total equity. Restrictions on foreign ownership of land limit the entry of foreign builders and developers into the construction sector. Projects with 51% or more foreign ownership still require a long procedure of government approval. There are also many unresolved problems relating to the overall investment climate. While "License Raj" (the infamous industrial licensing policy) has been largely eliminated at the center, it still survives at the state level, along with a pervasive "Inspector Raj."

Policies relating to outward FDI too have become more liberal in all countries, although they still remain more restrictive compared to those applicable to inward FDI. In India, relaxation of restrictions on overseas investment began in 1992. The first step was to introduce an automatic route for overseas investment up to $4 million. The authority for approval of proposals up to $15 million was vested with the Reserve Bank of India (RBI), but proposals for more than $15 million still had to be approved by the Minister of Finance. In 2002 the upper limit for automatic approval was raised to $100 million per annum, of which 50% could be obtained from any authorized dealer of foreign exchange. In 2004, firms were allowed to invest up to 100% of their net worth under the automatic route. In 2005 this limit was raised to 200% of net worth. Prior approval from the RBI was no longer required and firms were permitted to transfer funds though any authorized foreign exchange dealer. Indian firms' access to international financial markets was also progressively liberalized and they were

12 World Bank. 2010. *Investing Across Borders: Indicators of Foreign Direct Investment Regulation in 87 Economies*. World Bank: Washington, D.C.

permitted to use special-purpose vehicles in international capital markets to finance acquisitions abroad.[13]

Trade liberalization in all South Asian countries has largely been across the board, both unilaterally and as part of the liberalization commitments under the WTO. But, they have also embraced the new-found global enthusiasm for preferential (regional and bilateral) liberalization over the past two decades. The SAARC[14] Preferential Trading Agreement (SAPTA) was signed in 1993, and it became operational in 1995 when the first round of tariff concessions was exchanged. After 1995, two more rounds of tariff cuts were completed although a fourth round was interrupted by the military coup in Pakistan in 1999. However, the tariff concessions exchanged during the three rounds have hardly made any impact on trade integration within the region. Some of the most important sectors of trade were left out in the commodity-by-commodity negotiation process. Some tariff concessions were offered on products which were not even trade items. There was no attempt to remove nontariff barriers (NTBs).[15]

The South Asian Free Trade Area (SAFTA) superseded SAPTA in 2006. Article 7 of the SAFTA provides for a two-stage tariff reduction program to achieve "free" trade (a tariff structure with all rates below 5%) between the three Non-Least Developed Contracting States (NLDCS) member countries (India, Pakistan and Sri Lanka) by 2015 and all NLDCS member countries by 2018.[16] So far there has been little progress in the implementing of the proposed tariff

13 FICCI (Federation of Indian Chamber of Commerce and Industry). 2007. *India Inc's Acquisitions Abroad*. New Delhi: FICCI.

14 The South Asian Association for Regional Cooperation (SAARC) (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka) was formed in 1985. But, for the first decade it was largely engaged in confidence building and public relations campaigns designed to impress the domestic audience and foreign powers.

15 M. Dubey. 2010. Regional Economic Integration in South Asia: The Development of Institutions and the Role of Politics. In Dosani, Rafic, Daniel C. Sneider and Vikram Sood. *Does South Asia Exist? Prospects for Regional Integration*. New York: The Water H. Shorenstein Asia-Pacific Research Centre. pp. 53–84; S. Kelegama and Indra Nath Mukherji. 2007. India Sri Lanka Bilateral Free Trade Agreement: Six Years Performance and Beyond. RIS Discussion Papers. New Delhi: RIS.

16 Under SAFTA, India, Pakistan and Sri Lanka are categorized as Non-Least Developed Contracting States (NLDCS) and Bangladesh, Bhutan, Maldives, Afghanistan and Nepal are categorized as Least Developed Contracting States (LDCS). According to Article 14, the NLDCs and LDCs would bring down tariffs to 20% and 30% within the first three years. This would be followed by a further reduction of tariff by NLDCs to the 'free-trade level' (0–5%) within five years and LDCs within eight years.

reduction programs. Even if fully implemented, it is unlikely to bring about "free trade" in the region; all countries have opted to retain a long list of "sensitive" products with a view to protecting particular economic sectors against exemption of duties under SAFTA, and nearly 53% of current intra-SAARC imports are currently restricted under the sensitive list. India's sensitive list is more than three times as large as the one it offered in the last round of negotiations for an FTA with ASEAN. A variety of NTBs also continues to frustrate trade. Pakistan has decided not to extend its obligations under the agreement to its trade with India, in so doing excluding the largest segment of regional trade from the SAFTA process.[17] Some countries have implemented "paratariffs" (various levies and taxes which do not come under the SAFTA definition of tariffs) which have virtually counterbalanced the limited tariff preferences offered under SAFTA.[18]

A major qualitative change in regional economic integration initiatives in other parts of the world over the past two decade has been the recognition that effective integration requires more than simply reducing tariffs and quotas.[19] It is widely believed that many other types of barriers segment markets and impede the free flow of goods, services, investment, and ideas, and wide-ranging policy measures going well beyond international trade policies are needed to remove them ("deep integration"). In particular, promoting investment is a prominent objective of many regional integration agreements. However, SAFTA does not cover liberalization of investment: it only *lists* this in Article 8 under the title "Additional Measure."

The report of the Group of Eminent Persons (GEP), which was set up by SAARC in 1997 to draw a road map for the implementation of SAFTA, recommended the creation of a Common Investment Area under SAARC. Based on this recommendation, India came up with a draft investment agreement for permitting freer flow of intraregional investment in the region.[20] The proposals included measures to

17 Dubey 2010
18 G. Pursell. 2011. Trade Policies in South Asia. In Raghavendra Jha, ed. *Routledge Handbook of South Asian Economies*. London: Routledge. pp. 219–237.
19 Schiff and Winters, 7-9
20 RIS. 2008.

remove administrative and regulatory constraints on the flow of investment among SAARC countries, to exchange information on possibilities for investment, and promote investment from other regional countries. An agreement for the establishment of a SAARC Arbitration Council as a prelude to negotiating an investment agreement based on the Indian draft was signed by the SAARC member countries on 2 July 2007, but so far no further progress has been made.

The slow progress of the SAPTA process has led to attempts by some member countries to pursue a "fast-track" liberalization of trade through bilateral free trade agreements (FTAs). Currently there are three bilateral FTAs in the region: India-Bhutan, India-Sri Lanka and Pakistan-Sri Lanka. And four FTAs are under negotiation: India-Pakistan, India-Bangladesh, Pakistan-Bangladesh, and Sri Lanka-Maldives.

Under the India-Sri Lanka Free Trade Agreement (ISLFTA), which became operational on 1 March 2000, Sri Lanka and India have achieved a much higher degree of liberalizing bilateral trade than what had been possible under SAFTA. For instance, less than 14% of Sri Lanka's exports are covered by India's sensitive list under ISLFTA, compared to nearly 42% under SAFTA. So far 4,150 Indian tariff lines have been made zero duty for Sri Lankan exports to India and 3,932 tariff lines for Indian exports to Sri Lanka. Motivated by the positive outcome of the FTA, in 2002 the two governments decided to set up a Joint Study Group to explore possibilities of starting negotiations for a Comprehensive Economic Partnership Agreement (CEPA), modeled on the India-Singapore CECA, to cover both trade and investment. In 2002, the governments of India and Sri Lanka agreed to explore the option of converting LBBFA into an India-Sri Lanka Comprehensive Economic Partnership Agreement (ILCEPA) modeled after the India-Singapore CEPA which covers both trade and investment. Fourteen rounds of negotiations have been completed; the last was held in Colombo in December 2010.

The Pakistan-Sri Lanka FTA (PSLFTA) was signed in July 2002 and came into operation on 12 June 2005. At the time of negotiating the FTA there was hope that it will help Sri Lanka to acquire "hub state" in the Pakistan-India trade. Given the prevailing prohibition

on formal cross-border trade between India and Pakistan (see below), it was expected that Sri Lanka would be able to promote Indo-Pakistan trade by encouraging Pakistan investors to open operations in Sri Lanka in order to trade with India using ISBFTA.

Both Nepal and Bhutan have long standing trade treaties with India. In 1996 India and Bhutan also signed an FTA. India has a firm commitment to maintain smooth trade and investment links with these countries because of their geographical location; both countries are viewed by India as part of its security frontier with the People's Republic of China (PRC).[21]

In addition to the remaining tariffs and quantitative trade restrictions, restriction on cross-border transport remains a major barrier to trade and cross-border investment in the region. India does not permit transit facilities for the movement of Pakistani goods or persons through its territory. Bangladesh denies similar transit facilities to India. These restrictions add huge costs to trade between the two countries. For instance, it takes 45 days to transport a container from Delhi to Dhaka; if overland railway transport were permitted by Bangladesh; it would take only 2 to 3 days. Currently, trade between Pakistan and India takes place mostly via Singapore or Dubai. The landlocked countries of Bhutan and Nepal can make large savings in transporting their goods to destinations outside the region if India would allow transit facilities so that their goods could reach ports in Bangladesh.[22]

3.3. Intraregional FDI: Regional and Individual Country Experiences

In order to provide the context for analyzing the magnitude and patterns of intraregional FDI, total FDI inflows to, and outflows from, the countries in the region are summarized in Tables 3.1 and 3.2. FDI inflows to South Asia were rather small in the 1960s and 1970s. Following the liberalization reforms, there has been some increase, but the combined regional inflows amounted to a mere 3% of total (global) flows and 5.1% of flows to developing countries. India accounts for the lion's share (over 90%) of total inflows to the region.

21 Lama. 2010.

22 R. Sobhan. 2010. Bangladeshi Perspectives on South Asian Regional Integration. In Dosani, Rafic, Daniel C. Sneider and Vikram Sood, eds. *Does South Asia Exist? Prospects for Regional Integration*. New York: The Water H. Shorenstein Asia-Pacific Research Centre. pp. 84–98.

Table 3.1: Foreign Direct Investment Inflows, (1990-2011)
(US$ million)

	1990–1994	1995–1999	2000–2004	2005	2006	2007	2008	2009	2010	2011
South Asia	968	3 732	6 306	11 296	26 272	32 689	50 960	39 323	28 098	34 792
Afghanistan	0	1	59	271	238	189	94	76	211	83
Bangladesh	7	357	416	845	793	666	1 086	700	913	1 136
Bhutan	0	0	2	9	72	3	7	18	16	14
India	414	2 619	4 959	7 622	20 328	25 506	43 406	35 596	24 159	31 554
Maldives	7	10	30	73	95	127	174	152	212	282
Nepal	2	12	6	3	-7	6	1	39	87	96
Pakistan	420	536	633	2 201	4 273	5 590	5 438	2 338	2 022	1 327
Sri Lanka	119	196	201	272	480	603	752	404	478	300
Meme Items: FDI outflow as a % of,										
Global outflow	1	1	1	1	2	2	3	3	2	2
Outflow from developing countries	2	2	3	4	6	6	8	8	5	5

Note: Increase in recorded FDI inflows during this sub-period partly reflects revisions to the estimation procedures. The Reserve Bank of India revised the FDI estimation procedure in 2003 (with effect from 2001) to include retain earnings. In 2001 and 2002, this new component accounted for about 40% of the total reported FDI figures.[a]

[a] RBA. January 2004. Monthly Bulletin. Table 46.

Table 3.2: FDI outflow from South Asia, 1990–2011 (US$ million)

	1990–1994	1995–1999	2004–2005	2005	2006	2007	2008	2009	2010	2011
South Asia	22	146	1 574	3 072	14 427	19 768	19 376	16 047	13 259	14 873
Bangladesh	0	4	8	3	4	21	9	29	15	9
India	20	120	1 528	2 985	14 285	19 594	19 256	15 927	13 151	14 752
Pakistan	-3	11	29	45	109	98	49	71	47	62
Sri Lanka	4	11	9	38	29	55	62	20	46	50

	1990–1994	1995–1999	2004–2005	2005	2006	2007	2008	2009	2010	2011
Meme Items: FDI outflow as a % of										
Global outflow	0	0	0	0	1	1	1	1	1	1
Outflow from developing countries	0	0	2	2	6	6	6	6	3	4

Note: Annual average. No recorded outflow data for Nepal, Maldives and Bhutan (presumably negligible).

On the outflow side, total outward FDI from India recorded a notable increase from the early 2000s and surged from 2005 following the substantial removal of foreign exchange restrictions on capital transfer for overseas acquisitions. Total FDI outflow from India increased from about $20 million in the early 1990s to nearly $15 billion in 2011, albeit with some annual fluctuation. Over the past decade India has been the third largest foreign direct investor in the developing world after the People's Republic of China (PRC) and Brazil.[23] However, India still remains a net FDI recipient, even though the gap between outflow and inflow has been narrowing over the past few years. During the 1990s, annual outflows on average amounted to 7% of inflows. This increased from about 30% to 60% between 2000–2005 and 2010–2011. Outward FDI from the other countries still remains small and only figures for Sri Lanka have indicated a continuous increase over the past five years, albeit from a very low base.

How important are the intraregional FDI inflows to the South Asian countries compared to total inflows to these countries? The available data does not permit a precise comparison. The data pieced together in the previous section from FDI monitoring agencies in individual countries suggest that they account for rather a small share, perhaps less than 5% of the total cumulative FDI in the region by the turn of the last decade. At the individual country level, regional inflow seems to account for a significant share only in Nepal and the tiny countries of Maldives and Bhutan. In Sri Lanka, India has been the largest country of the South in recent years, but it still accounts for around 13% of total inflows.

23 This is based on FDI outflow data from UNCTAD, *World Investment Report Database*.

India is by far the largest regional investor in South Asia. However, the notable increase in India's total outward investment in recent years has not been reflected in its investment in the region. As can be seen in Table 3.8, the regional share of Indian outward investment has declined continuously, from 4.5% in 2003–2004 to a mere 0.1% in 2006–2007. Sri Lanka is the largest recipient of Indian FDI in the region. In 2006–2007, Sri Lanka received 85% of the total intraregional Indian FDI while Bangladesh received 11.1%. The data also point to a notable decline in the share of Nepal in India's intraregional FDI. In addition to the political instability in the country, the phasing out of MFA in 2005 which put an end to quota-hopping investment, and the gradual dissipation of profitability of "tariff arbitrage" due to significant tariff cuts in India in recent years, seem to have contributed to this decline.

A general characteristic of FDI from developing countries (or, FDI by the so-called emerging market multinational enterprises) is its heavy concentration in developing countries. Moreover, the bulk of their FDI is intraregional, mostly in neighboring countries. Until recently Indian companies investing overseas shared the general pattern of third-world concentration, although they were unique for their wider spread within the developing world. The past decade has also seen a clear compositional shift in Indian FDI in favor of developed countries and transitional economies.[24]

The significant shift in Indian FDI away from developing countries, and in particular the sharp decline in the share of intraregional investment has been underpinned by a notable shift in the sectoral/industry composition of overseas activities of Indian firms. The manufacturing share in total approved Indian FDI declined from 70% in the early 1990s to 30% by the middle of this decade, reflecting a notable services sector bias. Within manufacturing, iron and steel, pharmaceuticals, automotive parts, chemicals and fertilizer have become the major areas of concentration. Overseas operations of Indian MNEs in these product areas are predominantly horizontal (market-seeking) in nature, with a strong preference

24 P. Athukorala. 2009. Outward Foreign Direct Investment from India. *Asian Development Review*. 26 (2). pp. 131–159.

for locating in countries with large domestic markets. The tariff-jumping motive which was an important driver of their location in developing countries in the past has lost its relevance because of the significant across-the-board tariff cuts in these countries over the past few decades. Notwithstanding significant trade and investment liberalization coupled with dismantling of industrial licensing, so far there are no significant globally-oriented firms in electronics and electrical industries (other than in computer software) in India. Computer software is a notable exception, but most of the Indian global players in this industry are generally at the lower rungs of the vertically integrated global production chain with limited potential for further slicing of the value chain to generate VFDI within the region.[25]

As regards the industry/sectoral composition of regional FDI, HFDI has continued to account for the bulk of intraregional flows, with a notable shift from domestic manufacturing to services and construction. However, there are early signs that VFDI has begun to play a role in stimulating intraregional trade. The most prominent case is the textile and garment sector in which Sri Lanka is emerging as the hub of technology and managerial talents. Emerging patterns of textile and garment exports from the region show that there are substantial differences among countries in terms of their competitive advantage in different segments/product lines in global markets—Pakistan: bed linen, home furnishing, carpets, basic menswear (in particular denim) and hosiery; Sri Lanka: lingerie, swimwear and formalwear; Bangladesh: men's wear, sports and casual wear; and India: women's tops, blouses, skirts, embellished and embroidered clothing, and men's underwear. Moreover, India and Pakistan established textile (fabric) industries with unexploited potential for supplying fabrics to garment-producing firms. Given these strands of complementariness, there is significant potential for trade and investment expansion in the region through vertical specialization in the clothing and textile sector. There is also some evidence, in particular from Sri Lanka, of regional investment of the

25 A. Bhide. 2008. *The Venturesome Economy: How Innovation Sustains Prosperity in a More Connected World*. Princeton. NJ: Princeton University Press.

HFDI variety in some other industries attracted by the availability of specific natural resources or skilled manpower.

3.3.1 FDI Liberalization and Extent of South Asian FDI in Bangladesh

The Bangladesh economy began opening up to FDI with the enactment of the Foreign Investment (Promotion and Protection) Act in 1980, which provided for protection and equitable treatment to foreign investment, guarantee against expropriation or nationalization without compensation, and repatriation of invested capital and profits. The Bangladesh Export processing Zone Authority Act was passed in 1980 which provided for setting up three Export Processing Zones during the ensuing decade. The subsequent reforms in the early 1990s included allowing 100% foreign investment in all foreign investment projects, and extended EPZ privileges to all export-oriented projects regardless of their location.

No prior approval is required for foreign direct investment other than registration with the Board of Investment. All sectors in the economy are fully open to foreign capital participation, but in practice certain strategic sectors, including port and airport operation, railway freight transportation, and electricity transmission and distribution are dominated by publicly owned enterprises operating under monopolistic market structures, presenting obstacles for foreign investors. The Foreign Private Investment Act provides legal protection to foreign investors against nationalization and expropriation. It also guarantees repatriation of profit, capital and dividend.

Foreign investments can register with the Board of Investment, the Bangladesh Export Processing Zones Authority (BEPZA) and the Bangladesh Small and Cottage Industries Corporation (BSCIC). Registration is not compulsory, but registered investors have access to a “one stop” service for infrastructure and institutional support services, including pre-investment counseling, electricity, gas, water and sewerage connection, and telecommunication facilities. Registration with BOI is permitted only for investors in manufacturing. These investors are eligible for free repatriation

of profit. The BEPZA and BSCIC are also responsible for allocating industrial plots, entitlement to import items on the restricted list, approving the payment of royalties, technical knowhow or technical assistance fees, and appointing and remunerating foreign personnel.

Foreign investors enjoy the same incentives as domestic entrepreneurs in respect of tax holidays, accelerated depreciation allowances, concessional duties on imported capital machinery and other measures, as contained in the Industrial Policy 1999 and 2005. There are no distinctions between domestic private investors relating to investment incentives or export and import policies. Incentives include 100% foreign ownership in most sectors, tax holiday, reduced import duties on capital goods and spares, duty free imports for 100% export-oriented firms, tax exemption of technology fees, and interests on foreign loans.

As of 2007, Bangladesh has entered into bilateral agreements for avoidance of double taxation as well as the promotion and protection of investment with at least 18 countries. The Arbitration Act (2001) governs both domestic and international arbitrations. It grants the high court division of the Supreme Court of Bangladesh the power to determine the jurisdiction of the arbitral tribunal in certain circumstances. Commercial matters can generally be submitted to arbitration. Although the arbitration law is modern, in practice, the courts in Bangladesh are not yet fully supportive of the arbitration process. Furthermore, the domestic courts are overburdened, which lengthens the enforcement process. On average, it takes around 26 weeks to enforce an arbitration award in local courts, from filing an application to a writ of execution attaching assets

Extent of Regional FDI in Bangladesh

There were 169 South Asian ventures among the 1,600 foreign-invested enterprises (FIEs) which were set up in Bangladesh during 1977–2011 (Table 3.1).

Table 3.3: South Asian Investment in Bangladesh at 2011

Source country/Industry	Number of Firms	Cumulative investment ($ million)	Employment
INDIA			
Manufacturing	**108**	**266.083**	**30243**
Food	18	20.1	2127
Textile	2	20.4	2177
Clothing	24	54.2	17699
Leather products/footwear	3	36.1	2754
Wood products	1	0.5	51
Paper and paper products	3	2.4	255
Chemical, rubber and plastic	32	62.1	3626
Fabricated metal products	17	66.6	886
Other manufacturing	8	3.7	668
Construction/housing	4	4.2	468
Computer software and IT services	19	8.8	1277
Trade and services	11	29.6	1479
Clothing washing plants	6	7.5	1099
Total	142	308.635	33467
PAKISTAN			
Manufacturing	**39**	**93.4**	**6035**
Food	2	11.5	120
Textile	6	12.3	672
Clothing	6	6.8	2943
Leather products/footwear	1	0.1	30
Wood products	1	0.1	15
Paper and paper products	2	4.1	322
Chemicals, rubber and plastic	6	1.4	404
Nonmetallic mineral products	1	0.4	27
Fabricated metal products	10	56.0	1245
Other manufacturing	4	0.8	257

Construction/housing	2	1.4	333
Computer software and IT services	1	0.5	62
Trade and services	4	2.5	105
Total	46	97.7	6535
SRI LANKA			
Manufacturing	**23**	**29.0**	**6778**
Food and beverages	2	0.3	151
Textiles	2	7.4	151
Clothing	7	10.1	5463
Chemicals, rubber and plastic	2	0.4	148
Fabricated metal products	2	0.5	51
Miscellaneous manufacturing	8	5.2	814
Clothing accessories	4	2.8	219
Computer software and IT services	4	1.4	151
Trade and services	6	27.0	1121
Clothing washing plants	1	0.5	102
Total	31	51.4	8050
Memo items			
FDI from all source countries	**1598**	**10179.5**	**26007**
South Asian share	13.7	4.5	17.5
India	8.9	3.0	12.7
Pakistan	2.9	1.0	2.4
Sri Lanka	1.9	0.5	2.7

Source: Compiled from data extracted from the Bangladesh Board Investment website.

India has been by far the largest regional investor in Bangladesh accounting for 14% of the total number of firms, 4.5% of total cumulative planned investment, and 17.8% of total employment in 2011. Pakistan and Sri Lanka occupy the second and third positions, respectively, in terms of the number of projects and cumulative investment. However, the Sri Lankan firms employed more workers (6,778) compared to Pakistani firms (6,535). This

difference seems to reflect the greater concentration of Sri Lankan firms in the export-oriented apparel industry, compared to Pakistani firms.

There are no firm-level data on export performance. But, the data on industry profile and the available limited information from project descriptions suggest that Indian and Pakistani manufacturing investment is heavily concentrated in domestic-market oriented activities (HFDI. By contrast, Sri Lankan investment is more efficiency-seeking (VFDI) in nature, with a heavy concentration on the textile and clothing sector which accounts for over 80% of the total merchandise expositors from Bangladesh. Of the 22 Sri Lankan firms, 16 are in the textile and clothing sector and related activities (production of clothing accessories and clothing washing plants). The differences in the degree of export orientation of investment from the three countries also mirror the differences in the degree of capital intensity of firms: the average capital per worker in Sri Lankan firms was $3,390 as compared to $8,798 in Indian firms and $15,476 in Pakistani firms.

The largest among the Sri Lankan firms in the Bangladeshi clothing industry is Brandix Casualwear Bangladesh which started its operations in the Comilla FTZ in October 2010. This production facility is part of the Brandix Group's regional production chain, which procures fabrics from the group's plant in India and clothing accessories from its Sri Lankan production base to produce woven bottoms for Marks&Spencer and GAP. When fully operational it will have a total workforce of over 2,800, becoming the largest employer in Comilla EPZ. It is the first apparel producer in Bangladesh to receive "Plan A" certification for environmentally friendly production from Marks&Spencer.

It is important to note that activities of Sri Lankan firms tell only part of the story of Sri Lanka's involvement in the export-oriented apparel industry in Bangladesh. Many clothing factories in Bangladesh (both locally-owned and owned by investors from other countries) employ a large number of managers and technicians from Sri Lanka.[26] "Based on the early-mover advantage in the export-oriented clothing industry (following the liberalization reforms

26 R. Jacob. 2013. The Right Genes for Making Jeans. *Financial Times*. 22 January.

in the late 1970s) and the rich domestic human capital base, Sri Lanka has become a hub of managerial and technical talents for the clothing industry in the region (and beyond)."[27]

Indian investment in Bangladesh could have been much higher if it were not for some political constraints affecting the investment approval.[28] In the early 2000s, India's leading conglomerate, Tata, came up with a proposal to invest about $3.6billion in Bangladesh to set up a urea fertilizer plant, a steel mill, and a power plant. The Mittal Group, the biggest steel conglomerate in the world, sought to invest $2.5 billion in a steel mill. Both these projects had the potential to create export trade with India while narrowing the massive trade deficit in Bangladesh's trade with India.

These projects also had the capacity of attracting significant FDI in gas explorations and development ultimately transforming Bangladesh's image as an FDI destination. Unfortunately, however, these projects have not yet materialized due to political considerations. The BNP-led government, which held power in Bangladesh during 2001–2006, stalled on making a decision on both projects. The public reason given was that Bangladesh could not guarantee enough gas supplies to the two projects to ensure their long-term sustainability. However, as forcefully argued by Sobhan, the real reason appeared to be the concern that approval of such large projects involving Indian investment just prior to a national election might have consequences for the BNP particularly with regard to the fact that its main rival, the Awami League, has been traditionally viewed as being "India-friendly."[29] The "gas"argument seemed a non sequitur because these projects could have encouraged significant FDI in further gas exploration and development in the country.

27 S. Jayasuriya and D. Weerakoon. 2002. Foreign Direct Investment and Economic Integration in SAARC Region in T.N. Srinivasan, ed. *Trade, Finance and Investment in South Asia*. New Delhi: Social Science Press. pp. 1–27; J. Wijayasiri and J. Dissanayake. 2008. Trade, Innovation and Growth: The Case of Sri Lankan Textile and Clothing Industry. Regional Studies. Working Paper 12. Colombo: Institute of Policy Studies.

28 Sobhan 2010

29 Sobhan 2010

3.3.2 FDI Liberalization and Extent of South Asian FDI in India

India started trade liberalization and deregulation of the industrial sector in the mid-1980s. The process gathered momentum after 1991. Over the past two years, FDI has been regulated by the Consolidated FDI Policy issued by the Department of Industrial Policy and Promotion (DIPP). The first Consolidated FDI Policy was issued on 1 April 2010 to reflect the current regulatory framework by consolidating all prior regulations on FDI contained in the Foreign Exchange Management Act (FEMA) 1999, the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations 2000, and Reserve Bank of India circulars and press notes. Changes to the FDI policy are proposed by any ministry, discussed in interministerial meetings, approved by Cabinet, and released through press notes by the DIPP. These changes are reflected in the Consolidated FDI Policy issued every six months. Sectors not listed in the Policy are 100% open to FDI under the automatic route subject to applicable laws, rules, and security conditions.

In sectors where FDI is allowed up to 100%, FDI comes in via the automatic route, subject to sectoral regulations and other conditions. In sectors where FDI is capped, prior approval from the FIPB is required. Until 1 September 2012, India did not permit Pakistani citizens or entities incorporated in Pakistan to invest in India, and Indian nationals to invest in Pakistan. Permitting full-foreign ownership remains an apolitically sensitive matter, as was evident from the government's decision to permit majority foreign ownership in retail in November 2011, and then putting the decision on hold.[30]

Foreign companies must comply with reporting requirements mandated by FEMA, notify the regional office of RBI within 30 days of receipt of inward remittances, and file the required documents with that office within 30 days of issuing shares to foreign investors. Companies in India are allowed to open and maintain a foreign currency account with an authorized dealer. The minimum capital

30 For more details see: http://blogs.ft.com/beyond-brics/2011/12/07/rip-fdi-in-indian-retail/#axzz1rThp9unA

requirement for foreign and domestic companies is Rs100,000, which must be paid upon incorporation.[31]

India has signed 79 bilateral investment promotion and protection agreements (BIPA), of which 70 have been enforced as of late 2010. It is negotiating 20 bilateral investment protection agreements. The Arbitration and Conciliation Act (1996) governs domestic and international arbitrations. Certain federal acts and acts enacted by different Indian states have mandatory statutory arbitration provisions. There are no notable differences between domestic and international arbitration. Most commercial disputes can be submitted for arbitration, but there are certain exceptions, such as the nonpayment of admitted debt or income tax, and industrial disputes. Institutional arbitrations are slowly gaining momentum, although parties still tend to prefer ad hoc proceedings. Indian courts are able to assist arbitration proceedings with interim relief. Decisions enforcing or denying enforcement of arbitration awards may be appealed at the Mumbai High Court and the Supreme Court. On average, it takes around 33 weeks to enforce an arbitration award rendered in India, from filing an application to a writ of execution attaching assets (assuming there is no appeal), and 43 weeks for a foreign award.[32]

Extent of South Asian FDI in India

In Indian FDI approval data, intraregional FDI inflows are lumped together under the catch-all residual category of "other countries." This catch-all category has accounted for around 1.5% of the total value of approved investment during 2000–2011. During 1998–2007, the Indian government approved 55 intraregional projects. Sri Lanka is the largest regional investor (45 projects), with Bangladesh (6) and Maldives (4) accounting for the balance. As already noted, between 1947 and1 September 2012, there was a complete ban on Pakistani investment in India.

Bangladeshi and Maldivian ventures in India are in trade and distribution sectors. Sri Lankan firms are involved in a wide range

31 WTO. 2011. Trade Policy Review of India. Geneva.
32 World Bank 2010

of activities, with textile and garments dominating the product mix. During the past decade a number of clothing producers in Sri Lanka, including the two largest producers in the country, MAS Holdings and Brandix, have set up production bases in India. These companies are expanding their operations in India based on the firm-specific advantages accumulated over three decades of successful operations in the Sri Lanka supported by market-oriented policy reforms initiated in the late 1970s. The Indian operations are a strategic move to both gain scale economies by accessing the vast Indian market and reaping cost advantages in global apparel markets by exploiting India's vast unexploited potential for integrating domestic textile production within the global apparel value chain. Both companies have plans to expand operations in India, using Sri Lanka as the regional hub for product design and development, sourcing clothing accessories and top-end apparel production.

MAS and Brandix are family-based Sri Lankan companies with historical roots in textile trade in the country dating back to the colonial era.[33] Following the trade-cum-investment liberalization reforms initiated in the late 1970s, a large number of East Asian clothing producers (mostly from Hong Kong, China) set up production plants in the country. The founders of MAS and Brandix ventured into the export-oriented clothing industry through links forged with international buyers who came to Sri Lanka soon after. As the links with foreign buyers became firm based on timely delivery and meeting quality standards, these two humble, made-to-order clothing firms rapidly evolved to become groups of companies engaged in the production of fabric, apparel accessories (hangers and elastic, etc.), product design and development, wet-processing and finishing, and trade-related logistics in the clothing value chain. A number of foreign firms, which initially supplied fabric and clothing accessories to MAS and Brandix have set up backwardly-linked production bases in Sri Lanka.

The MAS group of companies, which grew on the basis of a

33 The MAS-Brandix story in this section is based on Abeyratne and Karunaratne (2013), MAS (2007), INSEAD (2006), Wijesiri and Ekanayake (2008), and material from the websites of the two companies.

longstanding strategic partnership with Victoria's Secret, is now the largest producers of lingerie (women's intimate wear) in South Asia. Casual wear forms the core of the Brandix group of companies, but it has also ventured into the production of lingerie and sportswear over the past two decades. The two groups are now well-established suppliers to a number of brands such as Victoria's Secret, Marks & Spencer, Nike, Speedo, Triumph, La Senza, GAP, DRA, H&M, Lululemon and Oysho, Athleta. MAS has set up production facilities in Sri Lanka in addition to operations in India, PRC, Indonesia, and Mexico. Brandix has large casual wear production plants in Bangladesh, and a Hong Kong, China based trading company (Brandix Asia), which acts as the overseas trading hub for the group. The annual sales turnover of each has been rapidly approaching the billion-dollar mark. MAS employs over 50,000 workers and Brandix over 35,000 in their Sri Lankan operations alone.

In 2006, Brandix started developing a 1000-acre vertically integrated textile and garment park called the Brandix India Apparel City (BIAC) in the port city of Vishakapatnam in India's Andhra Pradesh state. It was formally inaugurated in 2010. With an initial investment of $750 million, BIAC is so far the biggest foreign investment in the clothing industry in India. At full capacity, it expects to generate a turnover of $1.2 billion and employ over 60,000 people. Brandix Apparel, the Sri Lanka-based trading and sourcing arm of all apparel manufacturing entities of the Brandix Group, is the first enterprise to start operations in BIAC. It currently employs 1,600 workers and has begun to supply fabric from the Indian base to Brandix apparel firms in Sri Lanka and Bangladesh. A number of other world-class companies involved in various layers of the global apparel supply chain (ranging from spinning, knitting and weaving, clothing accessories, apparel making and embellishment, store services and logistics) have either already set up operations or made commitments to do so.

Intimate Clothing, a subsidiary of MAS Holdings has set up two plants, one in Chennai and another in Bangalore, and an integrated fabric park in Chintavaram in Nellore District, Andhra Pradesh. The two factories, which started operations in 2006, currently employ

over 1,500 and 1,300 workers respectively. In 2007, MAS launched a range of lingerie in India under its own brand name, *Amanté*. This brand was developed and designed in Sri Lanka to suit the South Asian climate and local taste in colour and print. After the initial launch in Chennai and Bangalore, the Amanté lingerie range is now sold in departmental stores and regional multibrand outlets all over India. The Amanté range sold in India was initially manufactured in Sri Lanka, but the production was shifted to a Chennai factory after three years. The company has plans to expand the distribution network to Pakistan and the Middle East from the Indian base. MAS has invested $10 million in the Amanté line with the aim of making the product a premier brand in the Asian region.

The MAS fabric park, which is located in a 714-acre site in Chintavaram, started operations in 2007 with an initial investment of $200 million. It expects to generate $500 million as export revenue and employ 30,000 workers in full capacity. The park is an integral part of MAS's global supply chain integration strategy, and is expected to attract investment in different stages of the manufacturing and finishing process of warp knit fabrics used in the production of corsetry, swimwear, and sportswear. The park has already attracted a $30 million three-way joint venture between MAS, Dogi, Spain and Elastic Fabric, US (MAS DogiEFA) and another joint venture between MAS and Miami Exports (a Sri Lankan firm). A unique feature of the park is a training college, the Asian Institute of Management and Technology (AIMT), which is a knowledge center for garment and textile technology, lean manufacturing and corporate social responsibility, and community development programs.[34]

The other Sri Lankan firms in India are largely HDFI in nature, set up largely to take advantage of the market opportunities arising from the growth in the Indian consumer market. They include Ceylon Biscuits (Munchee brand), Lion Brewery (Carlsberg beer), John Keels, Hayleys, and Aitken Spence (Hotels). There are also a number of Sri Lankan firms involved in the services industry, in particular the freight servicing and logistics sector. The Indian

34 For more details see: http://www.fibre2fashion.com/news/printStory.aspx?new_id=43172

beer venture of Lion Brewery is an interesting case of a large MNE (Carlsberg International of the Netherlands) to venture into India. The progress of this joint venture in India has been impressive. The C now operates four breweries, in Maharashtra, Rajasthan, Himachal, and Kolkata.

3.3.3 FDI Liberalization and Extent of South Asian FDI in Pakistan

In spite of various bureaucratic controls, the government had a favorable attitude to private investment in Pakistan throughout the 1950s and 1960s. The FDI regime was more liberal, although there was greater emphasis on joint ventures with minority foreign ownership and technology licensing compared to FDI in fully foreign-owned ventures. However, supremacy of state and a socialist ideology under a socialist government dominated policy in the 1970s. As a result, a large-scale program of nationalization of key industrial units, and widespread controls of domestic and foreign trade was instituted.

Reforms started slowly in the early 1990s as part of a widespread reform package in conformity with the World Bank conditionality. The removal of restrictions to foreign investment was a major element of the reform program. Full foreign ownership of firms, with full freedom for remittance of profit and investment proceeds, is not allowed in almost all sectors of the economy.

Pakistan's primary and manufacturing industries are largely open to full ownership by foreign investors with some exceptions.[35] Corporate agriculture was subject to a maximum ceiling of 60% on foreign investment until recently, but is now fully open; however, there is a requirement of a minimum investment of $300,000. It is specific services sectors where restrictions on foreign equity ownership are applied more stringently. Only Pakistani citizens can own local newspaper companies. Foreign ownership in nationwide television channels is limited to a less than-50% share. In banking, a maximum of 49% foreign ownership is permitted. In

35 In manufacturing, as in almost all countries, arms and ammunitions, high explosives, radioactive substances, and currency printing and minting are not open to foreign ownership. While the production of alcoholic beverages is also banned, industrial alcohol is not.

life insurance, the cap of 51% was removed in September 2006 to allow 100% foreign equity, but minimum investment requirements were retained. Other service sectors where restrictions remain are tourism and air transport. Pakistani equity restrictions on average are less than the South Asian regional and global averages for all sectors except banking, insurance, and the media. In openness to foreign equity participation, Pakistan scores better than India, but lags behind Bangladesh and Sri Lanka,

There is no minimum capital requirement for domestic or foreign companies. In general, there is no discrimination between foreign and domestic investors when it comes to availing of incentives such as liberal tariff and tax concessions (e.g., income tax holidays) administered by the Ministry of Commerce.

Pakistan ratified ICSID membership in 2005 (signed in 1966), and three cases have been settled through ICSID since 2002. Pakistan has also signed nearly 50 Bilateral Investment Treaties, and has signed 54 agreements with countries to avoid double taxation. Beyond the investment laws, it is the general political-economic climate of the country, especially after 2001 that has deterred foreign investment. In the face of risks posed by political instability, violence, crime and corruption, even favorable FDI regimes are able to attract very little FDI on their own.

South Asian FDI in Pakistan

Indian companies are not officially permitted to invest in Pakistan. However, there is some evidence of Indian investment occurring through unofficial channels. For instance, according to the *Locomonitor* (an electronics database which tracks media reports of overseas investment by large companies) three Indian companies set up business operations in Pakistan during 2002–2007: Tata Consultancy, UTI (a leading financial services company), and Dabur India (an Ayurvedic product firms).[36] According to this source Tata Consultancy and UTI ranked among the top five investors in Pakistan during that period. In addition, there may have been considerable

36 Aggarwal. 2008.

unrecorded investment undertaken by Indian nationals through long-established family-linked firms operating in Pakistan.[37]

The Pakistan Investment Board does not report individual country data on investment from other South Asia countries, presumably because these are rather small. During 2000–2010, the share of the lump-sum category of the "other country" in total approved FDI (which presumably covers intraregional investment) has varied in the range of 1% to 3%.

3.3.4 FDI Liberalization and Extent of South Asian FDI in Sri Lanka

As a reaction to the dismal economic outcome of an inward-looking policy, Sri Lanka embarked on an extensive economic liberalization process in 1977, becoming the first country in the South Asian region to do so. Liberalization of the foreign direct regime, with a major focus on attracting export-oriented FDI, was a key element of the reform program. The liberalization reforms initiated in 1997 were unique in South Asia in that it involved significant liberalization of both trade and investment regimes. The principal act governing FDI approval and monitoring is the Board of Investment Act of 1978 and the amendments made to it in 1980, 1983 and 1992. Article 157 of the Sri Lankan Constitution guarantees the safety of foreign investment.

Sri Lanka permits full (100%) foreign ownership in most manufacturing and in a number of services activities, including banking, insurance, finance, construction, and telecommunications. However, select strategic sectors, such as railway freight transportation and electricity transmission and distribution are closed to foreign capital participation. Foreign ownership in the primary sector (mining, oil, and gas) is limited to a maximum of 40%. In the media industry, foreign capital participation in local television channels and newspaper companies must be less than 40%. Foreign equity participation in the retail distribution sector is only allowed if it exceeds $1,000,000.

37 S. Jayasuriya and D. Weerakoon. 2002. Foreign Direct Investment and Economic Integration in SAARC Region in T.N. Srinivasan, ed. *Trade,Finance and Investment in South Asia*. New Delhi: Social Science Press. pp. 1–27

In 2000, Sri Lanka notified the WTO that its investment regime did not provide for local content requirements, trade balancing requirements, foreign exchange balancing requirements, exchange restrictions resulting in import restrictions, or domestic sales requirements involving restrictions on exports. The Board of Investment (BOI) encourages investors to locate their factories in BOI-managed industrial processing zones to avoid land allocation difficulties. It aims at being a "one-stop" shop for foreign investors but, in practice, investment in certain sectors requires the approval of several agencies. The BOI approves projects, grants licenses, establishes eligibility for tax incentives, and assists in procurement. It is also responsible for administering a number of tax incentives for the so-called "BOI companies," and for managing export-processing zones and industrial parks. However, some of the benefits provided by the BOI incentives schemes are contingent upon export performance requirements. There are no restrictions to the remittance of corporate profits and dividends of foreign companies operating in Sri Lanka. The government has not expropriated a foreign investment since the 1970s; the last expropriation dispute was resolved in 1998.

Sri Lanka has signed investment protection agreements with about 28 countries and double taxation agreements with about 38 countries. The Arbitration Act No. 11 of 1995 regulates both domestic and international arbitrations, and is based on the UNCITRAL Model Law. Most commercial matters may be submitted to arbitration, and parties are free to select arbitrators of any nationality, gender, or professional qualifications. There are several arbitral institutions, including the Arbitration Centre of the Institute for the Development of Commercial Law and Practice and the Sri Lanka National Arbitration Centre. The efficiency of arbitration is hindered by its interaction with overburdened domestic courts, and there are significant delays in enforcing arbitration awards. Enforcement proceedings take place in the High Court. On average, it takes around 103 weeks to enforce an arbitration award, from filing an application to a writ of execution attaching assets.[38] Unlike

38 World Bank Group. 2010.

in many countries, the longest part of the enforcement proceedings is the time it takes from the first hearing in enforcement proceedings to the first instance of a court decision (1 year).

South Asian FDI in Sri Lanka

According to the official records there were eight Pakistani firms (textile (4), apparel (2), gloves (1), paper/packaging (1)) and a Bangladesh firm (photocopy paper) operating in Sri Lanka in the early 2000s. There has not been any recorded investment from these two countries since then.

Annual approved investment from India increased from $5 million in the second half of the 1980s to about $7.5 million by the late 1990s. During the first decade of the new millennium, the average investment level was much higher compared to the previous decade, but fluctuated widely from year to year during the final stage of the ethnic conflict. Investment flows have been growing rapidly following the end of the ethnic conflict in 2007. During 2010–2011 India was the second largest investor in Sri Lanka (after Hong Kong, China).[39] Given the growing importance of India as a source of FDI, the Sri Lankan Board of Investment opened its first overseas branch in Bangalore on 23 May 2005.

Indian firms' involvement in Sri Lankan manufacturing dates back to the late 1960s when a number of joint ventures were set up in domestic-market oriented industries such as textile, glassware, refrigerators, and machine tools. Most of these import-substitution firms went out of business following the liberalization reforms initiated in 1977. In the 1980s and 1990s India had a relatively lower ranking among source countries of FDI in Sri Lankan manufacturing. The bulk of FDI in Sri Lankan manufacturing during this period was in export-oriented manufacturing (in particular, clothing, footwear, and other light manufactured goods) in which Indian firms do not have competitive advantage in overseas production

39 When Indian round-tripping investment taking place via Mauritius is taken into account. See Table 3.2; Note 2.

because of historical reasons.[40] In recent years, Indian investors have gained prominence with a district services sector. A number of factors, in particular the removal of restrictions on outward FDI by India, opening up of a number of services industries to FDI in Sri Lanka (in particular telecommunication and petroleum distribution), and improvement in the overall investment climate following the end of the civil conflict have underpinned these recent trends.

The industry profile of Indian investment in Sri Lanka is highly diversified, encompassing steel, cement, rubber products, tourism, computer software, IT-training and other professional services, and hotels and tourist resorts. Until the late 1990s, most Indian FDI inflows to Sri Lanka were in manufacturing. Since then the composition has tilted rapidly in favor of services, such as hospitals, restaurants, retail trade, and oil distribution. Some of the most visible Indian companies operating in Sri Lanka include Indian Oil Corporation, Tata (Taj Hotel, VSNL, Tata Tea, Tata Communication), Bharat Airtel, Apollo Hospital,[41] Adiya Birla Group (L&T), Ambuja, Rediffusion, Ceat, Nicholas Piramal, Jet Airways, Ashok Leyland, and Hero Motors. Indian Human Resources and Educational Companies like ICFAI and Manipal Medical Institute have also started entering Sri Lanka.

Most of the manufacturing ventures set up by Indian investors in recent years are engaged in the production/assembly of certain products (such as vanaspathi,[42] copper wire,[43] machinery parts and components) which enjoy tariff preferences (zero or low duty) under the ISLFTA but are subject to high tariff on India's imports from third countries. By 2005, exports by these "tariff-arbitrage" firms accounted for nearly 45% of total Sri Lankan exports ($559) to India, with vanaspathi and copper wire accounting for 22% and 28% of the total, respectively. In recent years, these exports have shown

40 R.B. Lall. 1986. *Multinationals from the Third World: Indian Firms Investing Abroad*. Delhi: Oxford University Press; P. Athukorala. 2009. Outward Foreign Direct Investment from India. *Asian Development Review*. 26 (2). pp. 131–159.

41 This was taken over by the Sri Lankan partner (the government-owned Sri Lanka Insurance Corporation) in 2008.

42 A type of vegetable oil derived from palm oil.

43 Extracted from imported scrap metal.

a sharp decline as the arbitrage margins eroded over time owing to multilateral tariff cuts in India.[44]

There are only a few Indian firms which have set up operations in Sri Lanka to exploit Sri Lanka's intrinsic comparative advantage in international production. Among them, perhaps the most prominent is the Indian tyre manufacturer, Ceat (a subsidiary of RPG Enterprises, one of India's largest conglomerates). It first set up a joint venture with a Sri Lankan company with a longstanding reputation in automobile and tyre trade (Associated Motor Wars) in 1993, and then in 1999 acquired the largest local tyre manufacturing company (Kelani Type, previously government owned) and amalgamated the two firms to form the Ceat Holding Company (CHC). CHC is now the largest tyre manufacture in Sri Lanka. By 2010 it had captured 55% of the domestic passenger vehicle market, 33% of the three-wheeler tyre market, and 45% of the light truck tyre market. Following successful domestic market operation, CHC has started exporting tyres to 14 countries in the world: Bangladesh, Pakistan, Mauritius, Nepal, and a number of countries in Africa and the Middle East.

Ceat's joint-venture operation in Sri Lanka is clearly illustrative of opportunities for creating intraregional trade and investment linkages through market-oriented reforms. The initial trade liberalization in Sri Lanka permitted Indian firms to penetrate the vehicle market early. This also created opportunities for Indian tyre manufacturers to supply the Sri Lankan market, using their specific technological assets and Indian production bases. The privatization program in Sri Lanka provided an investment opportunity to capitalize on cheap Sri Lankan rubber—reflecting the country's comparative advantage—and acquire a Sri Lankan production base. Liberalization in India facilitated outward FDI. The firm-specific assets accumulated over many years through successful operation in India enabled Ceat to produce tyres for both the Sri Lankan and export markets.[45] It is so far the only tyre manufacturing firm in Sri Lanka to obtain ISO 9000 certification.

44 D. de Mel and S. Jayaratne. 2012. Vertical Integration of Industries in South Asia. In Sultan H. Rahman, Sridhar Khatri and Hans-Peter Brunner, eds *Regional Integration and Economic Development in South Asia*. Cheltenham: Edward Elgar, pp. 45–99.

45 S. Jayasuriya and D. Weerakoon. 2002. Foreign Direct Investment and Economic Integration in SAARC Region in T.N. Srinivasan, ed. *Trade,Finance and Investment in South Asia*. New Delhi: Social Science Press. pp. 1–27

In the export-oriented clothing industry in Sri Lanka, Indian firms are small players compared to both Sri Lankan firms and firms from other countries. They have set up production bases in Sri Lanka mainly to access the Sri Lankan managerial and technical/design capabilities in producing for third-country markets.[46] Some of them are subcontractors to large Sri Lankan exporting firms.

3.3.5 FDI Liberalization and Extent of South Asian FDI in Nepal

In 1992, liberalization of FDI policy led to the promulgation of the New Industrial Policy, and the amendment of the Foreign Investment and Technology Act (of 1980). Nepal's investment framework consists of the Industrial Enterprises Act of 1992 and the Foreign Investment and Technology Transfer Act of 1992. The Industrial Enterprises Act established the One-Window Committee coordinated by the Director General of the Department of Industries under the Ministry of Industry. The investment regime permits foreigners to invest up to 100% in all sectors of the economy, except those that are on the "negative list."[47] Some of these exceptions may only be modified by the parliament, others may be amended by the government.

All agreements entailing the transfer of technology from abroad require government approval. This includes nonequity relationships such as franchising. Foreign individuals are not permitted to own land, but resident companies may do so even if foreign-owned. A further *ad hoc* restriction is that total foreign shareholding in all financial services institutions is limited to 67% of the issued share capital, except banks (80%). Prior approval is required for all FDI. The Department of Industries may itself approve FDI applications for projects with an investment cost of under the equivalent of about

46 There is no relative labor cost advantage; the average factor-worker wage now is much higher in Sri Lanka ($150–$180) compared to that in India (around $100–$120).

47 The list includes (i) cottage industries; (ii) personal services (e.g., hair cutting, beauty parlor, tailoring, driving training); (iii) arms and ammunitions industries; (iv) explosives and gunpowder; (v) industries related to radioactive materials; (vi) real estate business (excluding construction); (vii) motion picture industries (produced in national languages and the language of the nation); (viii) security printing; (ix) currency and coinage business; (x) retail business; (xi) travel agencies; (xii) trekking agencies; (xiii) water rafting; (xiv) pony trekking; (xv) horse riding; (xvi) cigarette, *bidi*, alcohol production (excluding those exporting over 90% of their production); (xvii) internal courier services; (xviii) atomic energy; (xix) tourist lodging; (xx) poultry farming; (xxi) fisheries; (xxii) bee keeping; and (xxiii) consultancy services (e.g., management, accounting, engineering, and legal services).

$12.5 million. Applications in respect of larger investments are decided by the Industrial Promotion Board.

No specific performance requirements are imposed as an inducement or condition of investment. Nepal prohibits the nationalization of any private-sector industries; it guarantees full repatriation of capital, profits, technology transfer payments, or dividends and interest on foreign loans. No income tax is imposed on interest income earned by a foreign investor from foreign loans; 15% income tax is levied on royalty, technical, and management service fees; a maximum rate of 20% is levied on export income; priority is given in supplying electricity to investment projects; and the government facilitates business visas to the families of foreign investors.

In case of a dispute with third parties or with the government, foreign investors have recourse to Nepali courts. International arbitration to settle a dispute with the government is available to foreign investors but only if the investment agreement provides for such a right. Nepal has signed reciprocal encouragement and protection of investment agreements with about five countries, and has double taxation avoidance agreements with 10 countries including PRC, India, Sri Lanka, and Thailand. Nepal signed a trade and investment framework agreement with the United States in April 2011, and the bilateral investment promotion and protection agreement (BIPA) with India in October 2011.

South Asian FDI in Nepal

According to the data on cumulative foreign investment in Nepal as of 2011, intra-South Asian investments account for 26% of total foreign-invested firm, 41% of employment in these firms, and 48% total cumulative investment. India is by far the largest source country, followed by Bangladesh, Pakistan and Sri Lanka, and Bhutan, in that order. There is no recorded investment from the Maldives.

Manufacturing accounts for more than half of the recorded projects and 60% of the total planned investment. Out of the total reported Indian projects (501) 60% are in manufacturing and they

account for nearly 65% of total cumulate investment. Manufacturing accounts for more than half of the projects and 65% of the total planned investment. Among the other sectors, hotel and tourism show a large concentration given the attractiveness of Nepal as a tourist destination.

Until 2005 when the export-quotas under the Multifibre Arrangement (MFA) were in force, a large number of Indian firms set up production plants in the clothing Industry in Nepal to circumvent MFA quotas applicable to garment exports from India. There is no annual data to assess the implications of MFA abolition for foreign investment in the clothing industry.[48] But, judging from the data on clothing exports from Nepal during the post-MFA years, it seems that most (if not all) of these "quota-hopping" firms would have gone out of business after the "easy access" to quota-protected markets disappeared.

A major inducement for the bulk, if not all, of the other Indian investors has been opportunities for profit making through "import deflection." Because of successive tariff cuts from the late 1980s, tariffs on imports of many intermediate products in Nepal are much lower than in India. This, combined with a virtual open border between the two countries, has made simple processing industries in a number of product areas (including vegetable ghee, copper wires, and some cosmetics) geared to the Indian market highly profitable.

Nepal has untapped potential for hydroelectricity production for both the domestic market and the neighboring states in India through FDI participation. Currently over 80% of electricity demand in the country is met by electricity purchased from India. The estimated hydroelectric power potential of Nepal is about 45,610 MW, but a mere 1.37% of this is currently exploited.[49] India and Nepal started cooperating in the construction of a number of projects including Gandak (15MW), Kosi (18MW), Trisuli (21 MW), and Devighal (14MW) during the 1960s and 1970s. However, little has been done since then; the Karnadi, Rapti, and Pancheswar projects

48 P. Athukorala and K. Sharma. 2006. Foreign Investment in Nepal: The Experience of a Least Developed Land-locked Economy. *Translational Corporations*. 15 (2). pp. 125–26.
49 Lama. 2010. Table 6.2.

have been discussed for nearly four decades without any progress because of the failure of the two countries in agreeing on how to share the benefits of these projects. The situation has become more complex because of domestic power politics over the past decade.[50] The government monopoly in electricity distribution and the compulsion for private-sector electricity producers to supply to the national supply grid (owned and managed by the Nepalese Electricity Authority) have also been a major hurdle for FDI in this sector.

3.3.6 FDI Liberalization and Extent of South Asian FDI in Bhutan and Maldives

Bhutan

In 2002, the government of Bhutan announced the national FDI policy and initiated measures to put in place the institutional and legal framework for creating an enabling environment for attacking FDI. The new policy replaced the ad hoc system of investment approval of the past and put in place a transparent system for approval and regulation of all foreign investment, with the exception of portfolio investment, which is not allowed. Investors are expected to meet a minimum investment size: $1 million in manufacturing and $500,000 in services. In both cases, the foreign investor is permitted to hold up to 70% of ownership. Repatriation of capital and profit is subject to government approval.

Maldives

The foreign investment regime in Maldives is very liberal. Foreign investors are permitted to fully own and operate business in all sectors of the economy. Investment incentives apply equally to foreign and domestic investors. There are no exchange controls on repatriation of profit and capital. There is no company tax, but foreign investors are required to pay an annual royalty fee.

50 Lama 2010

The royalty is 3% of gross income or 15% of profits, whichever is greater, for majority foreign-owned companies. For others, the two alternative rates are 1.5% and 7.5%.

South Asian FDI in Bhutan and Maldives

There are no data on FDI inflows to Bhutan and Maldives disaggregated by the country of origin. In Bhutan, India is believed to be the largest investor, with investment predominantly in hydropower.[51] Unlike in Nepal, Indian cooperation in harnessing water resources has been widely accepted in Bhutan and all hydropower projects in the country are jointly owned and managed by Indian companies in collaboration with government-owned companies. There has also been some investment by Singapore and India in tourism and the financial sector.

Some Sri Lankan clothing firms had set up production bases in the Maldives to circumvent the quota-biding restrictions on Sri Lankan exports to a developed-country market. These production bases were shifted back to Sri Lanka after the MFA was phased out in 2005. Sri Lankan and Indian firms seem to have a significant involvement in tourist resorts and hotels, and tourism-related services.[52]

3.4 Comparison of FDI Policies of South Asian Countries

A comparison of different aspects of FDI policies in South Asian countries is provided in Table 3.4. Except for India, Bhutan and Nepal, 100% foreign equity participation is allowed in all sectors in South Asian countries. Bhutan allows 70% foreign equity participation in all sectors, while Nepal has a negative list of industries where 100% foreign equity participation is not allowed. India by comparison is far more restrictive with respect to its FDI policies. It allows 51% of foreign equity participation in most industries and 100% in export-oriented industries. However, only upto 21% is allowed in small-scale industries.

51 C. Dorji. 2011.Bhutan in Jayatilleke Bandara, Prema-chandra Athukorala and Saman Kelegama, eds. *Trade Liberalization and Poverty in South Asia*. London: Routledge. pp. 61–79.
52 WTO. 2003. Trade Policy Review of Maldives. Geneva.

Except for Maldives, tax incentives have been used by all South Asian countries to attract FDI. All countries allow 100% repatriation of profits by foreign firms, but most of them have some minimum capital requirement for foreign firms. While capital requirement of $0.3 million is required for foreign firms interested in entering the agriculture and infrastructure sectors in Pakistan, $1 million is required to enter the manufacturing sector in Bhutan. Sri Lanka has a minimum requirement of $500,000 for foreign firms entering any sector. However, capital requirement to enter India is the lowest, i.e., $2100. Bangladesh has no minimum capital requirements for foreign firms. Most South Asian countries, except Nepal, encourage FDI in economic processing zones.

South Asian countries follow more restrictive policies with respect to outward investments and in most cases prior approval from government is required. There are also limits to the extent of outward investments that can take place. For example, in the case of India, $100 million is set as the limit to which outward investments can take place in a year.

In most of the countries, except for Bhutan and Nepal, international dispute settlement arrangements like the UN convention are agreed to by the host countries.

3.5 Conclusion

The analysis of FDI policies and the extent of intraregional FDI shows that the total annual flows of FDI into the South Asian region has increased substantially following the market-oriented policy reforms initiated three decades ago, but they still account for a small share (around 3%) of total global flows. India continues to account for over 90% of these flows. Compared to total inflows, intraregional inflows of FDI seem to have increased at a slower rate and still they account for about 5% of the total FDI in the region over the past three decades.

Total outward investment by Indian MNEs has increased rapidly since the late 2000s; India is now the third largest investor in the developing world after PRC and Brazil. But, the intraregional share of total outward FDI from India has shrunk in recent years. Indian

overseas FDI, both global and regional, is predominantly of the horizontal type (market-seeking). Notwithstanding significant trade and investment liberalization coupled with the dismantling of the industrial licensing system, so far no significant globally-oriented firm with potential for slicing the value chain among countries has emerged in Indian manufacturing.

Horizontal FDI has continued to dominate the composition of South Asian intraregional FDI, which shows a significant shift in favor of services-sector activities. There are some indications of vertically integrated cross-border production operations emerging, but it is unlikely that these emerging patterns would be powerful enough to transform regional trade patterns so as to substantially reduce the region's dependence on extraregional markets for trade expansion in the foreseeable future. These nascent vertical production chains have so far remained confined to a few product lines, predominantly in the garment sector, and also to some products for which availability of specific natural resources play an important role in the location decisions of the firms. In other industries, particularly in electronics and electrical goods industries (in which global production sharing is servility-concentrated), no significant new regional firms with the capacity to undertake significant outward FDI have emerged so far. The Indian computer software industry is the often-cited example of South Asian success in joining global production networks. But most of the Indian global players in this industry are at the lower rungs of the vertically integrated global production chain with limited potential for further slicing the value chain to generate VFDI within the region.

There is no data to probe the impact on the trade-FDI nexus of the preferential tariff cuts achieved so far under SAFTA and the bilateral FTAs that have been in force. However, information put together in this chapter suggests that it was the cross-border liberalization of trade and investment regimes (both unilaterally and as part of the WTO commitments), that have set the stage for the emergence of VFDI in the region. The export-oriented clothing industry of Sri Lanka, which has begun to act as the hub of the textile-clothing value chain in the region, grew out of the significant

concurrent liberalization of trade and investment policy reforms in the country over the past three decades. Liberalization reforms in India and Bangladesh enabled leading clothing firms in Sri Lanka to set up production bases in India and Bangladesh. It is important to note that the entry of these firms to set up integrated production complexes in India predates the signing of the India-Sri Lanka FTA. The latter was instrumental in attracting some "tariff-arbitrage" manufacturing firms to Sri Lanka, but, naturally, they have not had a lasting impact on the bilateral trade between Sri Lanka and India. When the Sri Lanka-Pakistan FTA was signed in 2002, there was much hope that it would enable Pakistani firms to set up production bases in Sri Lanka to trade with India by circumventing the prohibition on using land routes to get export goods into that country. But according to the Sri Lankan investment approval record not a single Pakistani firm has set up production bases in Sri Lanka.

Although, intraregional trade and FDI have remained largely untapped, all countries in the region have experienced marked liberalization in trade and FDI over the past three decades. In the next chapter, we examine the extent to which liberalization and reforms have been successful in boosting industrialization in these countries.

Table 3.4: Foreign Investment Policy Regimes in South Asian Countries in 2011

Areas	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
Limits on foreign Equity Participation	100%	Up to 51% in most industries; Up to 24% in small-scale industries; and 100% in export-oriented industries, power, electronics and software technology parks. Investment from Pakistan remained prohibited until 1 September 2012	100% foreign owned or joint venture in all sectors, except for negative list industries	100% in all sectors.	100% in all sectors	70% in all sectors	100%

Areas	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
Fiscal Incentives	i) Tax holiday for 7 years ii) Tax exemption on royalties, interest on foreign loans and capital gains from the transfers of shares iii) 5% import duty on capital equipment and spare parts for initial installation	i) Income tax holiday of 10 years for EPZ firms and 5 years for other investors. ii) Access to finance for export-oriented industries at concessional interest rates iii) Tax relief under A avoidance of double taxation agreements iv) 10–year income tax holiday for firms located in EPZ.	(i) Corporate tax rate for export-oriented industries is 8% of profit or 0.5% of export earnings ii) Corporate tax rate for import competing industries is 20% iii) 2.5% duties on imports of M/E and spare parts iv) 5–10% duties on most industrial intermediate inputs refunded to export-oriented industries under the duty draw back scheme	i) No custom duty on imports of plant, machinery & equipment for export-oriented and hi-tech industries ii) zero import tariff on plant and machinery (not available locally) used for agriculture	i) Exempted from income tax on capital gains arising from share transfers ii) income tax iii) Duty draw back for export-oriented industries	Selective tax exemption	No specific tax incentives

Areas	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
Repatriation of Profits and tax on expatriates, income	100% repatriation of capital and dividends is allowed	100% repatriation of capital, profits and dividend is allowed after payment of tax	100% repatriation of dividends and capital is allowed	100% repatriation of capital, dividends and profits is allowed	i) 100% repatriation of profits and dividends is allowed ii) expatriates income is taxed at a concessional rate of 15% for 5 years	100% repatriation of profits and dividends subject to approval	100% repatriation of profits and dividends is allowed
Minimum capital requirement	None	US$2100	None	Agriculture and infrastructure: $0.3mn Telecom: $0.15 Mn.	$500,000	Manufacturing: $1Mn Services: $0.5 Mn	None
EPZ status	Yes, in some designated areas	Areas Yes, in some designation area	No	Areas Yes, in some designated area	Areas Yes, country-wide		

Areas	Bangladesh	India	Nepal	Pakistan	Sri Lanka	Bhutan	Maldives
Protection of Foreign Investment	i) Guarantee against nationalization ii) International convention for settlement of industrial disputes	i) Settlement of disputes is governed by the Indian Arbitration Act 1940 ii) UN Convention for the recognition and enforcement of foreign arbitral awards	i) Guarantee against national alization ii) Dispute settlement through mutual consultations and in accordance with the arbitration rules of UN Commission on International Trade Law	i) Guarantee against nationalization ii) Settlement of dispute through the International Commission on Settlement of Investment Disputes	i) Protection against nationalization under the bilateral investment agreements and constitutional guarantee ii) International Convention for the Settlement of Investment Disputes		
Outward direct investment	All foreign investment requires prior approval	Overall limit of $100 million in one financial year subject to approval. Investment by Indian nationals in Pakistan was not permitted under the approval route.	No permission is given for foreign investment for Nepalese citizens except by Only by Government notice	All foreign investment require prior approval	All foreign investments require prior approval. Priority to investments which promote domestic exports	Strict controls on all foreign investments	Strict controls on all foreign investments

Source: IMF, Annual Report on Exchange Arrangements and Exchange Restriction supplements by various country source

4

Role of Trade and FDI Policies in Industrial Growth in South Asian Countries

4.1 Introduction

One of the major objectives of the reforms undertaken in the early 1990s in the South Asian countries was to promote the extent and pace of industrialization. Higher trade openness and higher inflows of FDI, following the reforms, were expected to provide higher specialization, higher economies of scale and also increase productivity and efficiency through technological progress and higher competition. Economic literature on "trade and industrialization" suggests that trade can impact the specialization patterns of countries and the rate of industrialization or structural change within industries. Under an open trade regime, countries tend to specialize in the production of commodities for which they have a comparative advantage, and import commodities which are relatively expensive to produce domestically. Trade openness is also likely to bring foreign investment into the country.[1] However, the composition of foreign trade matters, as well as the openness of trade specialization in itself may not necessarily lead to higher growth rates as is seen in the case of primary production,

1 See R. Banga and B. Goldar. 2007. Contribution of Services to Output Growth and Productivity in Indian Manfacturing: Pre- and Post-Reform. *Economic and Political Weekly*, Vol. 42 (No. 26). pp. 2769-2777.

which seldom promotes sustained economic growth. Structural transformations which accompany growth play a major role in determining the path and speed of development. The role played by trade in causing structural transformation has therefore gained importance. However, it must also be kept in mind, that with the rising importance of "network trade", where intermediate products cross boundaries several times, coupled with the rising import content of exports, the role played by trade in causing structural transformation in an economy has become doubtful.

Two kinds of structural breaks in the growth rates of the manufacturing sector have been identified in this chapter to examine whether liberalization policies were effective. These are a *gradual shift* in the mean of the series (Innovational Outliers) and a *sudden change* in the mean of the series (Additive Outliers) using Clemente et al. tests.[2]

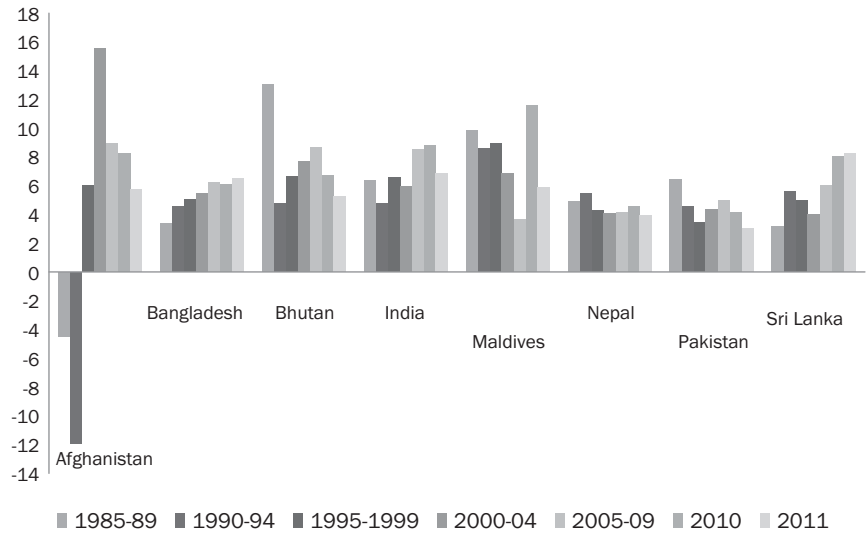
4.2 Growth in Real GDP and Manufacturing Real Value-Added

Although higher trade openness is expected to go hand in hand with higher growth of the economy as well as increased industrialization in the economies, this has not been the case with the South Asian countries. As discussed in Chapter 3, most South Asian countries embarked on their liberalization reforms in the early 1990s. Compared to the earlier period of 1985–1989, average growth in real GDP in the period 1990–1995 increased in Afghanistan, Bangladesh, Bhutan, India and Maldives. Nepal, Pakistan and Sri Lanka experienced a lower average growth in this period as compared to the earlier period. However, in the second half of the 2000s (2005–2009), most of the economies witnessed a spurt in their growth rates, except for Afghanistan and Maldives. The average growth in 2000–2004 as compared to 1990–1994 was higher in Afghanistan, Bangladesh, Bhutan and India. In spite of the global slowdown since 2008, India, Maldives, Nepal and Sri Lanka have experienced higher growth in 2010 as compared to average growth in 2005–2009. The year 2011 has been one of higher growth

2 J. Clemente, Antonio Montañés, and Marcelo Reyes. 1998. Testing for a Unit Root in Variables with a Double Mean. *Economics Letters*, Vol. 59 (No. 2). pp. 175-182.

as compared to 2010 only in Bangladesh and Sri Lanka. An average growth rate of 8%, which characterizes an economy as being on a high growth path, was experienced by Afghanistan (2000–2010), India (2005–2010), Bhutan (2005–2009), Sri Lanka (2010–2011), and Maldives in 2010. It therefore took almost a decade after reforms were initiated for countries to experience growth.

Figure 4.1 Growth in Real GDP in South Asian Countries: 1985–2011

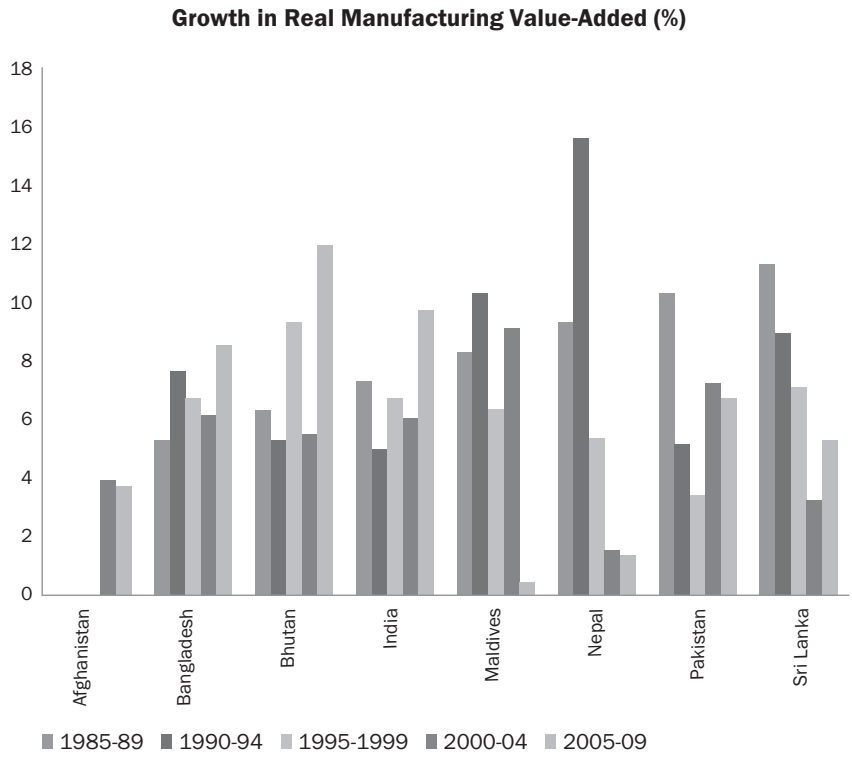


Source: UNCTAD STAT

Compared to the period 1985–1989, growth in manufacturing value-added fell in the period immediately following the reforms, i.e., in 1990–1994 in Bhutan, India, Pakistan, and Sri Lanka. Bangladesh, Maldives, and Nepal experienced a spurt in average growth in the manufacturing sector. However, as compared to the first half of the 1990s, average manufacturing growth declined steadily in Bangladesh in the second half of the 1990s;and further in the early 2000s (2000–2004) as compared to late 1990s. Only Bhutan and India enjoyed an accelerated average manufacturing growth in the late 1990s as compared to the early 1990s, while all other countries experienced a slowdown in their average manufacturing

growth. Even in India the average growth in late 1990s did not reach the level of the late 1980s. Manufacturing growth fell further in the early 2000s (2000–2004) as compared to the late 1990s in Bangladesh, Bhutan, India, Nepal and Sri Lanka. In 2005–2009, average annual growth in manufacturing value added surpassed growth in all earlier decades in Bangladesh, Bhutan and India. Sri Lanka experienced higher growth as compared to the early 2000s while Afghanistan, Nepal and Pakistan experienced lower growth in the late 2000s as compared to the early 2000s.

Figure 4.2: Growth in Manufacturing Real Value-Added in South Asian Countries: 1985—2009



Source: UNCTAD STAT

4.3 Countries which experienced Growth in Real Exports, Real Imports and Real Manufacturing Value Added in the post-1990s period

All four major economies in the region—Bangladesh, India, Pakistan and Sri Lanka— experienced growth in their real exports of goods and services, real imports of goods and services, as well as real value added in the manufacturing sector in the period following the 1990s (Figure 4.3). Imports of goods and services have risen much faster than exports of goods and services in all four economies if comparison is undertaken of the three components in USD constant prices (2005) and constant exchange rate (2005).

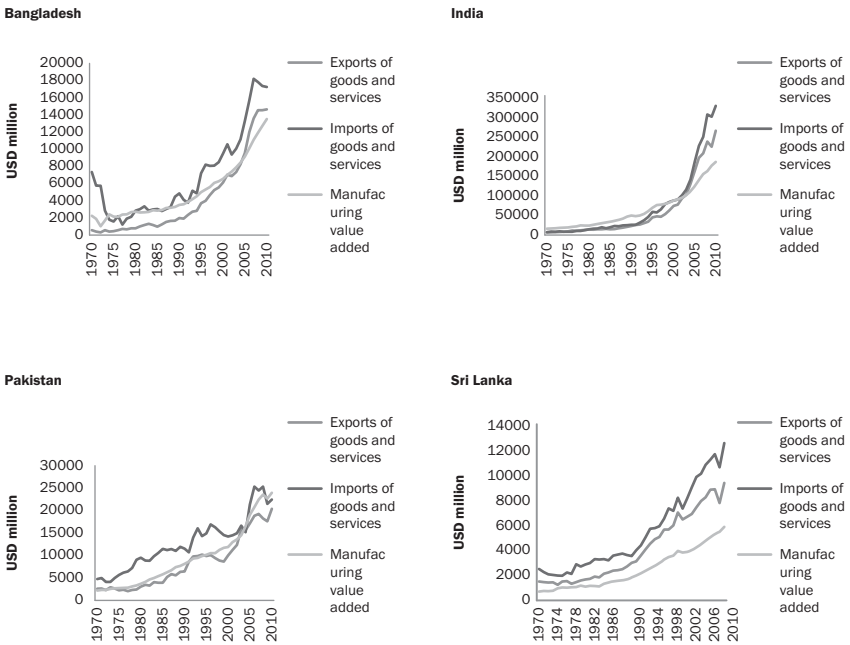
In Bangladesh, exports of goods and services surpassed manufacturing value added after 2005, while in India this change occurred in the early 2000s. In Pakistan, manufacturing value added surpassed the export of goods and services in all years barring a few years in the early 1990s. In Sri Lanka, manufacturing value added has remained much lower than the export of goods and services right from the 1980s.

The Least Developed Countries (LDCs) in the region, Afghanistan, Bhutan, Maldives and Nepal, experienced low manufacturing growth in the post-1990s period as compared to growth in their trade. Imports of goods and services far exceeded manufacturing value added. The gap between imports and exports widened over time in Afghanistan and Nepal. While exports did not pick up sufficiently in post 2005 in Afghanistan, they actually declined in Nepal.

These trends reveal the close association between manufacturing value added, export of goods and services, and import of goods and services. The reforms in the1990s encompassed not just tariff liberalization but also other financial reforms as well as industrial reforms. To assess whether trade provided an impetus to industrialization in South Asia, it is important to assess the impact of trade and FDI reforms on trade as well as on the growth of manufacturing value added. One way of assessing the success of trade and FDI policies is to identify structural breaks in real exports and imports and manufacturing

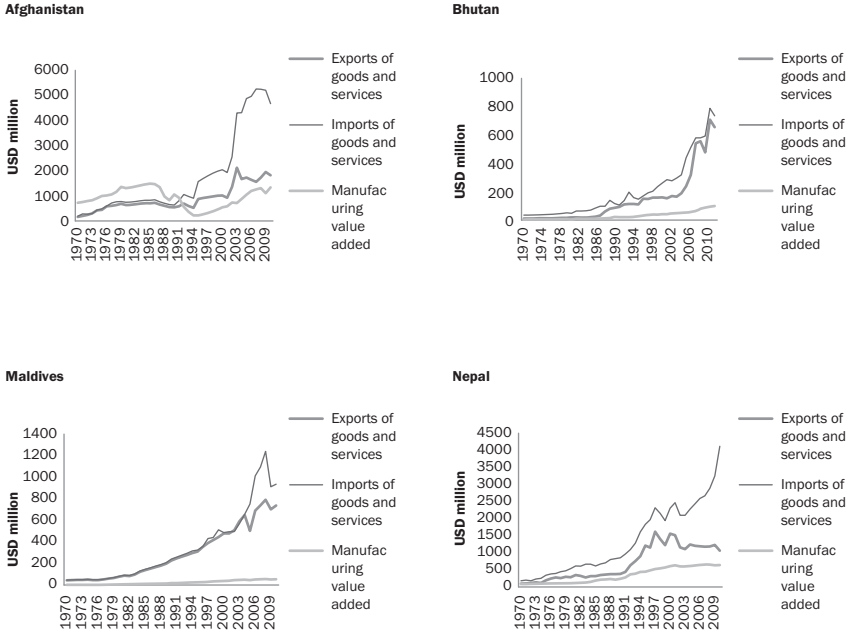
value added following the changes in trade and FDI polices. If structural breaks occured in manufacturing value added as well as real exports or real imports around the period when major policy changes in trade and FDI were made, we can conclude that the policies were successful in boosting exports and imports and contributed to manufacturing growth.

Figure 4.3: Countries with High Growth in Real Exports, Real Imports and Manufacturing Real Value Added in 1970–2010



Source: UNCTAD STAT

Figure 4.4: Countries with Low High Growth in Real Exports, Real Imports And Manufacturing Real Value Added in 1970–2010



Source: UNCTAD STAT

Section 4.4 discusses the results arrived at by identifying structural breaks in manufacturing value added, exports of goods and services, and imports of goods and services. Although a more direct way would have been to identify structural breaks in manufacturing exports and imports, it must be taken into account that manufacturing products which are exported use inputs across sectors, including agricultural inputs as well as services. The growing services input in manufacturing products makes it important to examine structural breaks in trade in goods as well as services. Further, it is increasingly becoming difficult to differentiate between trade and FDI policies with respect to manufacturing products and services.

4.4 Structural Breaks in Manufacturing Value Added, Exports and Imports

To identify the structural breaks, we use tests developed by Clemente et al., which identify multiple structural breaks in the series in the period 1970–2010.[3] Two kinds of structural breaks are identified, "sudden shift" or instantaneous shock that shifts the mean of the series through the AO (Additive Outliers) model, and "gradual shift", i.e., when the shock persists and dynamically adds to change the mean of the series over the rest of the period through the IO (Innovational Outliers)[4] model. One important advantage of these models are that they are able to identify more than one structural break in the series and the years of the break. These breaks are identified from within the data and are hence endogenous, i.e., unlike other tests there is no need to specify a year of break and then test. Structural breaks with respect to gradual shifts (IO model) are considered to be more apt for tracking the policy impact as compared to AO models as these breaks show that whatever change happened during that year added to the future growth of the series.

4.4.1 Structural Breaks in Trade and Industrial Growth Bangladesh

In Bangladesh, the beginning of policy reform and liberalization can be traced to deregulation measures introduced in 1976. Four notable features of policy during this period of greater market orientation were—reduction of restrictions on investment; gathering momentum of denationalization of public sector enterprises; limited reduction of tariffs and NTBs; and incentive packages for the emerging readymade garments sector. However, these reforms had neither a clear direction, nor a broad time frame for implementation. Since 1991, the country has experienced trade policy reforms in terms of import liberalization as well as export promotion. These measures included tariff reductions, the elimination of a large number of quantitative restrictions (QRs), a

3 Clemente et al.1998.
4 See Perron 2006; Perron and Volelsang 1992 for the underlying models estimated

flexible exchange rate regime, and the provision of a range of fiscal and financial incentives for export promotion. Reforms in the early 1990s also included allowing 100% equity in all foreign projects as well as extended EPZ privileges to all export-oriented projects. These policy changes were aimed at promoting trade, investments and industrial growth in the economy.

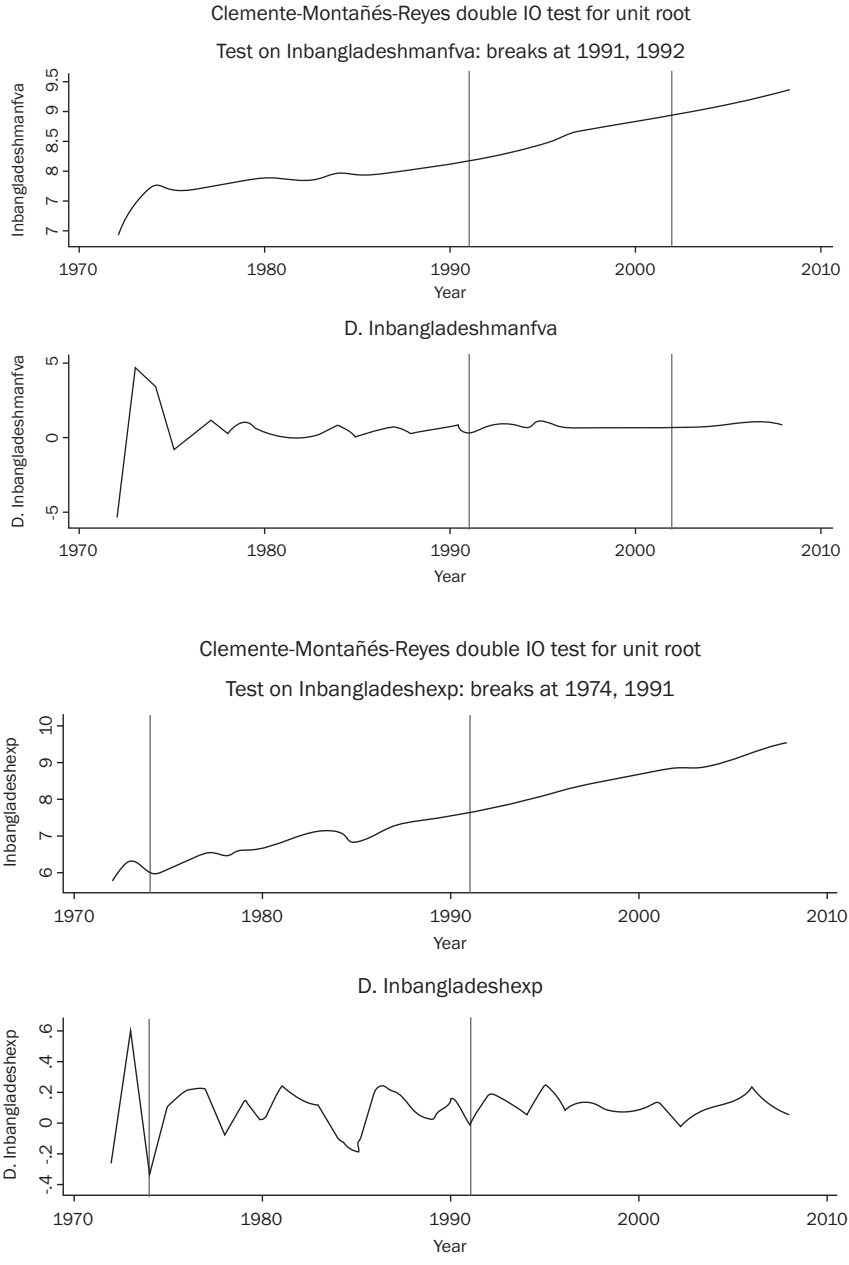
The structural break analyses identify sudden changes (AO break) in manufacturing real value added in 1992 and a gradual shift (IO break) in manufacturing real value added, which added to its growth since 1991. Both these years were statistically significant. Apart from these years, the second structural break is identified in 2003, but this was not a sustained break as there was no corresponding significant year identified by the IO model as representing a second structural break. This indicates that the reforms of 1991 were successful in structurally changing the manufacturing sector's growth but the policy reforms in the first decade of the 21st century did not contribute to any major changes in industrialization.

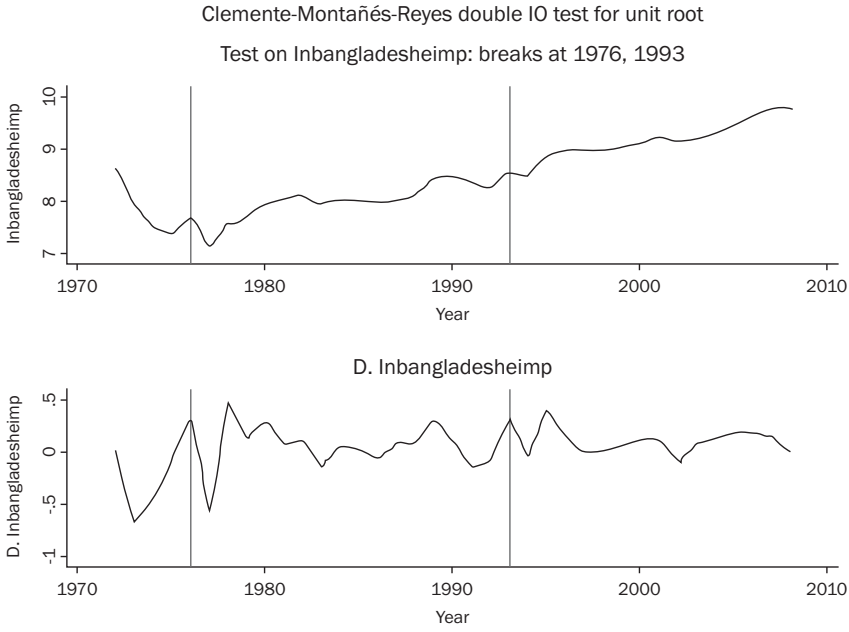
Table: 4.1- Structural Breaks using AO and IO Models in Real Manufacturing Value Added, Real Exports and Real Imports in Bangladesh

	Breakpoints by AO model	T-Stat (P-Value)	Breakpoints by IO model	T-Stat (P-Value)
Real Value Added in Manufacturing	1992[a]	9.06 (0.00)	1991[a]	5.05 (0.00)
	2003[a]	5.09 (0.00)	2002	1.15 (0.14)
Real Exports of Goods and Services	1983[a]	7.46 (0.00)	1974	0.66 (0.37)
	1998[a]	8.43 (0.00)	1991	1.03 (0.49)
Real Imports of Goods and Services	1975	-0.98 (0.33)	1976[a]	3.36 (0.00)
	1992[a]	8.86 (0.00)	1993[a]	2.78 (0.09)

[a] denotes statistically significant

Figure 4.5: Structural Breaks (IO Model) in Bangladesh's Manufacturing Value Added, Exports and Imports





Sudden structural breaks in real exports occurred in 1983 and 1998. But no structural breaks are identified by the IO model. Real imports, on the other hand, have experienced a sudden structural break in 1992 and gradual rise in growth since 1993, probably following the import liberalization reforms. The much discussed import policy of 2003–2006 of Bangladesh does not appear to have led to any structural breaks, either in exports or imports.

4.4.2 Structural Breaks in Trade and Industrial Growth India

Similar tests are applied to identify structural breakpoints in the growth of real value added in the manufacturing sector, real exports and real imports in India. The period of analysis is 1970–1971 to 2009–2010. The results of the AO[5] and IO[6] models for the manufacturing sector show that the sudden break points in the growth of value addition came in 1977 and 1997, while the structural

5 which assumes instantaneous changes in intercept.
6 which assumes a gradual change in the intercept and/or slope. The change persists in its effects beyond the initial shock.

break in the growth of real value added of the manufacturing sector that added dynamically to the rest of the series and led to a gradual shift of the mean of the series came in 1991 (Table 4.2 and Figure 4.6). The reforms of the 1980s do not appear to have led to any sudden or gradual shift in the value-added growth of the manufacturing sector. However, the 1991 reforms appear to have played a very important role in initiating a shift in the average growth of value added of the manufacturing sector.

One of the important policy interventions which may have contributed to the gradual shift in the growth series of the organized manufacturing sector is industrial de-licensing which was initiated in the 1980s, and which gathered momentum in the 1990s. The manufacturing sector in India was significantly shackled by the licensing system that specified the limit of output of each plant. Based on the specified output, every plant was allocated a fixed quantity of crucial inputs such as cement, steel, coal, fuel, furnace oil, etc. Industrial de-licensing, initiated in 1984–1985 removed constraints on output, inputs, location, and technology, allowing the manufacturing sector to take advantage of economies of scale. Free entry into de-licensed industries also enhanced domestic competition. Cumulatively, about 23% of output had been de-licensed by 1990. The process of de-licensing gathered momentum in 1991, when the entire manufacturing sector, with the exception of 16% of output, was de-licensed. Some of the remaining industries were de-licensed in 1993–1994.[7]

Although the structural breaks in the series provide some useful insights to the growth paths and one can relate the identified breaks with the policies adopted during that period, one needs to exercise caution while drawing conclusions. Structural breaks may occur due to a combination of various factors which may be internal or external to the economy. While important policy changes may occur during the period identified as a structural break period, it cannot be concluded that the structural break occurred due to a

7 R. Chamarbagwala and G. Sharma. 2008. *Industrial De-Licensing, Trade Liberalization , and Skill Upgradation in India*. See more at: http://www.isid.ac.in/~pu/conference/dec_08_conf/Papers/GunjanSharma.pdf.

change in the policy regime. But it is plausible that a sustained change may be the result of a change in the policy regime.

Though a number of changes were introduced in the tariff structure in the 1990s, the effective rate of protection remained relatively high in this decade and high tariff protection continued for consumer goods. In the first decade of 21st century, the dismantling of protection was much more effective as many nontariff barriers were lowered and quantitative restrictions were removed. The results of the AO and IO models show that with respect to the growth of real exports, instantaneous breaks came in 1990 and 2001 while the gradual additive shifts in export growth occurred in 1985 and 1997. The Y2K solution provided by the Indian IT sector led to a substantial break in the export of IT from India.[8] The industrial policy of export promotion of the 1980s seems to have played an important role in causing a structural break in the growth of export of goods and services, and policies followed from 1997 onward appear to have been instrumental in this matter. Although export promotion has been an objective of trade policy for a long time and incentives have been introduced for export promotion, it is difficult to say that the policy regime changed drastically in the first decade of the 21st century. The role of external demand may have been more important in this decade.

With respect to the import of goods and services, sudden shifts appeared in 1982 and 1999 while gradual shifts appeared after 1991 and 2002. Tariff liberalization also gathered speed after 2001 when across the board tariffs in manufactures, especially consumer durables, were brought down to 10%. This period also coincided with the policy of removing quantitative restrictions on consumer durables and a spurt in the import of capital goods and machinery.

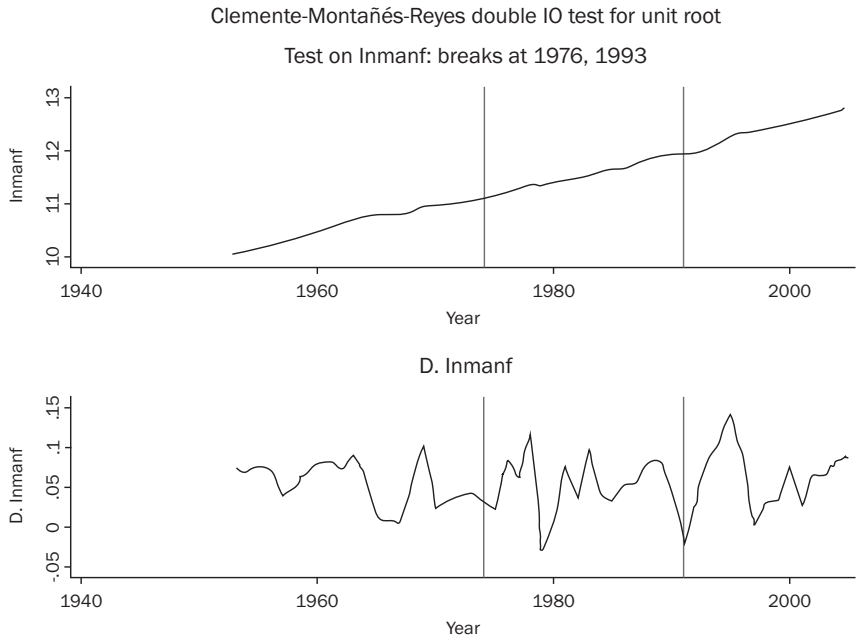
8 R. Banga and Kumar. 2011. India's Exports of Software Services: Role of External Demand and Productivity. *Science, Technology and Society*. 16 (3). pp. 285–307.

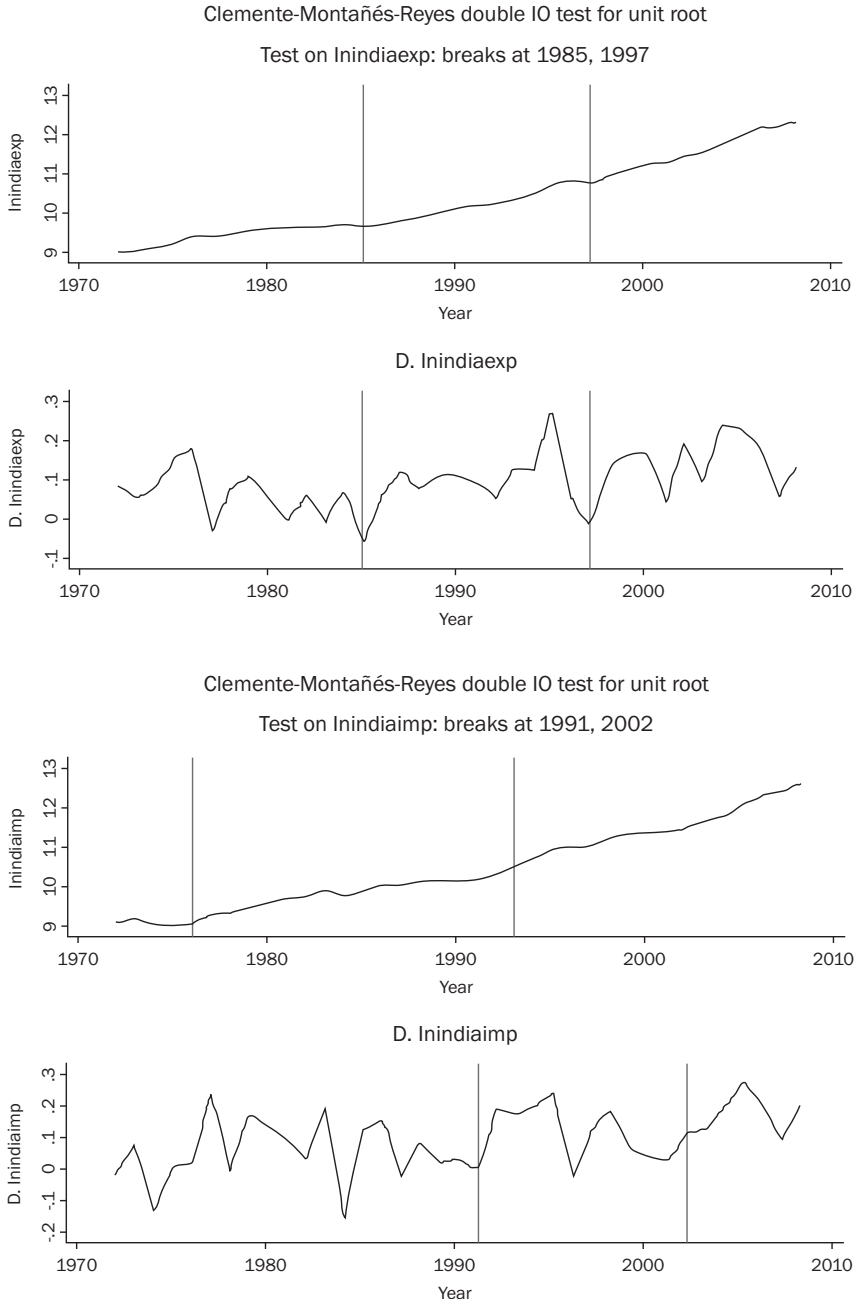
Table 4.6: Structural Breaks using AO and IO Models in Real Manufacturing Value Added, Real Exports and Real Imports in India

Value Added in	Breakpoints by AO model	T-Stat (P-Value)	Breakpoints by IO model	T-Stat (P-Value)
Real Value Added in Manufacturing	1977[a]	10.99 (0.00)	1974	1.28 (0.20)
	1997[a]	6.52 (0.00)	1991[a]	2.80 (0.007)
Real Exports of Goods and Services	1990[a]	2.47 (0.00)	1985[a]	2.47 (0.08)
	2001[a]	2.21 (0.00)	1997[a]	2.12 (0.04)
Real Imports of Goods and Services	1982[a]	7.13 (0.00)	1991[a]	2.62 (0.01)
	1999[a]	9.21 (0.00)	2002[a]	1.99 (0.05)

[a] denotes statistically significant

Figure 4.3: Structural Breaks in Value Added of Total Manufacturing Sector: IO Model




Clemente-Montañés-Reyes double IO test for unit root
Test on lnindiaexp: breaks at 1985, 1997
lnindiaexp
9
10
11
12
13
1970
1980
1990
2000
2010
Year
D. lnindiaexp
D. lnindiaexp
-.1
0
.1
.2
.3
1970
1980
1990
2000
2010
Year
Clemente-Montañés-Reyes double IO test for unit root
Test on lnindiaimp: breaks at 1991, 2002
lnindiaimp
9
10
11
12
13
1970
1980
1990
2000
2010
Year
D. lnindiaimp
D. lnindiaimp
-.2
-.1
0
.1
.2
.3
1970
1980
1990
2000
2010
Year

The above results indicate that the value-added growth in the total manufacturing sector underwent a structural break in1991 which changed the growth trajectory of the sector. An important break point for the growth of real imports occurred in 2002 while 1997 was an important break point in the growth of real exports. Together these results indicate that though policies with respect to liberalization started with the Industrial Policy of 1980, it was only after two decades, i.e., around the late 1990s or the beginning of 2000 that more effective trade policies were followed which produced the desired results with respect to exports and imports. Import competition, as well as export growth which increased after 2001, may have ignited higher value-added growth in the organized manufacturing sector.

4.4.3 Structural Breaks in Trade and Industrial Growth in Pakistan

For Pakistan the formulation of the new trade policy in 1987 holds special significance as after the incorporation of the other changes, the trade policy led, inter alia, to a reduction in tariff slabs from 17 to 10 and introduced a uniform tax in place of commodity-based sales taxes. The major focus of the government was to enhance the role of the private sector in the economy in this period and increasing export competitiveness. Different fiscal incentives were given for promoting exports such as tax holidays, tariff cuts and other profit augmenting opportunities for exporters. More specifically, the maximum tariff was reduced from 225% in 1986–1987 to 70% in 1994–1995. Similarly, the number of custom duty slabs was reduced from 13 to 5. Further, the flexible exchange rate system introduced earlier was kept in effect during this decade. Many new policies like promotion of liberalization, deregulation, and reduction in the cost of doing business were introduced in the period 2000–2003.These policies laid equal emphasis on encouraging a stable macroeconomic framework in terms of inflation, interest rate, and exchange rate. Further, they also concentrated on the promotion of export of services, which had not received proportional attention

in the past.[9] In fact, the promotion of services was made an integral component of the overall trade policy of the country.

In line with the policy changes, the structural break results of AO and IO models for Pakistan show that there was an instant break in manufacturing value added in 1984 and 2002 (Table 4.7 and Figure 4.4). In fact the policy reforms of 2002 appear to be very successful as this year also witnessed a structural break in terms of a gradual shift in the series (IO model). Real imports also experienced an instantaneous structural break in 2002 and a gradual shift from 2003 onward. In spite of all export promotion schemes, the policy reforms of 2000–2003, which led to an instant break in real exports in 2004, were not able to support the gradual shift over the years.

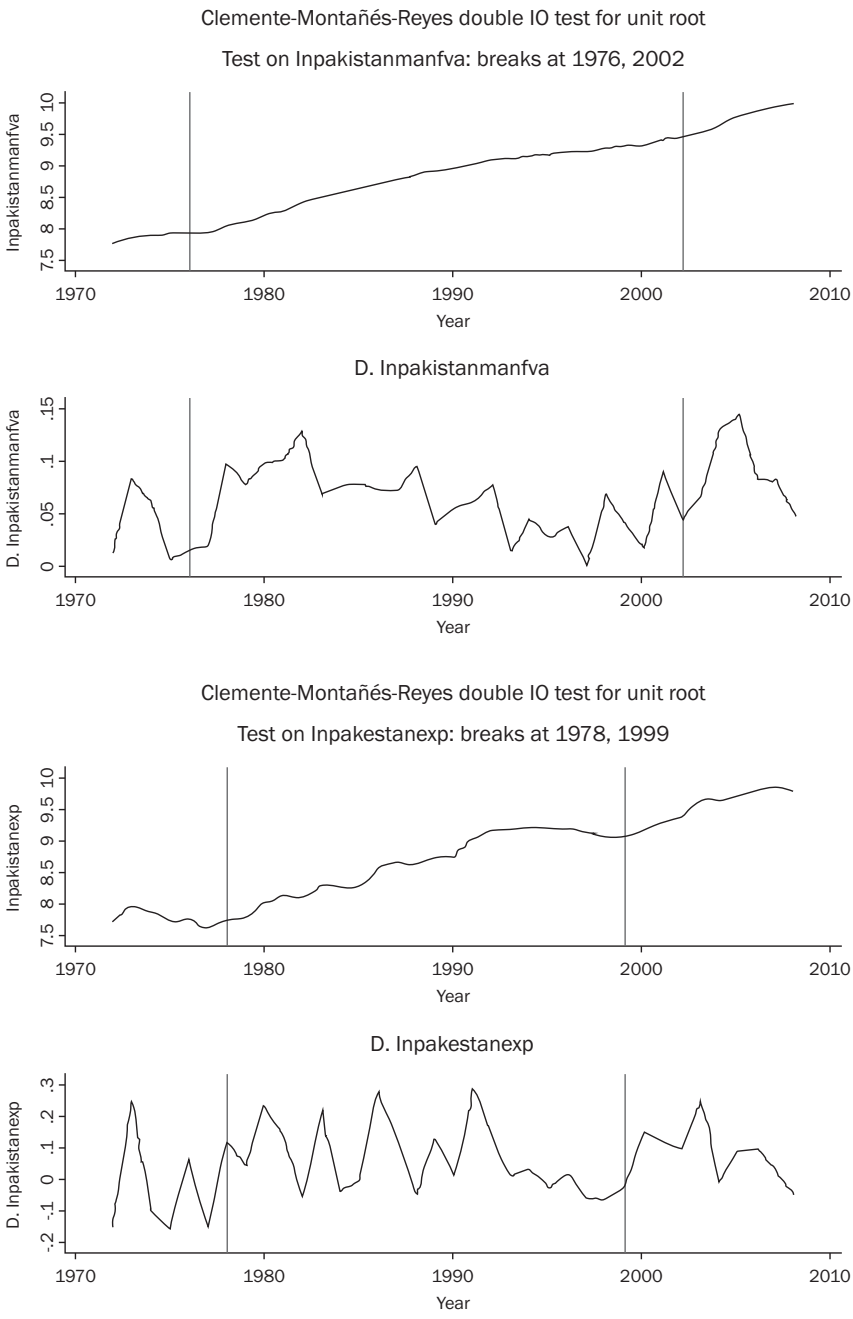
Table 4.7: Structural Breaks using AO and IO Models in Real Manufacturing Value Added, Real Exports and Real Imports in Pakistan

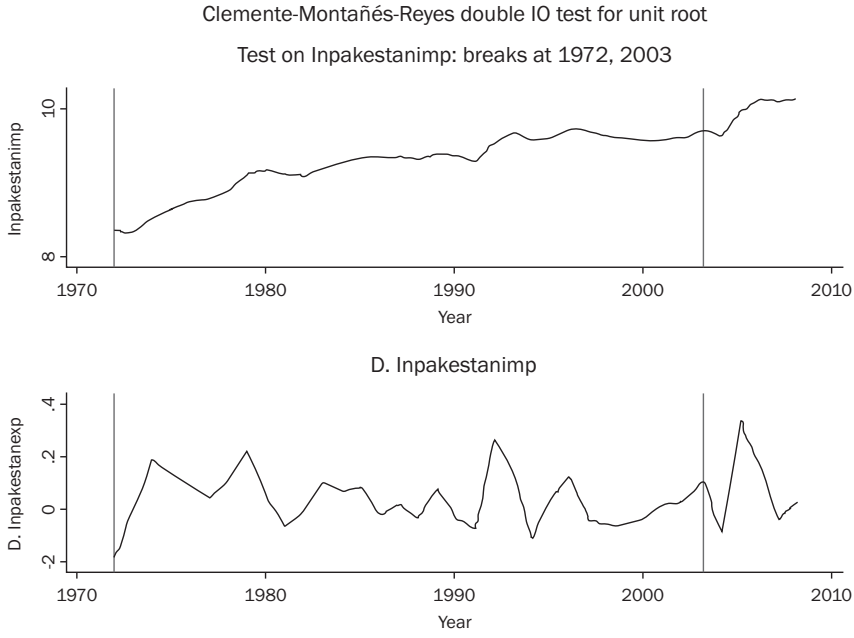
	Breakpoints by AO model	T-Stat (P-Value)	Breakpoints by IO model	T-Stat (P-Value)
Real Value Added in Manufacturing	1984[a]	12.07 (0.00)	1976[a]	2.95 (0.00)
	2002[a]	7.19 (0.00)	2002[a]	3.46 (0.00)
Real Exports of Goods and Services	1988[a]	12.35 (0.00)	1978[a]	3.23 (0.00)
	2004[a]	4.78 (0.00)	1999[a]	2.27 (0.00)
Real Imports of Goods and Services	1980[a]	9.31 (0.00)	1972	-
	2002[a]	5.59 (0.00)	2003[a]	2.67 (0.01)

[a] denotes statistically significant

9 B. Yasmin et al. 2006. Trade Liberalization and Economic Development: Evidence from Pakistan. *The Lahore Journal of Economics*. 11 (1). pp. 19–34 (See more at: http://www.lahoreschoolofeconomics.edu.pk/JOURNAL/Vol-11No1/Bushra%20Yasmin.pdf).

Figure 4.3: Structural Breaks in Value Added of Total Manufacturing Sector: IO Model





4.4.4 Structural Breaks in Trade and Industrial Growth in Sri Lanka

As a reaction to the dismal economic outcome of its inward-looking policy, Sri Lanka embarked on an extensive economic liberalization process in 1977, well ahead of the rest of South Asia. According to Athukorala, the first round of reforms carried out during 1977–1979 included:[10]

- Displacing quantitative restrictions on imports with tariffs and revising the tariff structure to achieve greater uniformity;
- Lifting of price controls on domestic trade; opening up the economy to foreign direct investment (FDI), with new incentives for export-oriented foreign investment under an attractive Free Trade Zone (FTZ) scheme;
- Unifying the exchange rate followed by a sharp devaluation;
- Financial reform of adjusting interest rates to levels above the rate of inflation, as well as opening the banking sector to foreign banks and freeing credit markets to determine interest rates; and

10 Prema-Chandra Athukorala. 2012. Sri Lanka's Trade Policy: Reverting to Dirigisme? *Working Papers in Trade and Development*. No. 2012/14. Canberra: Australian National University.

- Abolition of state enterprise monopolies over the imports of a number of key commodities and the introduction of limits on public sector participation in the economy.

However, the reform process lost momentum in the early 1980s, even though there was no retreat to the old control regime. The unfinished reform process regained momentum with a significant "second wave" of liberalization in 1990. This included an ambitious privatization program; further tariff cuts and simplification of the tariff structure; removing exchange controls on current account transactions and several important changes to the foreign investment policy framework in line with the increased outward orientation of the economy; and a more flexible exchange rate regime. By the mid-1990s, Sri Lanka had become one of the most open economies in the developing world.[11] The reforms reignited in 1997 in Sri Lanka involved significant liberalization of both trade and investment regimes. Most QRs were removed in the 1980s and by the end of the 1990s only a few remained on selected agricultural and industrial commodities, which were eventually removed in 1998.

The success of reforms of the late 1970s was visible by the early 1980s and 1982 has been identified as a year of gradual structural break (IO Model) in manufacturing value added; however no other statistically significant structural break is identified by the model. The reforms of early 1977 appear to have had a significant impact and caused a gradual structural break in real exports. The next structural break in real exports is identified in 1988. Reforms in 1990 led to a structural break in the real imports series. Structural breaks identified in trade do not synchronize with the structural breaks identified in manufacturing value added suggesting that trade has not necessarily been an important factor in boosting industrialization in Sri Lanka.

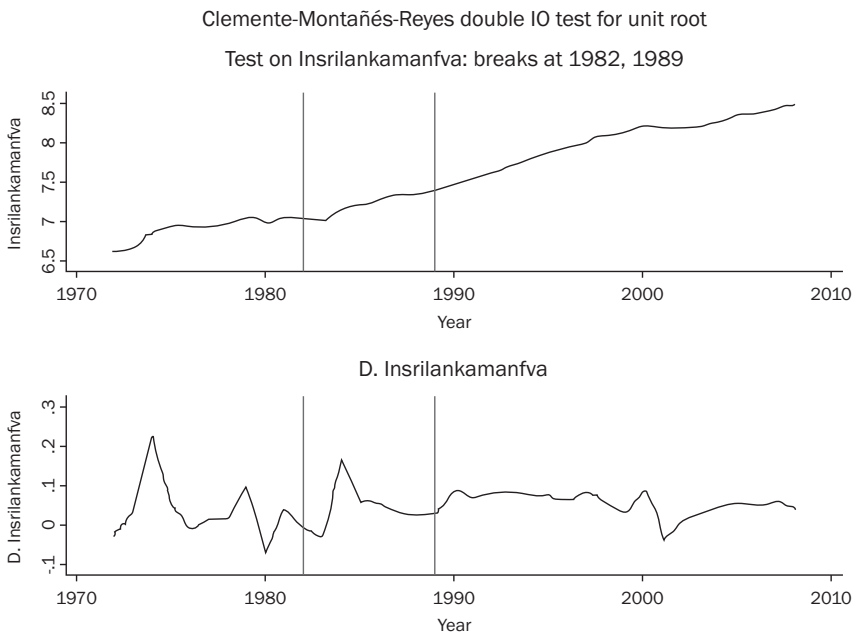
11 Footnote 10.

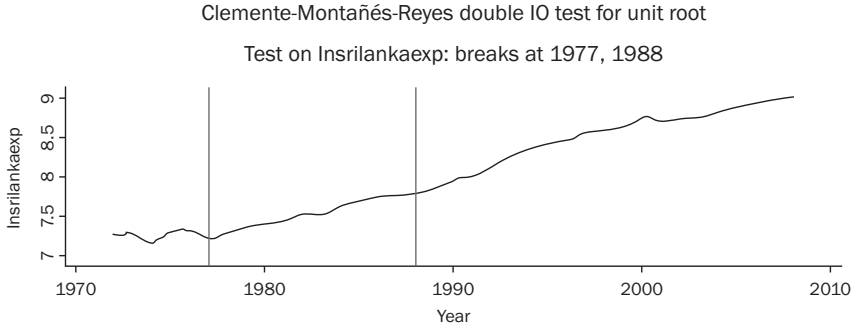
Table 4.8: Structural Breaks using AO and IO Models in Real Manufacturing Value Added, Real Exports and Real Imports in Sri Lanka

	Breakpoints by AO model	T-Stat (P-Value)	Breakpoints by IO model	T-Stat (P-Value)
Real Value Added in Manufacturing	1987a	8.65 (0.00)	1982a	2.04 (0.00)
	1997a	7.15 (0.00)	1989	1.60 (0.11)
Real Exports of Goods and Services	1986a	9.15 (0.00)	1977a	3.75 (0.00)
	1996a	8.73 (0.00)	1988a	3.15 (0.00)
Real Imports of Goods and Services	1979a	6.24 (0.00)	1974a	3.99 (0.00)
	1995a	11.5 (0.00)	1990a	3.60 (0.00)

[a] denotes statistically significant

Figure 4.4: Structural Breaks in Value Added of Total Manufacturing Sector: IO Model




Clemente-Montañés-Reyes double IO test for unit root
Test on lnsrilankaexp: breaks at 1977, 1988
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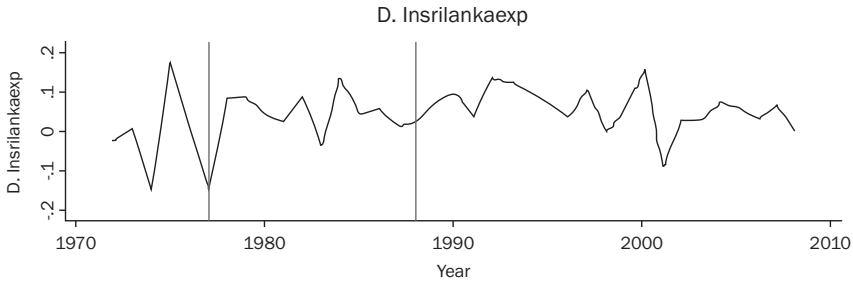
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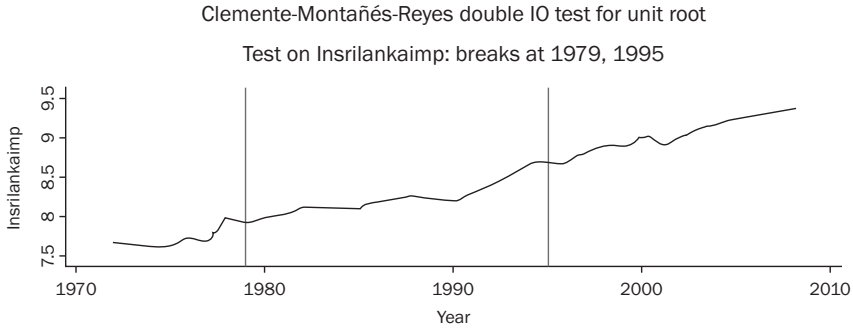
Clemente-Montañés-Reyes double IO test for unit root
Test on lnsrilankaimp: breaks at 1979, 1995
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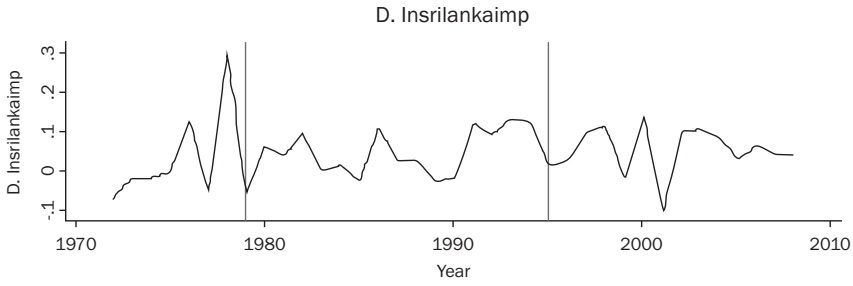
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4.5 Role of Trade Policies in Industrialization of Land-Locked LDCs and Small and Vulnerable Economies of the Region

4.5.1 Bhutan

Bhutan is one of the land-locked countries of the region. Planned development began in Bhutan in 1961, with the first two Five Year Plans wholly financed by the Government of India (GOI). Financial and trade ties of Bhutan with India have grown steadily. Over the period of 1981–2001, Bhutan's exports to India accounted for an average of 86% of its exports, and imports from India accounted for an average 79% of the total imports. In 2002, Bhutan became a member of UN and its sources of foreign aid diversified.

Bhutan has traditionally followed a sort of "controlled opening up" based on self-adjustment and participation in regional agreements. Being an import-dependent economy, there has been minimal compulsion to protect the domestic economy with import tariffs or quantitative restrictions in the trade policy. The tariff regime is made up of the Bhutan Sales Tax (BST) and the Customs Duty. Although Bhutan's participation in SAARC has increased its trade with other members of the organization, particularly Bangladesh, it is still heavily dependent on India for its trade. Over 95% of Bhutan's exports were sent to India, which was also the source of nearly 75% of its imports in 2010. Hydroelectricity is the main economic resource of Bhutan. Almost 90% of the electricity currently being generated is exported to India; the export tariffs are bilaterally negotiated at a political level. In 2002, the government of Bhutan announced the national FDI policy and initiated measures to put in place the institutional and legal framework for creating an enabling environment for attracting FDI. In 2010, a few more amendments were made to the policy to make it more open and business-friendly.

However, all these efforts have not been able to promote industrialization in Bhutan. The narrow domestic resource endowments and lack of economies of scale have severely limited the industrialization process. Bhutan has a small industrial sector dependent on processing agriculture, mineral and wood-based

industries. It does not have a mature and "organized" private sector or a sizeable manufacturing sector which could lead to product diversification. Consequently, Bhutan has relied excessively on the hydropower sector.[12] The availability of cheap electricity has, however, led to the development of certain power-intensive industries in the country.

A statistically significant structural break in manufacturing value added is found in 1979 by the IO Model, which suggests a gradual shift in manufacturing value-added growth, and in 1984 and 1997 by the AO model which suggest a sudden break in the series. Although, Bhutan's hydropower development has been an important driver of its rapid growth since the first major hydropower plant (Chhukha, 336MW) was commissioned in 1988, it did not seem to have spurred growth in the manufacturing sector. It has been argued that the hydropower sector itself can neither generate employment nor create backward linkage effects in the economy, and therefore has a limited impact on manufacturing value added growth in the country.[13] Significant structural breaks occurred in 1983–1984 and 2002 in both exports and imports of Bhutan. In the period 1999–2001, new legislations were enacted, which included the Bankruptcy Act, Companies Act, Sales Tax, Customs and Excise Act, and Income Tax Act, in order to strengthen the legal framework. The FDI policy of 2002 which led to major changes in these legislations probably also affected the trade pattern of the country.

12 T. Wangyel 2013. Rhetoric and Reality: An Assessment of the Possible Impact of WTO on Bhutan in Karma Ura and Sonam Kinga, eds. 2004. *Spider and the Piglet*. Bhutan: Centre for Bhutan Studies.

13 P.K. Shrestha. 2010. *Structural Changes and Economic Growth in Nepal*. New York: New School for Social Research.

Table 4.9: Structural Breaks using AO and IO Models in Real Manufacturing Value Added, Real Exports and Real Imports in Bhutan

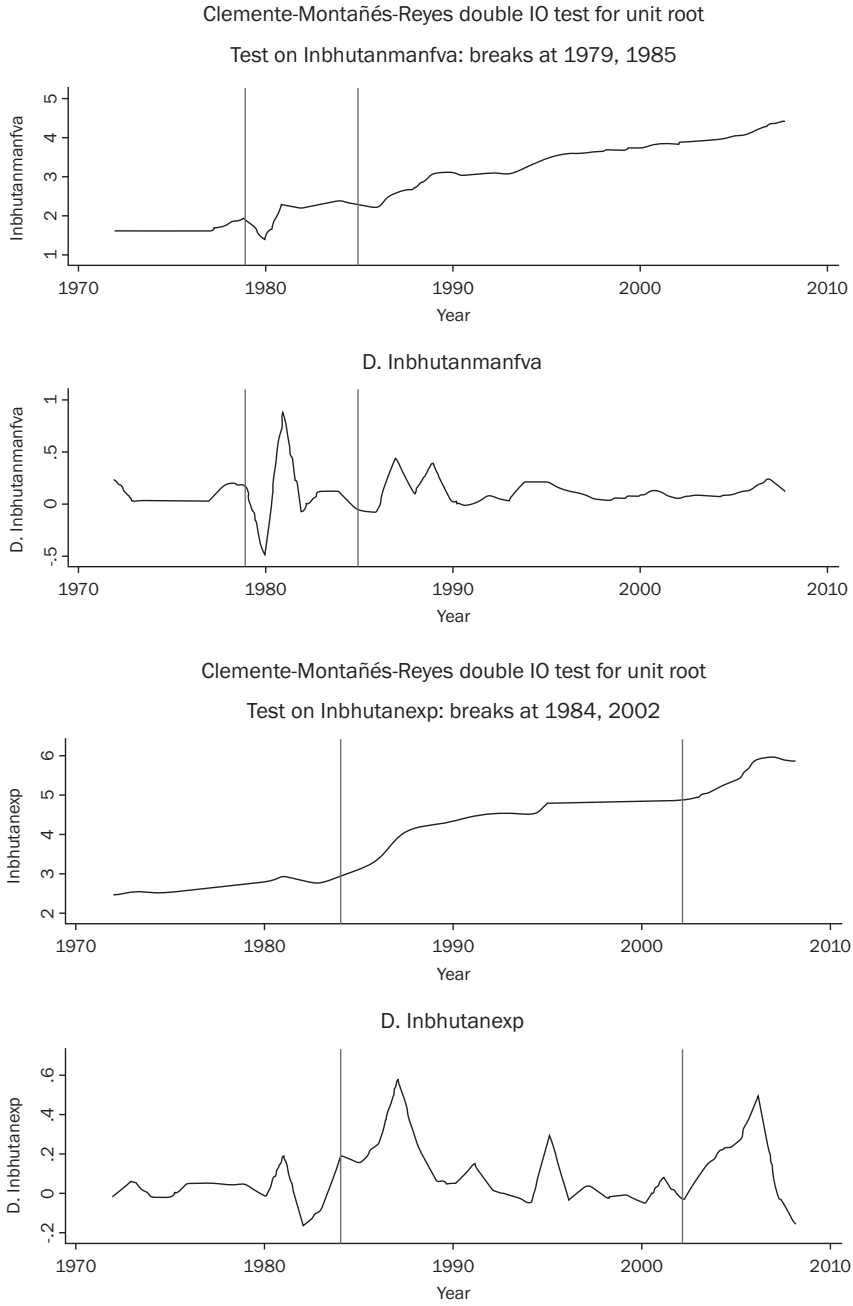
	Breakpoints by AO model	T-Stat (P-Value)	Breakpoints by IO model	T-Stat (P-Value)
Real Value Added in Manufacturing	1984[a]	8.57 (0.00)	1979[a]	3.69 (0.00)
	1997[a]	7.05 (0.00)	1985	0.47 (0.46)
Real Exports of Goods and Services	1989[a]	11.87 (0.00)	1984[a]	5.12 (0.00)
	2007[a]	3.56 (0.00)	2002[a]	4.50 (0.00)
Real Imports of Goods and Services	1987[a]	10.28 (0.00)	1983[a]	1.96 (0.05)
	2001[a]	7.33 (0.00)	2002[a]	2.13 (0.04)

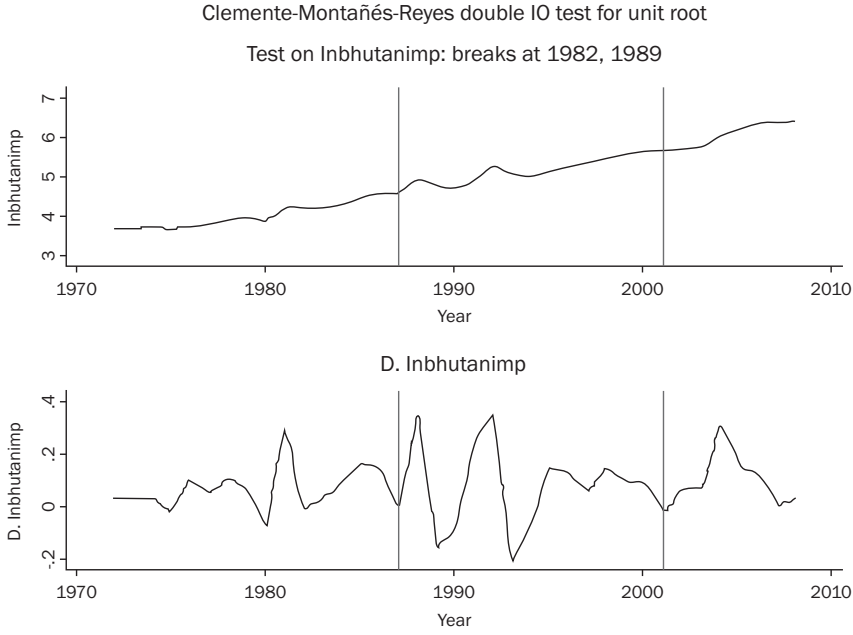
[a] denotes statistically significant

4.5.2 Nepal

Nepal is a land-locked country situated between India and the People's Republic of China (PRC). It is mainly an agrarian economy, with the share of manufacturing being only 6% of the real GDP. Nepal started economic reform measures in 1985 under the Structural Adjustment Program. In order to increase the pace of the reforms, the second Structural Adjustment Program SAP-II was implemented in 1989–1990 for three years.

Figure 4.5: Structural Breaks in Value Added of Total Manufacturing Sector: IO Model





Nepal started to liberalize its trade and investment regime, unilaterally in 1992 when license and quota requirements on imports were removed and tariffs reduced. Under the New liberal Trade Policy of 1992, it also liberalized its investment laws, restructured its tax system, and started to privatize a number of state-owned enterprises, which were performing poorly and became the first LDC to join the WTO through the full accession process in April 2004.

Like Bhutan, Nepal also has close trade and economic interlinkages with India, and the Nepali rupee is pegged to the Indian currency. Consequently, prices in Nepal are greatly influenced by inflation in India. Under the Nepal-India Trade Treaty, in both countries primary products originating in the other country are exempt from tariffs. India also agrees, on a nonreciprocal basis, to exempt industrial products manufactured in Nepal from customs duties.[14] In 2010, 65% of Nepalese exports went to India (up from 52.4% in 2003), and 57% of Nepalese imports were from India (up from

14 The Nepal-India Trade Treaty was most recently extended in October 2009.

53%). However, these shares underestimate the reality as there are large amounts of informal trade between Nepal and India.[15] These policies have aimed to promote foreign investment in an attempt to boost industrialization. Incentives have been provided for boosting industrial growth, for example, no permission is required for the establishment of industry, except those related to security, public health and the environment, and substantial tax exemption. In the large and medium-sized industries, full foreign equity participation is permissible, with no restrictions on repatriation of invested funds. The Foreign Investment and Technology Transfer Act 1992 has simplified both the process of obtaining visas for foreign investors and the dispute settlement mechanism.[16]

To promote investment, the government introduced market-oriented new policies and acts such as the Industrial Policy 1992, Industrial Enterprises Act 1992, Foreign Investment and One-window Policy 1992, and the Foreign Investment and Technology Transfer Act 1992. The Industrial Promotion Board was established in 1992 to formulate and coordinate the implementation of industry and investment policies.

The AO model identifies 1992 as a year of structural break in real exports and real imports. However the reforms do not appear to have had a sustained impact on exports and imports as there is no gradual shift adding to the sudden structural breaks in 1992. The IO model identifies 1990 as a year of structural break in manufacturing value added and real exports which has gradually helped the change over time.

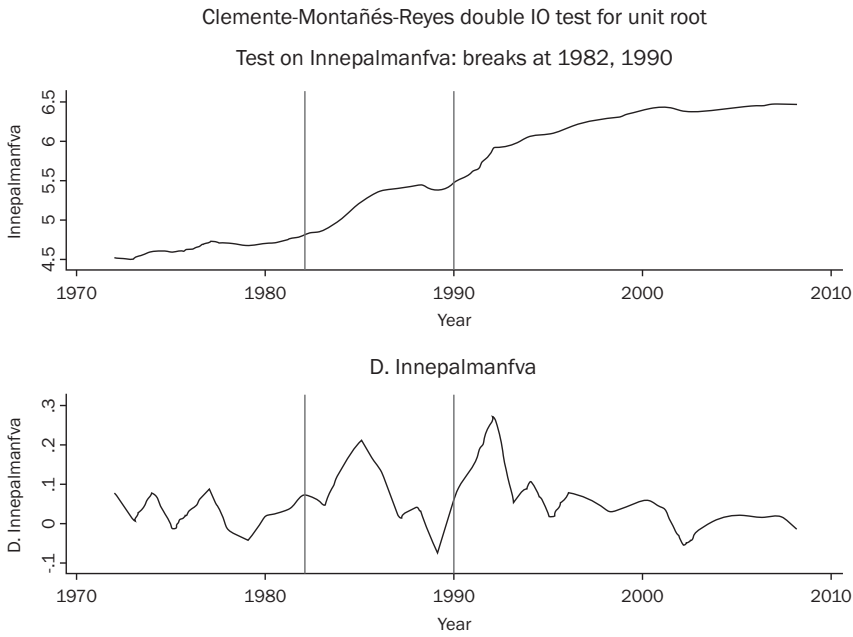
15 WTO, 2012. Trade Policy Review of Nepal. Geneva.
16 Footnote 13.

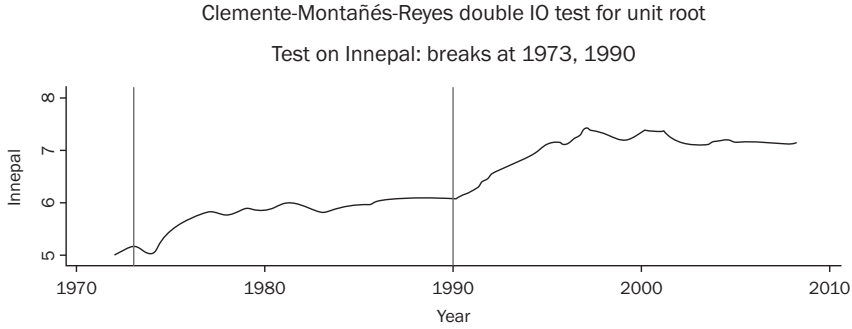
Table 4.10: Structural Breaks using AO and IO Models in Real Manufacturing Value Added, Real Exports and Real Imports in Nepal

	Breakpoints by AO model	T-Stat (P-Value)	Breakpoints by IO model	T-Stat (P-Value)
Real Value Added in Manufacturing	1987[a]	9.39 (0.00)	1982[a]	6.41 (0.00)
	1995[a]	6.00 (0.00)	1990[a]	5.02 (0.00)
Real Exports of Goods and Services	1972[a]	5.61 (0.00)	1973[a]	4.22 (0.00)
	1992[a]	14.5 (0.00)	1990[a]	5.99 (0.00)
Real Imports of Goods and Services	1977[a]	8.25 (0.00)	1973[a]	1.98 (0.07)
	1992[a]	12.79 (0.00)	1990	-0.85 (5.45)

[a] denotes statistically significant

Figure 4.6: Structural Breaks in Value Added of Total Manufacturing Sector: IO Model




Clemente-Montañés-Reyes double IO test for unit root
Test on Innepal: breaks at 1973, 1990
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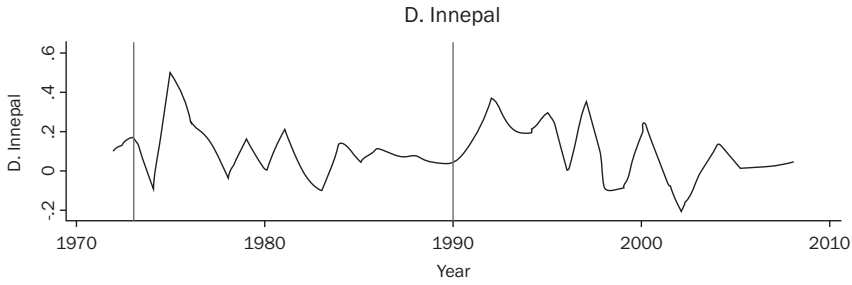
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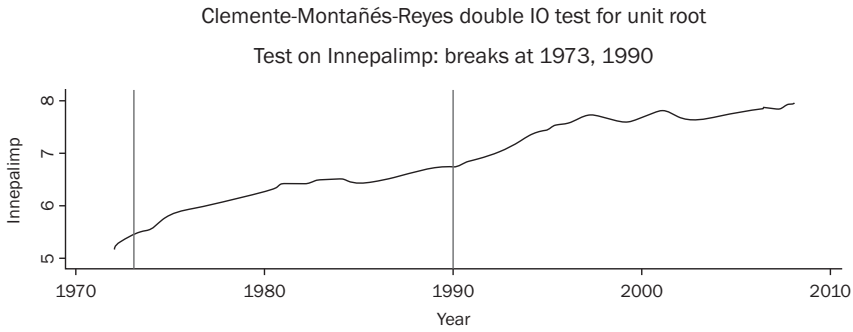
Clemente-Montañés-Reyes double IO test for unit root
Test on Innepalimp: breaks at 1973, 1990
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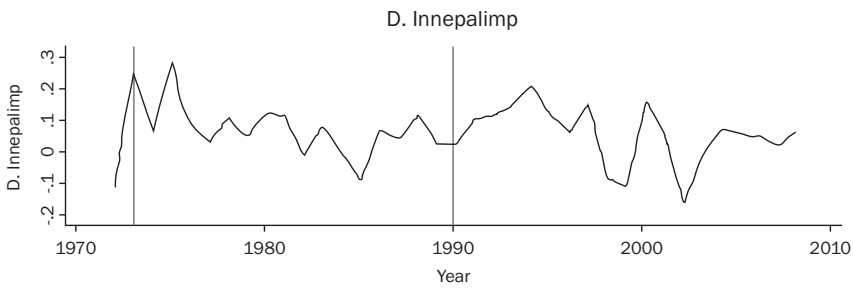
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4.5.3 Maldives

Maldives is a small and vulnerable developing country of the region, which graduated from the status of LDC in the year 2011. The economy of Maldives is highly dependent on services, mainly tourism and fishing. Heavy dependence on these two sectors has increased the country's vulnerability to international conditions and climate change. Any rise in sea levels from global warming can pose special concerns for Maldives which is a low-lying country.

Maldives experienced relatively high (but declining) growth rates during 1997–2002, fueled primarily by tourism and related expenditures, such as in construction, transportation, and distribution. Slower economic growth after 2002 was partly due to adverse external developments as tourism was severely affected following the September 2001 attacks in US Industrialization is extremely limited in the country and fisheries account for almost all merchandise exports. Fish processing is limited. Given this scenario of restricted industrialization, trade liberalization policies too have played a limited role in Maldives, and relatively high tariffs are maintained mainly for revenue considerations. A privatization program was launched in 1999, but it remained a long-term priority, and state-owned enterprises remained dominant. The country has the most liberal regime with respect to FDI with a simple and transparent regulatory framework with most of the FDI being channeled through the government route. There are no exchange controls on repatriation of profit and capital.

The structural breaks are all found to be insignificant with the IO Model which suggests sustainable structural breaks did not take place but sudden structural breaks are found in manufacturing value added in 1994, in real exports in 1998, and real imports in 2000. Decline in the importance of fisheries in GDP and the rise of tourism and related construction and other activities may have been the probable reason for the sudden structural break in manufacturing value added in 1994, and in real exports of goods and services in 1998. However, this phase of industrialization was not sustained with further policy changes as it did not generate the required linkages in other manufacturing sectors. A fall in tourism

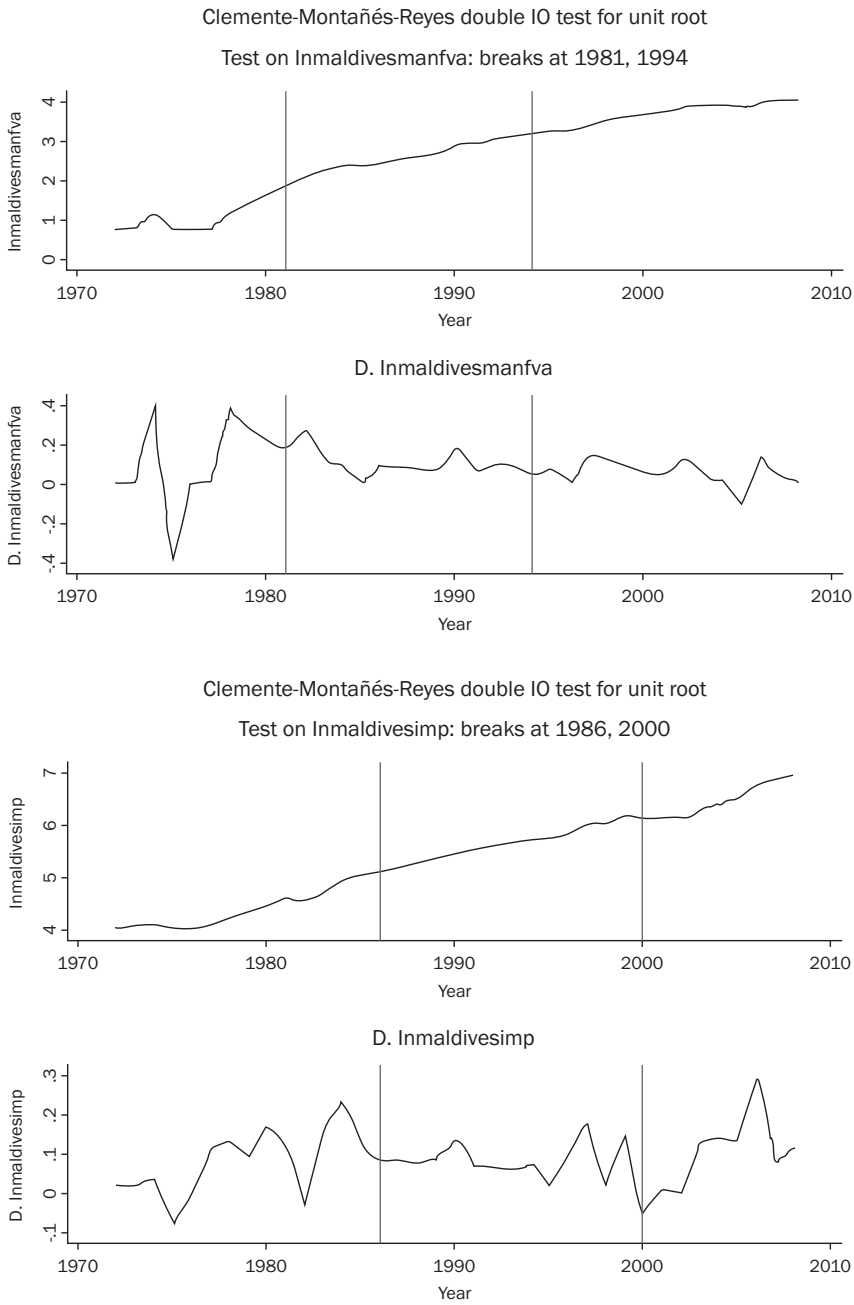
after 2000 could also be a probable reason for a structural break in imports.

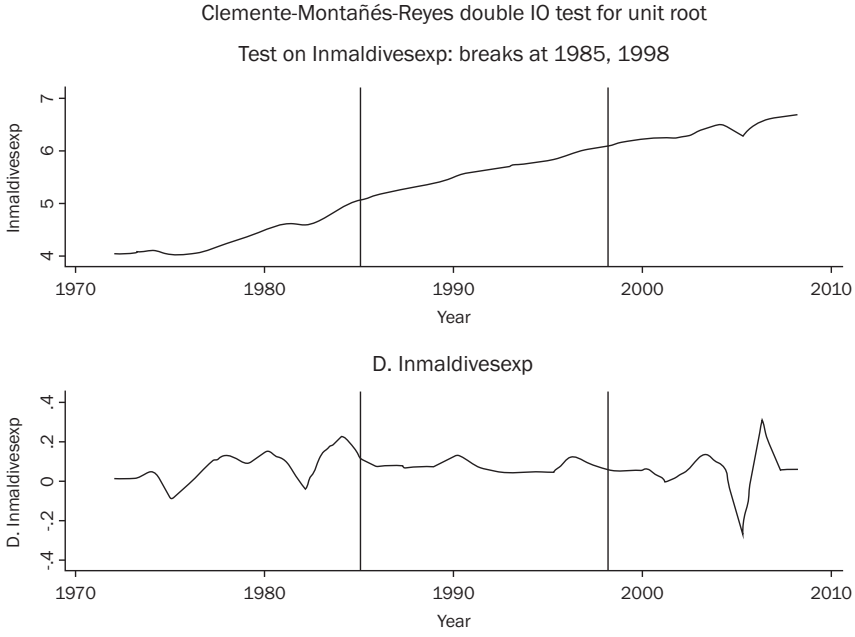
Table 4.11: Structural Breaks using AO and IO Models in Real Manufacturing Value Added, Real Exports and Real Imports in Maldives

	Breakpoints by AO model	T-Stat (P-Value)	Breakpoints by IO model	T-Stat (P-Value)
Real Value Added in Manufacturing	1981[a]	11.93 (0.00)	1973	-
	1994[a]	8.70 (0.00)	1976	-6.16 (-5.45)
Real Exports of Goods and Services	1985[a]	11.51 (0.00)	1976	-
	1998[a]	6.61 (0.00)	2005	-0.17 (-0.86)
Real Imports of Goods and Services	1986[a]	10.64 (0.00)	1976	-
	2000[a]	5.94 (0.00)	2002	1.83 (0.07)

[a] denotes statistically significant

Figure 4.6: Structural Breaks in Value Added of Total Manufacturing Sector: AO Model





4.6. Conclusions

The above analyses provide very useful insights into the role played by external policies like trade and FDI policies in promoting industrialization in the countries of the region. While reforms were initiated in the early 1990s in almost all the countries of the region, due to varying reasons, the major policy changes with respect to trade and FDI did not always correspond to sustained structural breaks in real exports and imports and even less with structural breaks in manufacturing value added.

In countries like Bangladesh, the structural break in manufacturing value added occurred in the early 1990s and corresponded with the reforms. Import liberalization policies show success in terms of causing a structural break in real imports, but export promotion policies do not seem to have been particularly successful in leading to sustained export growth; however, there was a sudden structural break in real exports in 1998.

India has also experienced sustained structural breaks in manufacturing value added corresponding to its reforms. However, sustained changes in real exports occurred in 1997 and in real imports in 2002 following the dismantling of quotas and small-scale reservations.

While reforms have been accompanied by structural transformation in India and Bangladesh in the early 1990s, Pakistan seems to have had more success with its reforms of the first decade of the 21st century and the corresponding sustained structural break in manufacturing value added in 2002. However, trade policy reforms seem to have caused a structural break in imports but not in exports in early 2000 although a sudden break can be seen in real exports in 2004.

Sri Lanka was an early bird in terms of its reforms which started in 1977, well ahead of the rest of South Asia, followed by the next wave in 1990. The reforms of the 1970s seem to have been more successful in Sri Lanka in terms of leading to a sustained structural break in manufacturing value added in 1982 and in real exports. The next phase of reforms caused sudden breaks but was not able to sustain the structural changes.

The LDCs and SVEs of the region like Bhutan, Nepal, and Maldives (data for Afghanistan is not available for the comparable time periods) do not appear to have succeeded in using trade and FDI policies in making any significant or sustained breaks in their manufacturing value added.

Reforms include a much broader package of policies including financial reforms, changes in industrial policies, and other related reforms. However, trade and FDI policies are integral components of liberalization reforms. If major changes in these policies are accompanied by structural breaks which are sustained over time in real exports and imports, it indicates that these policies have been successful. If structural breaks in exports and imports are also accompanied by structural breaks in manufacturing value added, it indicates that trade and FDI policies have been able to facilitate structural shifts in the economy. While a clear case of successful trade and FDI polices promoting industrialization

emerges for Bangladesh, India, and Pakistan, these polices do not appear to have had much success in other countries of the region in promoting industrialization.

5

Identifying Export-Led Industrialization in South Asian Countries

5.1 Introduction

In Chapter 4 we looked at the importance of trade and FDI policies in the realm of industrialization in South Asia by identifying the points of structural breaks in manufacturing value added, real exports, and real import for countries of the region. While the structural breaks analysis provides an indication of the impact of policy reforms on manufacturing and export outputs, it is also important to understand the relationship between the two sectors. Trade measures may affect both the sectoral outputs but information about the interrelationships between manufacturing and export helps in better determining if policies have been effective in achieving objectives. It is therefore important to pose the question: how is manufacturing growth related to the export sector?

Exports and imports both play an important role in the growth of any sector. However, the relative importance of the two for the growth of the economy is an important issue, especially in times of increased volatility in the world economy. Further, knowledge of the direction of causality of the relationship between export/import growth and growth of the sector is necessary for future policy directions.

Export-led Growth (ELG) literature is extensive and is based primarily on the Keynes theory, where in a particular economy demand drives the economic system to which supply adjusts, as opposed to Say's law wherein supply creates its own demand. It is argued that developing countries lack the demand which is required for growth in the long run. In a situation where these countries are producing below their productive capacities (given the surplus labor), the growth of the economy would be determined by a growth in external demand.[1] To bring about a structural change in the growth trajectory of the developing countries, therefore, one of the driving forces suggested is increase in external demand or exports.

The proponents of Trade as an Engine of Growth found empirical support in the 1980s in the successful experiences of some economies like Hong Kong China, the People's Republic of China (PRC), Japan, and the Republic of Korea, which were able to increase their growth through ELG strategies, and not so successful experiences, mostly in Latin America, where import substitution polices did not yield the desired growth rates.[2] Export-led Growth was proposed to generate higher capacity utilization, higher economies of scale, improved productivity, and better allocation of resources based on comparative advantage. A stream of empirical literature supported this ELG hypothesis.[3]

The East Asian economic crisis of 1997 and the global economic crisis of the post-2007 period have shaken the belief in ELG strategies and has brought the role played by domestic demand to the forefront. It is argued that domestic demand-based growth models can reduce dependency on other markets, which may become volatile given the current economic scenario, and provide cushioning against the increasing competition presented by Chinese exports in the third country market.[4] One of the major criticisms against the ELG strategies is that they lead to the creation

1 Thirlwal.1994.
2 B. Balassa. 1980. The Process of Industrial Development and Alternative Development Strategies. *Princeton Essays in International Finance*, (No. 141). Princeton, NJ: Princeton University; Jeffrey D. Sachs and Andrew M. Warner. 1995. *Economic Convergence and Economic Policies*. No. w5039. National Bureau of Economic Research.
3 See Blecker.2000.
4 Felipe.2003.

of excess capacity in the manufacturing sector.[5] This excess capacity undermines the financial soundness of investments, as was the case for East Asian economies during the financial crisis. Some of the studies have further questioned the causality of this approach. According to Rodriguez and Rodrik, successful export performance can be a result of successful development rather than the cause.[6]

Along with ELG strategies, import liberalization has also been proposed as a key to economic growth. Endogenous growth models have emphasized the static as well as dynamic gains arising from imports.[7] Imports of intermediate products can enable the creation of new domestic varieties and further boost productivity.[8] For instance, imports of consumer durables can lead to an increase in domestic competition leading to improved productivity, while imports of improved technologies and capital goods can further foster higher efficiency and productivity gains.[9] However, with higher imports there is also a danger of crowding out domestic investments if the domestic industry is unable to compete. This may lead to reduced output and adversely affect productivity growth.

Using an econometric analysis, this chapter estimates long-term relationships between the growth of exports and growth of manufacturing output. For countries where the relationship is found to be strong, further analysis is conducted to assess whether exports lead to manufacturing growth or vice-versa. Importantly, many South Asian countries, like India, have emphasized export targets as instrumental in spurring manufacturing growth and industrialization.

5 Kaplinsky.1993; Ertuk.1999.

6 Footnote 15, Chapter 1.

7 Paul M. Romer. 1986. Increasing Returns and Long-Run Growth. *The Journal of Political Economy.* pp. 1002–1037; 1990.

8 J. Markusen. 1986. Explaining the Volume of Trade: An Eclectic Approach. *American Economic Review.* 76. pp. 1002–1011; G.M. Grossman and E. Helpman. 1991. *Innovation and Growth in the Global Economy.* Cambridge, MA: MIT Press; H. Kasahara and J. Rodrigue. 2008. Does the Use of Imported Intermediates Increase Productivity? Plant-level Evidence. *Journal of Development Economics*. 87. pp. 106–118.

9 Melitz and Ottaviano.2007.; E. Helpman and P.R. Krugman. 1985. *Market Structure and Foreign Trade.* Cambridge, MA: MIT Press; Andrew B. Bernard, J. Bradford Jensen, and Peter K. Schott. 2006. Trade Costs, Firms, and Productivity. *Journal of Monetary Economics*,Vol. 53(No. 5): 917–37.

5.2 Methodology Adopted to Identify Export-Led Industrialization

Graphical plots of data are often used to indicate the nature of association between variables. However, it is now well-known that as many macroeconomic time series variables (such as exports and manufacturing output) are strongly trended (i.e., nonstationary data), no credible conclusions should be derived about their comovement based on the visual inspections alone. Ordinary least square regressions involving the nonstationary data are also of not much use to confirm a relationship statistically. To ascertain a valid long-run relationship (termed as cointegration), first the variables in question need to tested for unit roots to determine if they are stationary or nonstationary. In the event of their being nonstationary in nature, suitable cointegration tests then need to be performed.

There are several methods for testing unit roots. Having applied different tests as part of this empirical exercise, it is found that one single test would be enough for summarizing the main statistical results and deciding about the outcomes. This test is known as the Augmented Dickey Fuller (ADF) test, which remains the most popular method for assessing time series properties.[10] The test is carried out on both the level and first (and if required high order) difference of the variables. It is most common to find that macroeconomic time series data are nonstationary on their levels but stationary on their first or higher order differences. Following Engle and Granger a time series is said to be integrated of order d [usually denoted as ~I (d)] where d is the number of times the series needs to be differenced in order to become stationary.[11]

10 This test is based on the equation $\Delta Y_t = \tau + (\psi - 1)Y_{t-1} + \chi T + \delta \Delta Y_{t-1} + e_t$ where Y is the variable under consideration, Δ is the first difference operator, subscript t denotes time period, T is the time trend and e is the error term. The null hypothesis for this test is that $(\psi - 1) = 0$ (i.e., Y_t is nonstationary) against the alternative of $(\psi - 1) < 0$ (i.e., Y_t is stationary). The "t" test on the estimated coefficient of Y_{t-1} provides the ADF test for the presence of a unit root.?? However, the estimated t-ratios on $(\psi - 1)$ are nonstandard, requiring the computed test statistics to be compared with the corresponding critical values to infer about the stationarity of the variables. These critical values were first computed by Dickey and Fuller (1981). If the computed test statistics exceed the critical values, the null hypotheses underlying the ADF tests are rejected. Computed t-ratios and the corresponding critical values are compared on their absolute levels. These days many econometric software provide simulated critical values based on the model specifications, e.g., if the interest and/or trend term are included or not, and the number of observations.

11 Engle and Granger.1987.

Once it is determined that the variables in the model are nonstationary, the only way to infer about the long-run relationship is to employ some kind of cointegration technique. The most powerful and popular test in this respect is Johansen's Full Information Maximum Likelihood (FIML) procedure.[12] Johansen's cointegration test is used as a starting point in the vector auto regression (VAR) model. The vector auto regression model of order p (VAR (p)) is constructed as the following equation:

$\Delta yt = \Phi 0 + \Sigma \Gamma i \, \Delta yt\text{-}i + \Pi yt\text{-}1 + \varepsilon t$

where yt is a vector of variables in the model. Φ0 is the intercept vector and εt is a vector white noise process. The matrix of coefficients and information regarding the short-run relationships among the variables is denoted by Γi. On the other hand, the long-run information is contained in the matrix Π. If the rank of Π is r, where $r \leq n - 1$, then Π can be decomposed into two nxr matrices, α and β, such that $\Pi = \alpha\beta'$ where β is the matrix of cointegrating vectors; the elements of α are known as the adjustment parameters in the vector error correction model. The Johansen-Juselius procedure is based on the maximum likelihood estimation in a VAR model, and calculates two statistics—the trace statistic and the maximum Eigen value in order to test for the presence of r cointegrating vectors. Both these testing procedures consider the possibility of k-1 cointegrating vectors, where k is the number of endogenous variables in the specification.

One important advantage of the VAR system employed under the Johansen procedure is that it allows all variables to be considered as jointly determined (endogenous). Therefore, unlike the OLS regression techniques one does not need to define one variable as dependent and others as exogenous. This is particularly useful in our case as arguably export and manufacturing can be jointly endogenous.

However, there are some challenges associated with this method. First of all, the results from the Johansen procedure can be very sensitive to the choice of lag-length in the VAR system. Although there are statistical tests for choosing the appropriate

12 Johansen's.1988.

lag-lengths, in a small sample such tests may not be feasible. Use of lags involving all the variables in the model could significantly reduce the degrees of freedom. Moreover, a severe problem of collinearity may arise among the regressors when a considerable size of VAR is used. In the present case, this problem did not turn out to be a severe one. The use of annual data would imply that considering lag length beyond 2 was not necessary and initial experiments revealed that in an overwhelming majority of cases our cointegration test results were not sensitive to the choice of lag length between 1 and 2.[13]

When variables cointegrate, there must be at least one causality relationship involving the variables.[14] While the concept of causality has a strict statistical interpretation, it would be of interest to know, in addition to long-run association, if output increase in manufacturing can have causal effects on the export sector and vice-versa. The popular causality testing procedure (known as the Granger causality test) needs to be adapted to the integrated properties of the variables. Sims et al. show that if the variables are cointegrated of Order 1, Wald tests of Granger noncausality in levels VAR could be used based on the error-correction model.[15] However, Toda and Yamamoto provide a simpler statistical procedure to test for Granger causality involving nonstationary level variables.[16] In this section therefore we use the Toda-Yamamoto Granger causality test.

5.3 Empirical Results Identifying Export-Led Industrialization

An empirical exercise was undertaken by first conducting unit root tests for real exports and manufacturing value added, using logarithmic transformation of both the series, for Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka for the period 1970–2011. Because of lack of sufficiently long-time series data, Afghanistan had to be dropped from the exercise.

13 Hence, most results we report on Johansen procedure are based on one lag length.

14 C.W.J. Granger. 1988. Some Recent Developments in a Concept of Causality. *Journal of Econometrics*, Vol. 39 (No. 1) pp. 199-211.

15 C. A. Sims, J. H. Stock, and M. W. Watson, 1990. Inference in Linear Time Series Models with some Unit Roots. *Econometrica* Vol. 58 (No.1). pp. 113-144.

16 H.Y. Todo and T. Yamamoto. 1995. Statistical Inference in Vector Autoregressions with Possibly Integrated Processes. *Journal of Econometrics*, Vol. 66 (No.1). pp. 225-250.

Following the standard practice, prior to the application of the unit root tests, each data series was plotted on their level and first difference variables to determine if a linear trend term needs to be incorporated into the ADF regression equation. While the detailed statistical outputs are not reported here, the results as reported in Table 5.1 seem to confirm nonstationary variables of exports and manufacturing value added on their levels for all countries and stationarity of the growth rates of these variables (i.e., first difference of logarithmic transformations). Hence, the variable can be regarded as integrated of order one ~I(1). The empirical results associated with long-run relationship and causality tests differ across different countries.

Table 5.1: Unit Root Tests of the Variables

Variables	ADF test statistics		Variables	ADF test statistics		Conclusion
	Without trend	With trend		Without trend	With trend	
$BDGm_t$	2.4909	-0.3196	$\Delta BDGm_t$	-3.3054[a]	-4.7820[a]	$BDGm_t$ ~I(1)
$BDGx_t$	-3.8968[a]	-2.8256	$\Delta BDGx_t$	-3.0428[a]	-4.6395[a]	$BDGx_t$~I(1)
$BHUm_t$	-2.8956	-2.5298	$\Delta BHUm_t$	-3.4771[a]	-3.8044[a]	$BHUm_t$~I(1)
$BHUx_t$	2.7598	-1.0235	$\Delta BHUx_t$	-4.1784[a]	-4.7776[a]	$BHUx_t$~I(1)
$INDm_t$	2.8362	-0.8181	$\Delta INDm_t$	-4.3152[a]	-5.4735[a]	$INDm_t$~I(1)
$INDx_t$	1.9282[a]	-2.1181	$\Delta INDx_t$	-5.2709[a]	-6.6793[a]	$INDx_t$~I(1)
$MALm_t$	7.3929[a]	1.5256	$\Delta MALm_t$	-3.0932[a]	-3.5827[a]	$MALm_t$~I(1)
$MALx_t$	1.5263	2.2563	$\Delta MALx_t$	-3.2548[a]	-3.7893[a]	$MALx_t$~I(1)
$NEPm_t$	2.2693	1.8539	$\Delta NEPm_t$	-4.5782[a]	-4.2210[a]	$NEPm_t$~I(1)
$NEPx_t$	4.3925[a]	2.2536	$\Delta NEPx_t$	-3.5687[a]	-3.6693[a]	$NEPx_t$~I(1)
$PAKm_t$	2.2142	2.2225	$\Delta PAKm_t$	-4.5269[a]	-4.0123[a]	$PAKm_t$~I(1)
$PAKx_t$	1.5263	2.5478	$\Delta PAKx_t$	-3.6589[a]	-3.8923[a]	$PAKx_t$~I(1)
$SRLm_t$	-1.5623	-2.5369	$\Delta SRLm_t$	-4.2587[a]	-4.2222[a]	$SRLm_t$~I(1)
$SRLx_t$	-2.3668	-2.1763	$\Delta SRLx_t$	-3.789[a]	-4.2356[a]	$SRLx_t$~I(1)

Note: BDG, BHU, IND, MAL, NEP, MAL, PAK, and SRL are for respectively Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka; m_t and x_t represent logarithmic transformation of manufacturing value added and export receipts; Δindicates first different of the relevant variables. The 95% simulated critical value using the corresponding sample size and 1,000 replications for the level variables without trend is -2.8607 and for models with trend is -3.6589. For first differenced variables, the comparable critical values are slightly different: -2.8738 and -3.5273 for models without and with the trend, respectively.

[a] indicates the rejection of null-hypothesis (i.e., the variable is nonstationary). All variables on their levels are strongly trended and the ADF test with the trend term included is to be considered most appropriate in which none

of the variables can reject the null hypothesis. All variables on their first difference reject the null-hypothesis of nonstationarity under the ADF test without trend. This is the most appropriate testing equation for growth rates (over a sufficiently long period of time, growth of any of these variables is unlikely to be trended) in which case we can conclude that all first difference variables are stationary.

5.3.1 Bangladesh: Case of Export-Led Industrialization

In the case of Bangladesh, the empirical results support the hypothesis of an export-led industrialization. The Johansen tests provides very strong evidence of cointegration and positive association between exports (X) and manufacturing output (M). These results hold irrespective of the lag lengths considered (either 1 or 2) and procedure involved (i.e., either maximal eigen value or trade tests). The confirmation about cointegration would necessitate at least one causality direction.

The Toda-Yamamoto Granger causality test results suggest that while one can reject the causality effect running from manufacturing to exports, the reverse causality cannot be rejected at the conventional 95% confidence level. *That is, it is the growth of the export sector that has caused the growth of manufacturing output.* Since the early 1980s, Bangladesh's economy has witnessed a significant structural transformation that has resulted in the rapid rise of an export-oriented apparel sector. Until the mid-1980s, the country's export basket was overwhelmingly dominated by primary exports such as jute, tea, and fish and fish products. Over the next two decades the manufacturing exports (mainly apparels but later other products such pharmaceuticals, small engineering items, etc.) grew rapidly to capture a share of more than 90% of exports. These export-oriented sectors have also contributed to an overall expansion in the manufacturing output. Therefore, the statistical results are very much consistent with the country's well-documented structural transformation experiences.[17]

17 e.g.,Razzaque et al.2008.

5.3.2 Bhutan: No Evidence of Export-Led Industrialization

For Bhutan, there was no evidence of any valid long-run relationship between exports and manufacturing activities. Bhutan exports mainly primary commodities and the co-movement in manufacturing output and exports is likely to be weak. Even in the absence of a valid long-run relationship it is possible to find short-run causality effects. And, out results indicate bi-directional causality effects. This suggests that despite not having a long-run relationship between export and manufacturing, short-run growth activities exert causality effects in both directions.

5.3.3 India: No Evidence of Export-Led Industrialization

Interesting results are found for India which is the largest and most dynamic country in the set. The results depict no cointegrating relationship between export and manufacturing activities. Since the 1960s, the relative significance of the manufacturing sector in India's overall GDP has stagnated around 15% while the share of such exports in total merchandise exports has seen a roller-coaster ride—first doubling from close to 40% in the early 1960s to about 80% in the late 1990s before falling to just about 60% in recent years. The services sectors have played an important role in the country's export and overall output growth and composition. In the light of these stylized facts, the statistical finding involving the relationship between exports and manufacturing output seems to be plausible. For India the testable hypothesis that exports does not Granger cause manufacturing output cannot be rejected while the hypothesis of manufacturing not causing export growth is strongly rejected.

Similar results with respect to export-led industrialization is also found by Banga and Das [18], who using similar cointegration analysis arrive at the conclusion that "*the relationship between output growth and export growth runs from 'output growth → export growth' and not the other way around."* Higher growth in manufacturing output leads

18 R. Banga and A. Das, eds. 2012. *Twenty Years of India's Liberalization: Experiences and Lessons*. UNCTAD (See more at: http://unctad.org/en/publicationslibrary/osg2012d1_en.pdf).

to higher exports. They also find that higher growth of domestic output or "output net of exports" causes higher exports. This can be the case if more and more firms explore international markets with the growth of their output. The growing diversity of the export basket may be the result of this output growth. The unidirectional causality effect has thus interesting policy implications: support provided to the manufacturing sector would cause export growth. However, in the absence of any long-run relationship, these causality effects are short-term in nature.

5.3.4 Maldives and Nepal: No Evidence of Export-Led Industrialization

Although low export orientation and slower growth in the export sector of a country with a big domestic market (e.g., India, and to some extent also Bangladesh and Pakistan) may not be a major impediment to its overall economic growth as long as the non-export sector flourishes, a robust performance by the export sector is often considered to be central to the acceleration of the growth process. Just like small economies, a greater degree of export-orientation in low-income large countries is likely to generate several advantages. First, being directed at world markets, the low purchasing power of domestic consumers cannot act as a hindrance to the exploitation of economies of scale in export production. Second, export activities require a relatively nondistortionary policy environment, which promotes efficiency and discourages unproductive rent-seeking activities. Moreover, when exports grow in line with the static comparative advantage of the economy, any reallocation of resources from the non-export to the export sector increases total factor productivity, which, in turn, raises the GDP.

It is also argued that the export sector generates positive externalities in the non-export sector through more efficient management styles, skill accumulation by labor, and improved production techniques. With a bigger non-export sector, the accrued benefits could be quite substantial for the overall economy. Apart from these, the expansion of export activities facilitates the import of capital goods and encourages technology transfer. For these

reasons, a strategy of export-led industrialization is supposed to achieve both the objectives of greater export orientation in the economy and overall economic growth.

However, for small economies of South Asia, especially, Maldives and Nepal, there seems to be no evidence of export-led industrialization.

For Maldives, the cointegration tests do not support a long-run relationship between the two sectors of our interest. There is also no evidence of causality from either direction. Only about 7% of Maldives' GDP is due to manufacturing activities, and in recent times the share of such exports in total exports has fallen drastically. The significance of the services sector is very high—currently at 80% of the GDP. Given the low manufacturing activity, and high dependence on service-oriented exports (such as tourism), the relationship between exports and manufacturing is unlikely to be strong.

Turning to Nepal, which has a relatively small manufacturing sector measured at only about 6% of GDP, the evidence of cointegration between export and manufacturing is again quite weak. With a VAR lag length of 1 order, Johansen's maximal eigen value test rejects the null hypothesis of non-cointegration but the trace test fails to reject the same. When VAR lag order is increased to 2, there is no support for cointegration in either test. Significant short-run causality effects are not found in any direction although the effect running from manufacturing to exports can be significant only at a lower probability level (i.e., at the 11% level as against the conventional 5% level).

5.3.5 Pakistan and Sri Lanka: No Evidence of Export-led Industrialization

In the case of Pakistan too, the movements in manufacturing and export activities cannot be linked to a long-run relationship. The evidence is not sensitive to the choice of VAR lag lengths and the particularly type of test (i.e., either maximal eigen value and trace tests) is being considered. These results are truly interesting as almost 19% of Pakistan's GDP and more than 70% of its merchandise exports are due to the manufacturing sector. Nevertheless, the

Table 5.2: A Summary of Toda-Yamamato Granger Causality Results

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Testing for exclusion of exports ln(X) (VAR Block Erogeneity Wald Tests)							
Computed Chi-squared	11.14	8.44	2.22	1.12	1.62	0.28	1.24
Probability	0.0038	0.0147	0.3281	0.5699	0.4439	0.8660	0.5360
Conclusion	Noncausality of exports cannot be rejected	Noncausality of exports cannot be rejected	Noncausality of exports cannot be rejected	Noncausality of exports cannot be rejected	Noncausality of exports cannot be rejected	Noncausality of exports cannot be rejected	Noncausality of exports cannot be rejected
Testing for exclusion of manufacturing output ln(M) (VAR Block Exogeniety Wald Tests)							
Computed Chi-squared	2.51	7.72	5.33	1.44	4.47	0.99	1.05
Probability	0.7764	0.021	0.0693	0.4853	0.1067	0.6094	0.5863
Conclusion	Noncausality of manufacturing cannot be rejected	Noncausality of manufacturing is rejected	Noncausality of manufacturing is rejected	Noncausality of manufacturing cannot be rejected	Noncausality of manufacturing cannot be rejected	Noncausality of manufacturing cannot be rejected	Noncausality of manufacturing cannot be rejected

long-run relationship cannot be established statistically. Also, the Toda-Yamamoto tests fail to reject any noncausality effects.

The results found for Sri Lanka are qualitatively identical to those for Pakistan. There is no cointegration between exports and manufacturing activities and there are no causality effects. The share of manufacturing in Sri Lanka's exports and GDP is also comparable to that in Pakistan. It could be that for both countries primary and services sector activities significantly but differently influence the manufacturing and export sectors.

5.4. Conclusion

As can be inferred from the previous chapters, the trade policy stance in individual South Asian countries made a shift from an inward-looking industrialization approach to an outward-oriented export-promotion strategy. The underlying objective behind this policy switch was to trigger the transformation of the productive structure of the economy in such a way that export growth is accelerated paving the way for sustained overall growth. The strategy is essentially influenced by the so-called ELG paradigm that postulates exports to be an "engine" of economic growth. For relatively small economies, e.g., when measured in terms of population size such as Bhutan, Maldives, and Sri Lanka, the role of exports cannot be overemphasized. Without taking advantage of the global markets, most of the firms in these countries would continue to operate as small and medium size enterprises with limited opportunities for reaping the benefits of economies of scale resulting in weak competitiveness. Lack of trade openness can easily generate weak competitive pressure in the product markets of small economies causing greater inefficiencies in production with adverse growth implications.

The effectiveness of policy reforms and resultant implications has always drawn a lot of attention. In each of the South Asian countries, the impact of policy reforms on the export sector performance has been the subject matter of intense policy debate and discussion. What however has not been given adequate

consideration is the impact on manufacturing activity and its relationship to exports. This is particularly important as all South Asian countries have aimed to diversify their production base by expanding their manufacturing activities. Therefore, one important question is if export-led growth focus has been necessarily linked to manufacturing capacity expansion and vice-versa.

The empirical results of this chapter show that only in the case of Bangladesh exports appear to have led to industrialization. Real exports and manufacturing output are found to be cointegrated and have a long-run relationship with the causality running from exports to manufacturing output. However, no other country yields any evidence to support export-led industrialization. While in small economies where the manufacturing sector contributes a small share in total GDP, this may not be expected, for example, in the case of Nepal and Maldives, in other economies like Sri Lanka and Pakistan this result emphasizes the need to focus more on industrial policies rather than trade policies. In the case of India again, the results show no evidence of export-led industrialization which is plausible given its large domestic market.

6

Development Impact of Bilateral Trade and Investment Agreements with India

6.1 Introduction

India emerged as one of the fastest growing economies in the world in the first decade of the 21st century. The phenomenal growth of India and its conc growing market size provides new opportunities for trade and investments in the region. Economic theory suggests that the presence of a faster growing economy in the region can act as a "growth pole" for the region and lead to substantive growth spillovers.[1] However, for a country to act as a growth pole for the region, it needs to be considerably integrated with the region. Banga estimates the extent to which India's growth is co-integrated with the growth of other countries of the region and finds that it is limited.[2] India's growth is found to be interlinked with the growth of only two countries in the region, i.e., Bangladesh and Bhutan.

In an attempt to improve its integration with the region, India announced the LDC package in November 2011, which included

1 F. Perroux. 1988. The Pole of Development's New Place in a General Theory of Economic Activity. In B. Higgins and D. Savoie, eds. 1988. *Regional Economic Development: Essays in Honour of Francois Perroux*. Boston. pp. 48–76; J. Friedman. 1972. A General Theory of Polarized Development. In N.M. Hansen, ed. *Growth Centers in Regional Economic Development*. New York: Free Press.

2 R. Banga. 2013. Has South Asia Benefitted from the Growth of India? In M.A. Razzaque and Y. Basnett, eds *Regional Integration in South Asia Trends, Challenges, and Prospects*. Commonwealth Secretariat: London.

exemption of all goods (barring a few products like wines, spirits, and, tobacco and tobacco products) from customs duties when imported into India from LDCs of the region, provided that the good originates in the exporting country. Apart from being an active member of SAFTA, India also signed bilateral FTAs with Sri Lanka (which came into operation in 2000) and the Bilateral Investment Protection and Promotion Agreement (BIPPA) and Double Tax Avoidance Agreement (DTAA) with Nepal in October 2011. It would be helpful, therefore, to review the development impact of the Indo-Sri Lanka FTA on the Sri Lankan economy and that of Indian investments on Nepal's economy, in an attempt to derive policy directions with respect to intra-regional trade and investment policies.

6.2 Brief Review of Existing Literature on "Growth Poles"

The theory of growth poles leading to regional development dates back to the 1950s when Perroux put forward his theory of active units which assumed that under certain conditions actors have the capacity to change their environment.[3] Perroux argued that the poles of development, which are centers of the most intense activity, could produce polarization in leading sectors determined by proximity in economic space resulting in growth in the corresponding close sectors. Friedman applied these ideas to physical space as opposed to economic space to arrive at the much discussed "core-periphery model."[4] Since then there has been much interest generated in the regional growth models, which have been based on the fundamental condition of geographical proximity.

In his Nobel lecture, Arthur Lewis argued that if growth in the North slowed down sharply due to some reasons then to sustain the growth of the South, South-South trade could be an important

3 F. Perroux. 1950. Economic Space: Theory and Application. *Quarterly Journal of Economics* 64. pp. 89–104; F. Perroux. 1970. Note on the Concept of Growth Poles in D. McKee, RD. Dean and WH. Leahy, eds. *Regional Economics: Theory and Practice*. New York: The Free Press. pp. 93–104; F. Perroux. 1988. The Pole of Development's New Place in a General Theory of Economic Activity. In B. Higgins and D. Savoie, eds. 1988. *Regional Economic Development: Essays in Honour of Francois Perroux*. London: Routledge pp. 48–76. G. Pursell. 2011. Trade Policies.

4 J. Friedmann. 1966. *Regional Development Policy*: A Case Study of Venezuela. London: MIT Press; J. Friedmann. 1972. A General Theory of Polarized Development. In N.M. Hansen, ed. *Growth Centers in Regional Economic Development*. New York: Free Press.

instrument.[5] The growing markets in some countries of the South could generate demand for the South and fill the gap left by contracting markets in the North. Based on this, many studies have argued that with their expanding markets, the People's Republic of China (PRC) and India, the two Asian Emerging Economies, can play the role of growth poles for other developing countries of Asia.[6] However, while the above theories around growth poles have greatly enhanced our understanding of regional development, they have not always been supported by empirical evidence, as very little empirical evidence exists with respect to linkages between growth rates of Emerging Economies and those of other developing countries. Reisen finds that a slowdown of one percentage point in PRC's growth would reduce the growth rate of low-income countries by 0.56% and that of middle income countries by 0.36% for the period 1990–2009.[7]

Banga and Kumar look at the growth linkages between developing Asia and the two Asian Emerging Economies in terms of cointegration and causation in their growth rates.[8] They put both short-term and long-term relationships between the growth of PRC and India and that of developing countries of Asia for the period 1970–2009 to the test. They further examine whether these countries can provide a market for the South. The results show that while PRC has acted as a growth driver for developing Asia, no empirical evidence of this is found for India. Banga estimates the growth linkages between India and other South Asian countries using the cointegration analysis for the period 1970–2009 and finds limited evidence of India's growth spillovers.[9] The only relationship that is found between India's growth and that of other countries' growth in the region is with Bangladesh and Bhutan. The analysis provides some vital leads in understanding the complex issue

5 A. W. Lewis. 1979. The Dual Economy Revisited. *The Manchester School.* 47 (3). pp. 211–229.

6 R. Kaplinsky and D. Messner. 2008. Introduction: The Impact of Asian Drivers on the Developing World. *World Development.* 36 (2). pp. 197–209; Jenkins et al. 2008. The Impact of PRC on Latin America and the Caribbean. *World Development.* 36 (2). pp. 235–253.

7 Helmut Reisen. 2010. Global Imbalances, the Renminbi, and Poor-Country Growth. http://www.VoxEU.org.

8 Footnote 8, Chapter 4.

9 R. Banga. 2013. Has South Asia Benefitted from the Growth of India? In M.A. Razzaque and Y. Basnett, eds. *Regional Integration in South Asia: Trends, Challenges*, and Prospects. Commonwealth Secretariat: London.

of growth spillovers in the region. The existence of fast growing economies within the region may not necessarily lead to regional growth. It is not the "extent of trade and investments" with faster growing economies which matters, but rather "what is being traded and where the investments go." The composition of trade and investments determines the extent of growth linkages that may emerge in the short term as well as in the long term. The more integrated the economies are in each other's supply chains by exporting inputs to each other, the higher the growth linkages.

6.3. Impact of Indo-Sri Lanka FTA on Industrial Growth of Sri Lanka[10]

The India-Sri Lanka Free Trade Agreement (ISLFTA) was signed in December 1998 and was among the first attempts to promote trade liberalization in South Asia. It was India's first bilateral free trade agreement and resulted in substantial growth in trade between the two countries after becoming operational in March 2000.

6.3.1 Indo-Sri Lanka FTA Negotiations and Special and Differential Treatment under the ISLFTA

To begin with, ISLFTA entails different levels of commitments by Sri Lanka and India. By 2000, under ISLFTA, India had committed to a 100% tariff cut for 1,351 items. By March 2003, India had concluded a tariff phase out for 2,797 items, with these items having 100% preference.[11] This was conducted in two stages, with the applicable tariffs reaching zero by the end of the phase out. India's commitments also included a tariff rate quota for tea, reaching 50% preferential market access by 2000 with an MFN rate being applied to an amount of 15 million kg per year. Garments also enjoyed a 50% preferential market access for a volume of 8 million pieces, of which a minimum of 6 million pieces must contain Indian fabric. The negotiation process yielded the requirement that no category

10 Saman Kelegama and Chandana Karunaratne. 2013. Experiences of Sri Lanka in the Sri Lanka - India FTA and the Sri Lanka - Pakistan FTA. Background paper for the UNCTAD on Regional Value Chains. http://unctad.org/en/PublicationsLibrary/ecidc2013misc1_bp10.pdf

11 Yatawara Ravindra A. 2007. Exploiting Sri Lanka's Free Trade Agreements with India and Pakistan: An Exporter's Perspective. *South Asia Economic Journal*. Sage Publications.

of garments can go beyond an amount of 1.5 million pieces a year. A Margin of Preference (MOP) was applied to textiles, which enjoyed a 25% preferential duty margin for 553 textile products without any limit on quantity. The negative list includes 429 items, including 231 garment items. India's Rules of Origin (ROO) are such that items must have 35% domestic value added or 25% Sri Lankan value added if using 10% Indian inputs.

Sri Lanka's commitments to India were different under the FTA. Sri Lanka committed to a 100% tariff cut for 319 items (6-digit HS code) by March 2000, and implemented a tariff phase-out in the following manner: in March 2000, Sri Lanka committed to a 50% reduction on 889 items, followed by a 70% reduction in 2001, a 90% reduction in 2003, and a 100% reduction (implying duty-free status) in 2006. By March 2003, the remaining 2,779 items would experience a reduction of at least 35%, followed by a reduction of at least 70% in 2006, and a reduction of at least 100% by 2008. Sri Lanka's Negative List includes 1,220 items, and its Rules of Origin state that 35% of the items must be domestic value added or 25% Indian value added if using 10% Sri Lankan inputs.

In an analysis[12] conducted in 2007 of Sri Lanka's trade with India, specific items were allocated a number of preference points based on competitive advantage. The analysis uncovered that 100 preference points (the maximum number possible) were awarded each to sunflower seed, peanut and palm oil, sugar, coffee, wheat, sausages, motorcycles, and motor cars. However, out of these nine products, only sausages, palm oil, and vegetable oil were exported to India. The analysis also examined the value of these preferred items and concluded that the only items worth more than $1 million of exports were cloves, pepper, palm oil, and cardamom, which as of 2005, contributed the following in terms of exports to India: $16.50million, $10.79million, $5.21million, $3.72million.

Considering the substantial asymmetry between the economies of the two countries, key allowances were made to help Sri Lanka. Among them, a more extensive negative list was created for Sri

12 Yatawara Ravindra A. 2007. Exploiting Sri Lanka's Free Trade Agreements with India and Pakistan: An Exporter's Perspective. *South Asia Economic Journal*. Sage Publications. .

Lanka to help its economy protect its most sensitive industries, including agriculture and livestock items, rubber products, paper products, iron and steel, machinery, and electrical items. Sri Lanka's negative list features 1,180 items (or tariff lines), whereas India's numbers only 429 items. India's negative list includes those items which are most sensitive to its own industries, including garments, plastic, and rubber products.

In addition, Sri Lanka was granted a much longer period for liberalization of its tariff lines, as shown in Table 6.1. A period of eight years was given to Sri Lanka to phase out its tariffs, while India was given a period of only three years to do the same. Obligations regarding duty concessions for Sri Lanka were split into three stages, with 35% at the time of implementation of the agreement, 70% in 2006, and 100% in 2008. India, on the other hand, was to grant 100% of its duty concessions in 2003.[13]

Table 6.1: Tariff Phasing Out Period and Duty Concessions

Tariff Phasing Out List	Period	Duty Concession		
India	3 years	100% in March 2003		
Sri Lanka	8 years	35% At present	70% in March 2006	100% in March 2008

Source: Board of Investment of Sri Lanka, "Services Provided by BOI: Indo-Sri Lanka FTA," available [http://www.investsrilanka.com/international_agreement/indo_sri_lanka_fta_agreement.html#1.3].

Further, the ROO criteria are more flexible for Sri Lanka. Items that are produced entirely from local sources, such as tea, fish, and certain spices,[14] are permitted duty-free concessions as long as they are not on India's negative list.

13 Services Provided by BOI: Indo-Sri Lanka FTA. *Board of Investment of Sri Lanka*. http://www.investsrilanka.com/international_agreement/indo_sri_lanka_fta_agreement.html#1.3

14 Nonetheless, pepper has been a contentious item that has seen Indian authorities demanding a cap on imports to 2,000 metric tonnes per annum, down from the 6,000 metric tonnes per annum that were being shipped from Sri Lanka to India in 2007.Kelegama and Mukherji. India-Sri Lanka Bilateral Free Trade Agreement. 2007.

6.3.2 Impact on Sri Lanka's Trade

Following the 100% tariff reduction in March 2003, which translated into complete free trade for 2,797 items, trade between the two countries surged. Sri Lanka's exports enjoyed an increase of 107% from $245 million in 2003 to $506 million in 2006. However, this growth came primarily from a handful of items, including animal fats, vegetable oils, copper and aluminum products, and pharmaceuticals, contributing 77% of the surge in exports. If one were to examine the top five exports and imports from Sri Lanka to India for 1999 (the year immediately before the implementation of the agreement), 2005 (two years after India implemented full liberalization), and 2011 (the year for which the latest data was available), it is found that in 2005, following the year the ISLFTA was put into operation, vegetable fats and oils were the prime export, followed by copper products and pharmaceutical goods (Table 6.2). One reason why vegetable oils were such a key export in 2005 may be due to the high quantity of exports of Vanaspati, a type of vegetable oil, for which tariff concessions were made under the ISLFTA. The top five imports from India for the same years were petroleum products and motor vehicles (Table 6.3). This is potentially due to the tariff concessions made in the ISLFTA that promoted the imports of these items.

Table 6.2: Top 5 Exports to India from Sri Lanka

1999		2005		2011	
Product	**Value (SL Rupees)**	**Product**	**Value (SL Rupees)**	**Product**	**Value (SL Rupees)**
Whole pepper	695 million	Vegetable fats and oils	12 billion	Animal feed	5.2 billion
Areca nuts	382 million	Refined copper and copper alloys	7.9 billion	Insulated wires & cables	4.7 billion
Scrap iron	272 million	Copper wire	4.1 billion	Cloves	3.8 billion
Dried fruit	214 million	Aluminum wire	3.1 billion	Waste & scrap paper	3.2 billion
Cloves	199 million	Antibiotics	2.2 billion	Garments	3.2 billion

Source: Calculated using data from the Department of Commerce, Sri Lanka

Table 6.3: Top 5 Imports from India into Sri Lanka

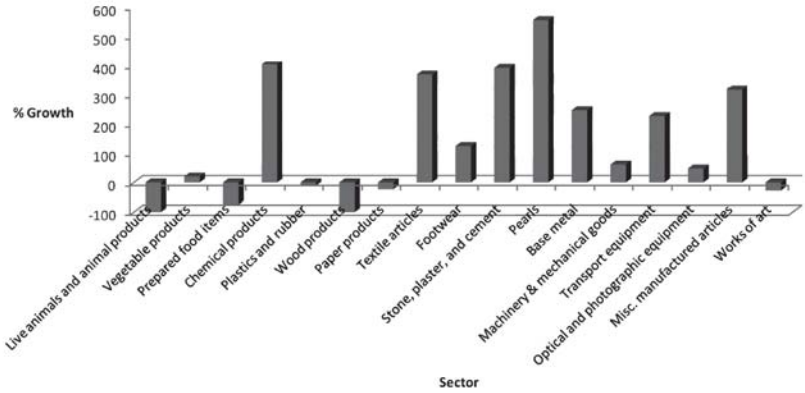
1999		2005		2011	
Product	**Value (SL Rupees)**	**Product**	**Value (SL Rupees)**	**Product**	**Value (SL Rupees)**
Lentils	2.1 billion	Refined petroleum oil	16 billion	Gas oil and diesel	47 billion
Ayurvedic medicine	1.4 billion	Motorcycles	8 billion	White cane sugar	35 billion
Motor cars	1.3 billion	Motor cars	6.3 billion	Petrol	32 billion
Milled rice	1.3 billion	Medicaments	5.3 billion	Motorcycles	19 billion
Pepper	1.2 billion	Crude petroleum oil	4.1 billion	Auto-trishaws	18.8 billion

Source: Calculated using data from the Department of Commerce, Sri Lanka

The case of vanaspati (a type of vegetable oil) exports from Sri Lanka sparked some controversy, as it was established that Indian investors were setting up processing plants in Sri Lanka which were converting imported crude palm oil into vanaspati and then exporting this to India, in order to avoid the 80% Indian tariff rate on the product (whereas Sri Lankan tariffs amounted to only 15%). Processing palm oil into vanaspati in Sri Lanka made further financial sense to these Indian exporters because the product enjoyed a zero duty rate under the ISLFTA.

The sectoral analysis of percentage growth of Sri Lanka's exports from 2000–2001 to 2001–2002 is reported in Figure 6.1. Most sectors experienced growth above 100%, with industries such as chemical product manufacturing, cement manufacturing, and pearl harvesting achieving above 300% growth. Nonetheless, several industries did suffer negative growth, including the export of live animals and animal products, prepared food items, and wood products, which contracted by 100%, 75%, and 100% respectively. Among Sri Lanka's key exports, textile articles grew noticeably by 370% in the same period.

Figure 6.1: Impact of ISLFTA on Sri Lankan Exports to India (2000–2001 to 2001–2002)



Source: Mukherji, Indra Nath, Tilani Jayawardhana, and Saman Kelegama, 2002, Indo-Sri Lanka Free Trade Agreement: An Assessment of Potential and Impact. (See more at: http://www.saneinetwork.net/Files/03_02.pdf)

Tariff concessions under these ROO rules, along with other concessions offered under the ISLFTA, have encouraged several key industries in Sri Lanka. Some industries that were already established prior to the ISLFTA, such as the processing of spices and manufacturing of garments, experienced a surge in exports to India. Sri Lanka's exports to India of cloves experienced almost a 20-fold increase from 1999 to 2011, from LKR 199 million to LKR 3.8 billion.[15] Garments export, which has risen in prominence in terms of exports to India and was among Sri Lanka's top five exports to the country as of 2011, recorded a value of LKR 3.2 billion of exports to India in 2011.[16]

Interestingly, industries which were not particularly well-established prior to the ISLFTA have also experienced a surge in growth. The export of animal feed, insulated wires and cables, and waste and scrap paper were among the top five exports to India as of 2011 and recorded an export revenue of LKR 5.2 billion, 4.7 billion, and 3.2 billion in 2011 respectively.[17]

15 Calculated using data from the Department of Commerce, Sri Lanka.
16 Footnote 15.
17 Footnote 15.

It is argued that despite exporting 3,173 products (6-digit HS level) around the world, Sri Lanka exports only 887 products to India. Yatawara shows that Sri Lanka exports only 121 "High Preference Point goods" to India while exporting 578 items of the same preference globally.[18] Yatawara argues that, while Sri Lanka has the capacity to produce these "High Preference Point" products, it has yet to fully exploit the Indian market.[19] Sri Lanka's top 50 exports to India in 2005 ranked by value consist of copper products, animal fats, vegetable oils, aluminum, pharmaceuticals, cloves, pepper, nutmeg, scrap metal and paper, diamonds, rubber products, tea, wall tiles, wooden furniture, and white goods such as air conditioners and refrigerators.

6.3.3 Impact of ISLFTA on FDI from India

That bilateral FTAs can lead to higher bilateral FDIs is a well-established fact. From 1978 to 1995, India contributed a mere 1.2% of total FDI in Sri Lanka, whereas after the implementation of the ISLFTA, foreign investment from India rose significantly and has reached a point where India is currently Sri Lanka's second biggest foreign investor.[20] From 1998 to 2008, the value of these investments jumped from $1.4 million to $125.9 million, contributing to 14% of the total foreign direct investment in Sri Lanka.[21] Furthermore, 63% of these Indian investments have been in the services sector, an area which has seen a significant expansion following the implementation of the ISLFTA. Companies such as Bharti Airtel, Apollo Hospitals, Lanka Oil Company, Taj Hotels, and Jet Airways have contributed to the 70 Indian investment projects that had been set up in Sri Lanka as of 2007, and which were employing 6,747 people at the time. Several Sri Lankan IT companies have ventured into the Indian market, providing internet-related services (as in

18 Yatawara. 2007.
19 Footnote 18.
20 S. Kelegama. 2009. India-Sri Lanka Bilateral Free Trade Agreement: Sri Lankan Perspective and Implications. Presentation to the Asian Regional Workshop on Free Trade Agreements: Towards Inclusive Trade Policies in Post-Crisis Asia jointly organized by IDEAS, GSEI, & ITD. Bangkok. 8-9 December.networkideas.org/ideasact/dec09/ppt/Saman_Kelegama.ppt
21 Devan Daniel. Indo-Lanka FTA is 10 Years Old. *The Island Online*.http://www.island.lk/2010/03/15/business1.html

the case of Inter-blocks providing services to Indian banks) and mobile phone services (as in the case of Micro image providing Tamil sms services to Airtel). Tourism companies based in Sri Lanka, including Aitken Spence and Jetwing, have begun operations in India.[22]

The ISLFTA has also led to better connectivity with India, resulting in an expansion in the number of flights and tourist arrivals from the northern neighbor. As of 2011, the Department of Immigration and Emigration of Sri Lanka registered 171,374 arrivals from India, translating to 20% of all tourist arrivals and over 50% of tourists from Asia for 2011.[23] Furthermore, this improved connectivity with India through the expansion of airline services has led to an increase of 64% of tourist arrivals from India from 2004.[24]

Nonetheless, the development-oriented impact of the ISLFTA appears to have been fairly limited. Despite Indian investment in Sri Lanka increasing substantially following the inception of the Agreement, there has not been a proportionate generation of employment in Sri Lanka. Despite the Board of Investment (BOI) of Sri Lanka reporting the creation of 5,900 jobs as a result of Indian investment between1993 and 2007, many of these jobs were simply reallocations of previously existing jobs. For example, 1,500 employees of the Ceylon Petroleum Corporation were transferred to retail outlets of Indian oil firms. Rather than the generation of new jobs, this was more an exercise in the reallocation of labor.

But it has been reported that vanaspati processing offered limited benefits and did not offer large-scale employment to Sri Lankans. Following protests by vanaspati manufacturers in India who complained about the Sri Lankan product flooding their markets, the Indian government imposed a quota and a canalization policy on this import, leading to many of the vanaspati manufacturers in Sri Lanka shutting down. During such closure, it was estimated that close to 4,000 jobs were at stake.[25]

22 Footnote 21.
23 Annual Report. 2011. Central Bank of Sri Lanka.
24 Footnote 22.
25 S. Kelegama and Indra Nath Mukherji. 2007. India Sri Lanka Bilateral Free Trade Agreement: Six Years Performance and Beyond. RIS Discussion Papers. New Delhi: RIS.

However, a rigorous analysis of the impact of the ISFTA on job creation in Sri Lanka has not been conducted. Questions regarding the number of overall jobs created and lost; the new jobs created as a result of the loss of other jobs; whether Sri Lankans or Indians were the primary beneficiaries of this employment generation; and the types and quality of employment arising from the Agreement have not been answered by existing literature on the ISLFTA.

6.4 Development Impact of Indian FDI in Agro-Processing Sector in Nepal[26]

6.4.1 Importance of FDI in Agro-Processing Industries

Despite the vital significance of the agricultural sector for the livelihoods of billions of people across the developing world, the global flow of FDIs leaves this sector relatively untouched because they flow mostly in services, manufacturing and "extractive" industries. In the case of Nepal, the manufacturing sector still accounts for a significant portion of FDIs, and agriculture accounts for a meager 1% of the cumulative FDI approved between 1998–99 and 2010–2011 (see Figure 6.2).This shows that the significance of the foreign investment in contributing to agricultural growth, which helps in achieving the first goal of the Millennium Development Goals (i.e., alleviating poverty and hunger) is under-appreciated. Attracting FDI in this sector may help resource- and technology-starved LDCs such as Nepal to move up the value chain ladder toward achieving gradual structural transformation.

The salience of the agricultural sector for the Nepalese economy and the need to promote this sector cannot be underestimated due to several reasons. First, the share of agriculture in the national gross domestic product (GDP) has recently increased to 35% after declining ever since the onset of industrial development in the country.[27] Of late, due to the relatively better performance of

26 Ratnakar Adhikari. 2013. Indian Foreign Direct Investment in Agro-processing Industry in Nepal A case study of Dabur Nepal Pvt. Ltd. Background Paper for UNCTAD on Regional Value Chains. http://unctad.org/en/PublicationsLibrary/ecidc2013misc1_bp9.pdf

27 MoF.2012.

the agricultural sector and the deteriorating performance of the manufacturing sector, the agricultural sector is becoming more important for the Nepalese economy. Another related issue is that two-thirds of the economically active population of the country is engaged in the agricultural sector for their livelihoods. Most agriculture households in rural areas are smallholders[28] practising subsistence farming with only a small portion of farms using modern production methods and technologies.[29] Since poverty in rural areas is much higher (35%) than in urban areas (10%), the objective of inclusive economic growth, which the Government of Nepal appears to be promoting—particularly after the end of internal conflict—can be achieved only through the development of the agricultural sector. Indeed, as argued by Sharma, the central challenge for poverty and inequality reduction is to increase agricultural growth by shoring up investment in the sector.[30]

Second, due to the agro-climatic variations Nepal offers prospects for diverse agricultural practices.[31] In a recent paper prepared for the South Asian Analysis Group, Jha notes that Nepal being a unique country having all three natural features—plains (Terai), hills, and mountains, many plants or crops grown in any part of the world could be produced in the country.[32] Citing the example of DNPL, which has already been "reaping dividends from investment" in this sector, he makes a strong case for attracting investment in the agricultural and herbal sector. This could be one of the reasons for viewing agriculture as a sector in which Nepal has a comparative advantage (besides hydro-electricity and tourism). This is proven by the fact that 10out of 14 products enlisted by the Trade Policy 2009 as "thrust areas" and seven out of 12 products identified for export expansion by the Nepal Trade Integration Strategy 2010 are agricultural products.[33]

28 About 45% of the farming households have less than 0.5 hectares (ha) of land and are amongst the poorest. See Ansab 2011.
29 Footnote 147.
30 Sharma. 2009.
31 Samriddi. 2011.
32 Jha. 2012.
33 This document, prepared as a part of the Diagnostic Trade Integration Strategy (DTIS) under the Enhanced Integrated Framework (EIF), is considered the blueprint for the expansion and diversification of Nepalese exports.

Third, of all the sectors in which FDI has been attracted, agriculture is the sector in which the development spin-off measured by the twin criteria of domestic value addition and employment opportunities is the highest. While investment in manufacturing or services sectors should also be promoted because they provide reasonable employment opportunities and help in the structural transformation of the country, it is the FDI in the agriculture sector which contributes most to the inclusive development of the country. One can discuss this with the examples of readymade garment and orthodox tea. While the former uses, on an average, more than 60% imported inputs and often fails to meet the value added criteria for being eligible to export under the Generalized System of Preferences scheme or free trade agreement, almost 100% value addition takes places in the country in the case of tea (except for packaging materials for which foreign inputs may have been used).

Moreover, employment in the garment sector (which otherwise provides decent employment potential due to the labor-intensive nature of the production process) pales in significance while compared to the orthodox tea sector. This is because in the garment sector the employment is generated only in the processing stage (cutting, sewing, ironing, packing, and exporting), while in the tea sector employment is provided from the very beginning of the process (cloning of plants, plantation, application of organic manure, harvesting, drying, blending and packaging). Orthodox tea, as opposed to conventional cut, trimmed, and curled (CTC) tea, provides an even higher share of employment opportunities, primarily because 67% of all the producers of the former sector are smallholder farmers, while the remainder is produced by organized tea states.[34] This means that the contribution of orthodox tea in helping the government achieve the objectives of inclusive growth is much higher than that of the garment sector, or any other manufacturing sector for that matter.

Fourth, even in the context of FDI, the contribution of agricultural FDI to employment is higher than any other FDIs in

34 Footnote 28.

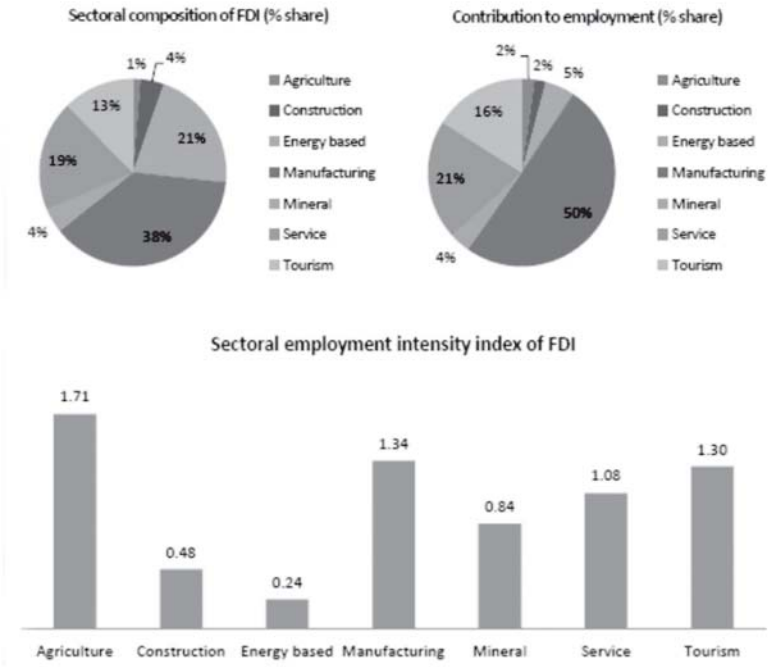
Nepal. Based on the Department of Industry data for approved FDIs, the sectoral composition of FDI (Figure 6.2, upper-left panel) has been computed which shows that of the total FDIs approved till 2010–2011 the share of the agricultural sector is the lowest (1%) as opposed to the investment in other sectors such as manufacturing (38%), energy-based (21%) and services (19%).[35] Then the share in employment generated by approved FDIs is calculated by sectors (Figure 6.2, upper-right panel), which shows that the contribution of agricultural FDI is merely 2% compared to sectors such as manufacturing (50%), services (21%), and tourism (14%), although agriculture does relatively better given the percentage share of FDIs coming into the sector.

Thus Figure 6.2 helps us calculate what we call the "employment intensity index of FDI." This is done by dividing the percentage share of employment (proposed to be) generated by FDI by the percentage share of the amount of (approved) FDI (Figure 6.2, lower panel). The results show that FDI in agriculture sector tends to have the highest intensity (1.71), followed by manufacturing (1.34) and services (1.3), whereas energy-based and construction sectors with indices of 0.24 and 0.48 have the lowest and second lowest employment intensity respectively.[36] This shows that per dollar of FDI in agriculture is worth more than per dollar FDI in any other sector in terms of potential employment opportunity, which has a major policy implication for development policy. However, the above conclusion should be considered as tentative at best because the figures included in the analysis reflect approved and prospective investment and employment, and not the realized ones. This is because the Department of Industry does not have data for the actual inflow of FDI and number of people employed in each establishment because it does not have the monitoring apparatus in place for this.

35 Posh Raj Pandey, Ratnakar Adhikari and Bandita Sijapati. 2012. European Report on Development: Nepal Case Study, Overseas Development Institute Report. London.

36 The indices are provided up to two decimal points for the sake of accuracy whereas shares of various sectors in FDI value and employment have been rounded off.

Figure 6.2: Sectoral Composition of FDI, Employment Share (in percentage) and Employment Intensity Index based on Cumulative FDI Data up to 2010/11



Source: Posh Raj Pandey, Ratnakar Adhikari and Bandita Sijapati. 2012. European Report on Development: Nepal Case Study, Overseas Development Institute Report. London.

6.4.2 Indian Investment in Agriculture-Related Sector in Nepal

India is the single largest foreign investor in Nepal. There are several factors responsible for this, some of which deserve elaboration. First, Nepal and India have had a *de facto* Customs Union type of arrangement particularly since 1950, when treaties of Peace and Friendship and Trade and Commerce were signed between the two countries. At that time, Nepal's dependence on India for its external economic relations was so high that 90% of Nepal's trade was conducted with India.[37] However, the investment relationship

37 SAWTEE. 2012(a).

expanded between these two countries in the aftermath of the economic liberalization initiated in both countries. This further paved the way for Nepal to welcome FDI in general and Indian investment in particular, a process which was hastened due to a relaxation on the movement of investment out of the country on the Indian side of the border. However, it was the signing of the most liberal trade treaty between the two neighboring countries in 1996 that led to an increased investment from India into Nepal to take advantage of the zero tariff market access available in the Indian market without any rules of origin requirement. During this period all kinds of investment flowed in—both genuine FDIs as well as investment made by "fly-by-night" investors who wanted to make quick profit due to the tariff differential prevalent between the two countries and shift location as the differential disappeared.[38]

Second, due to the open border it is considered that goods manufactured in one country may be exported more easily into the other without much problem. Although this was true to some extent, the notion that the two countries having an open border do not face nontariff barriers (NTBs) and customs-related irritants has proved a myth at least in the context of India and Nepal.[39]However, these problems have been found to be less severe in the case of ventures in which Indian companies have relatively high stakes. This is probably because Indian companies are more adept in working their way around the Indian bureaucracy in matters of quarantine offices, customs, and security agencies. Another plausible reason is that the authorities tend to take a softer approach to these companies because they tend to think that these are their "own" companies, whereas ventures owned purely by the Nepalese and any other foreign investors are often viewed with suspicion.[40] Another related issue is that there is no visa restriction on the movement of people between the two countries, which has definitely played a role in increased business contact as well as

38 Adhikari. 2009.
39 Footnote 37.
40 See Adhikari 2012. This argument was echoed by Prakash Chandra Lohani, who chaired the session in which the author made the presentation. Lohani happens to be a former minister in-charge of various portfolios including Finance, Foreign Affairs, Commerce and Agriculture in different periods.

the flow of FDI from India to Nepal. The reverse is not true because the Central Bank of Nepal does not allow any Nepalese citizen or organization to make investment abroad.

Third, due to similarities in culture and language and the existence of cross-border relationships—of blood as well as conjugal ties—the establishment and operation of business in Nepal becomes an easier proposition for Indian businesspeople. Moreover, cultural similarities mean that consumer tastes and preferences tend to be similar. Therefore, products manufactured in one country can be marketed in another country without having to incur extra costs. One such glaring example is that the cost of advertising Indian products in Nepal is extremely low because most Indian television channels, magazines, and newspapers that advertise their products can derive the benefit of exposing the content to the Nepalese consumers free of costs as these media are freely available in Nepal. Even when Nepalese television media is used all they need to do is to dub the content into Nepali or English.

Fourth, and probably more important than the other reasons mentioned above, is that the Nepali currency is pegged to the Indian currency and the latter is freely convertible through any bank in Nepal. This is not the case in other South Asian countries such as Bangladesh and Sri Lanka, where the Indian currency must be changed into convertible currency before converting it into the local currency and vice-versa thus creating uncertainty particularly in the present context of highly volatile currency rates. To add to Indian investors' confidence, the exchange rate of 1 Indian Rupee to 1.60 Nepali Rupees, last fixed in 1993, has not changed in the past two decades. This assures the Indian investors investing in Nepal that the value of their currency would not be changed abruptly. Although Bhutan has even more favorable currency arrangements with India, with the exchange rate of the currency being 1:1, the Nepalese market is 45 times bigger than the former and hence more attractive for Indian investors.

Despite the favorable prospects, Indian investment in the Nepalese agricultural sector has been extremely limited, apart from the investment made by Dabur Nepal Private Limited (DNPL). For

example, ever since the systematic recording of FDI was done by the Department of Industry, only seven Indian investments in the agricultural sector were approved, which represents a meager1.26% of all the Indian investments approved till 2010–2011 (Table 6.4).

Table 6.4: Indian Investment in Nepal, Cumulative Figure upto 2010–2011

Sector	Number of industry	Total project cost (NPR 'million)	Total fixed cost (NPR million)	Foreign investment (NPR million)	Employment
Agriculture	7	793	343	417	784
Construction	17	2,246	1,614	1,876	830
Energy	12	8,336	9,810	5,147	1222
Manufacturing	296	29,493	21,023	14,687	36142
Mineral	6	4,477	3,633	2,261	1521
Service	112	12,355	10,016	6,485	11,781
Tourism	51	5,025	4,679	1,517	4,127
Total	501	62,725	51,119	32,390	56,407

Source: DOI. 2011. (57)

However, for some reason the agricultural FDI from India in the above table, for some reason, does not consider investment in agro-processing sectors such as tea, dairy, ice cream, and bakery as agricultural investment, but they are categorized under manufacturing. Even after accounting for these investments, this may not significantly alter the percentage of agricultural FDI from India in total FDIs.

6.4.3 Development Impact of Indian Investment in the Agro-Processing Industry: A Case of Dabur Nepal Ltd.

As noted above, apart from DNPL, there have been very few Indian investments in the agro-processing sector in Nepal. The idea of establishing DNPL was mooted when some senior officials of the parent company in India visited Nepal in 1990, when India was still a closed economy while Nepal was creating a favorable and welcoming environment to lure FDIs to its shores. According to Udayan Ganguly, former CEO of DNPL and present regional business

head of Dabur India overseeing Nepal, Bangladesh, and Sri Lanka, Nepal provided a very good manufacturing base for export to India with favorable customs and tax rules.[41]

When the company was established in Nepal, with the parent company holding 82% and the Nepalese promoters holding 18% shares, it was in for a long haul.[42] This is proven, among others, by the fact that the company has firmly placed itself on the ground in Nepal, where it has not only established its processing plants but also initiated several projects, which are interwoven with the social and economic fabric of the country. The company considers Nepal a very important investment as well as an important production base.[43] It operates greenhouse projects for medicinal plants in various parts of the country and has provided direct and indirect employment opportunities to a number of farmers and workers, while contributing to the commercial yet sustainable use of local resources. The assessment of the development impact of this investment is made on the following criteria: (a) employment opportunities; (b) export revenue; (c) government revenue; (d) linkage with local economy; (e) sustainability; (f) technology; and (g) corporate citizenship.

(a) Employment Opportunity

Although no official data is available, estimates put the employment figure at 5,000 and indirect at 25,000[44] on farms, and 1,000 direct employment in the factory.[45] Since the above figures were dated, we wanted to confirm this from company sources, who declined to officially provide any information. However, an official from the company, under condition of anonymity, confirmed that the company has provided direct employment to nearly 2,000 workers and indirect employment to nearly 20,000 people.[46]

41 Ganguly. 2008.
42 Pro Public. 2007.
43 Mathema. 2008.
44 See [43]
45 Indian Express. 2011.
46 Information received from the company source on 30 September 2012.

(b) Export Revenue

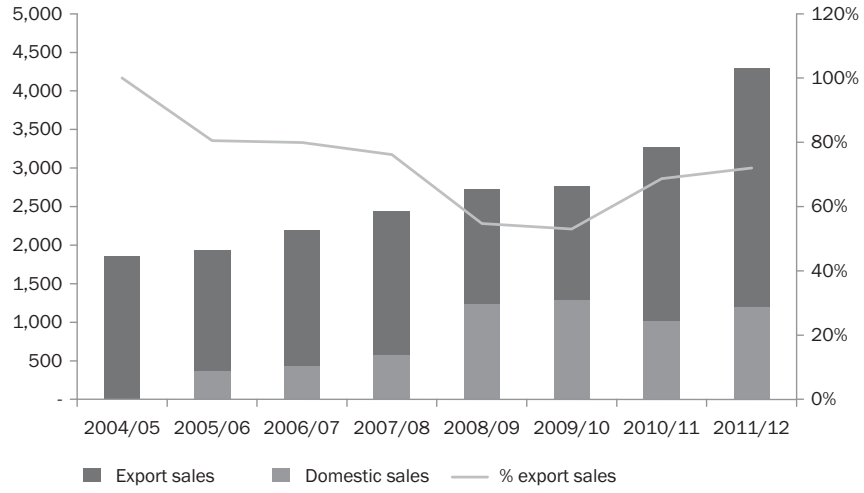
Nepal's merchandise trade deficit has been ballooning since 2002 due to a confluence of factors including the revision of the Nepal-India trade agreement, gradual phasing out of textiles and clothing quotas at the multilateral level, and supply-side constraints.[47] As per the preliminary estimates for the fiscal year 2011–2012 recently released by the Trade and Export Promotion Centre, the import export ratio has worsened to 6.7:1 from 6.2:1 a year earlier, despite a favorable export growth of 14.8% achieved during the year.[48]

Although the trade deficit is currently being financed by remittance incomes, the sustainability of such flow is questionable given the fact that such incomes depend on many exogenous factors. In such a milieu, every rupee of export income matters and the role of DNPL, one of the largest contributors to merchandise exports of the country, cannot be underestimated. This is because DNPL was primarily established with the objective of processing agricultural and forest products in Nepal and exporting them to the Indian market, and it has delivered on that count. Since 2005–2006 onward, it has even started catering to the domestic market, thereby substituting imports and helping Nepal, at the very least, save its precious foreign currency. Figure 6.3 provides the details of the export revenue, domestic revenue, and total revenue of DNPL between 2005 and 2012 (as of 31 March each year, when the company's book is closed). In the figure while sales revenues (in INR million) are shown on the left-hand vertical axis, export sales as percentage of total sales are shown on the right-hand vertical axis.

As can be seen from the figure, although the company has started catering to the domestic market since 2005–2006 it still focusses predominantly on the export market for generating its revenue. This can be seen from the fact that the export revenue, which had gradually reduced to 53% in 2009–2010, has picked up since to reach 72% in 2011–2012, which means domestic sales, despite being quite sizeable in value terms, accounts for merely 28% of the total sales of DNPL as of 2011–2012.

47 Footnote 37.
48 TEPC. 2012.

Figure 6.3: Shares of Domestic and Export Sales of DNPL (INR million) and Percentage

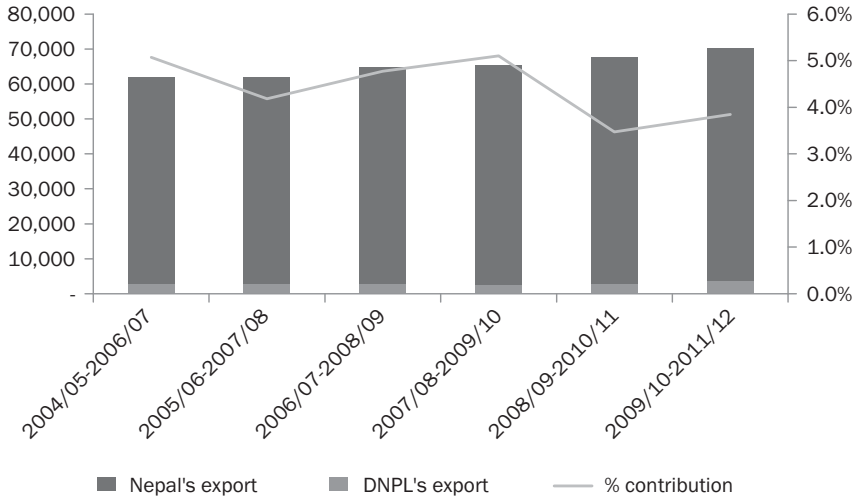


Source: DNPL Annual Reports (2005–2012)

Since direct comparison with national data is not possible because of the differences in fiscal years,[49] we take the three years moving average of Nepal's exports and the exports of DNPL to gauge the contribution it has made to the merchandise exports of the country. The results shown in Figure 6.4 are quite illuminating in the sense that DNPL, a single company, made a mean contribution of 4.6%to the total exports of Nepal, which is nontrivial by any standard. While the peak contribution was 5.1%, the lowest contribution was 3.5%.

49 Nepal's national export data is calculated on the basis of the Nepalese fiscal year (mid-July to mid-July); DNPL follows the Indian fiscal year (April to March) for accounting purposes.

Figure 6.4: DNPL's Contribution to Nepal's Exports (%)



Source: Nepal's exports (TEPC) and DNPL exports (DNPL's annual reports)

(c) Government Revenue

DNPL makes a contribution to government revenue under various headings. First, although it is either entitled to duty refund or is provided with a duty free facility for the import of raw materials used in exports and capital equipment, it is obliged to pay import duty for the importation of items that are not directly used in the production process (such as vehicles, air conditioners, furniture, etc.). Second, it is obliged to pay excise duty in the process and value added tax (VAT) on its imports not meant for export processing. Third, the company is also required to pay corporate income tax on its profits. Fourth, the company's staff and workers pay tax on income they earn. Fifth, the company's shareholders pay tax on the dividend they receive from the company. Although it is not feasible for us to calculate all these contributions the company makes to the government revenue, it is possible to calculate the following from the annual reports of the company:

a. Corporate income tax: Although the audited financial report attached to the annual report of the company does not provide

the exact amount of corporate income tax paid each year, it does provide what is known as "provision for tax" which is the bare minimum the company has to pay to the government each year.

b. Excise duty: This figure is provided in the profit and loss account of the company.
c. VAT: Since the company does not provide the VAT amount anywhere in its financial statement, we imputed VAT at the rate of 10% in 2004–2005 and at the rate of 13% thereafter (in line with the prevailing rates applied by the Government of Nepal). In order to arrive at these figures, we took the import data from the company's financial statement, and calculated VAT by multiplying them by share of domestic sales because exports would be entitled to VAT exemption. These imputed figures, therefore, should be taken as best approximation but not as definitive.

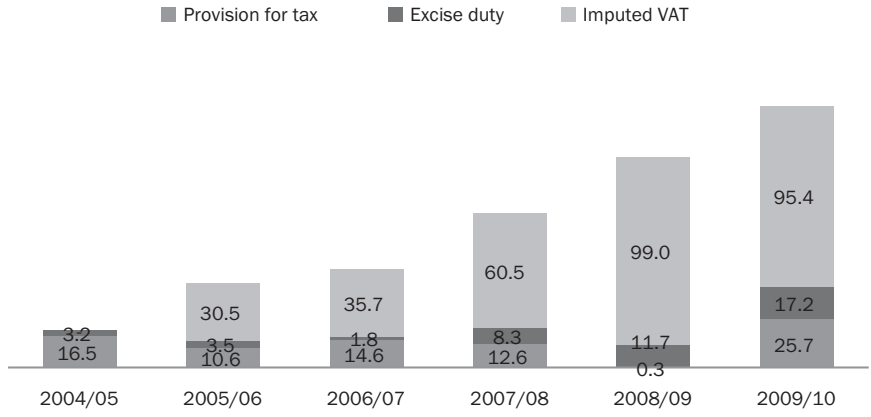
Although it is not possible for us to calculate the tax on salary and emoluments paid to DNPL's staff due to nonavailability, we attempt to capture the above three components of the company's contribution to government revenue in Figure 6.5. According to the figure, although the company's contribution has generally been rising in line with the growth of the company's business, there was a reduction in 2008–2009 both on income tax and VAT. Although income tax as well as excise duty have picked up in 2009–2010, VAT has further reduced. It also needs to be noted that these figures are available only upto 2009–10 because thereafter, possibly because of the change in accounting format, it is not possible to trace the above mentioned contributions from the company's financial statements.

(d) Linkage with Local Economy

DNPL seems to be making efforts toward increasing indigenization. The data relating to the percentage of raw materials used is not available from the year 2010 onward, probably due to a change in the format of the financial report. However, available figures suggest that the use of local inputs has increased from 2.42% in 2005 to

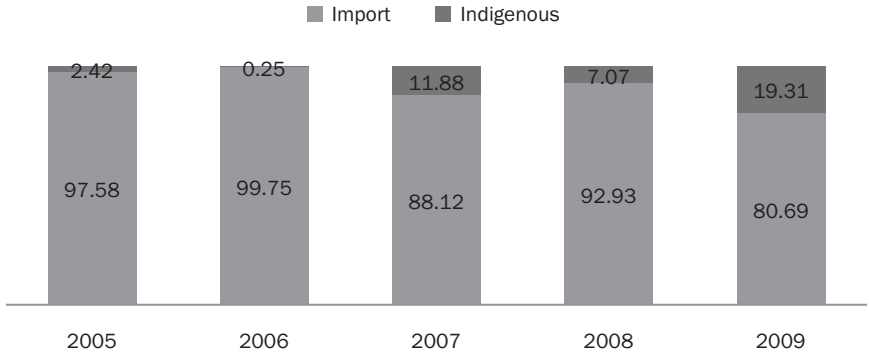
19.31% in 2009, although there have been significant variations in the mix between these two periods, with indigenization reaching its lowest level in 2006, when it was merely 0.25%(see Figure 6.6).

Figure 6.5: DNPL's Contribution to Government Revenue (INR million)



Source: DNPL Annual Reports (2005–2012)

Figure 6.6: Raw materials mix of DNPL (%), 2005–2009



Source: Annual Reports, DNPL (2005–2010).

The level of indigenization could have increased further in the past few years because the company has been operating a greenhouse project for medicinal plants in Banepa, a town adjacent to the

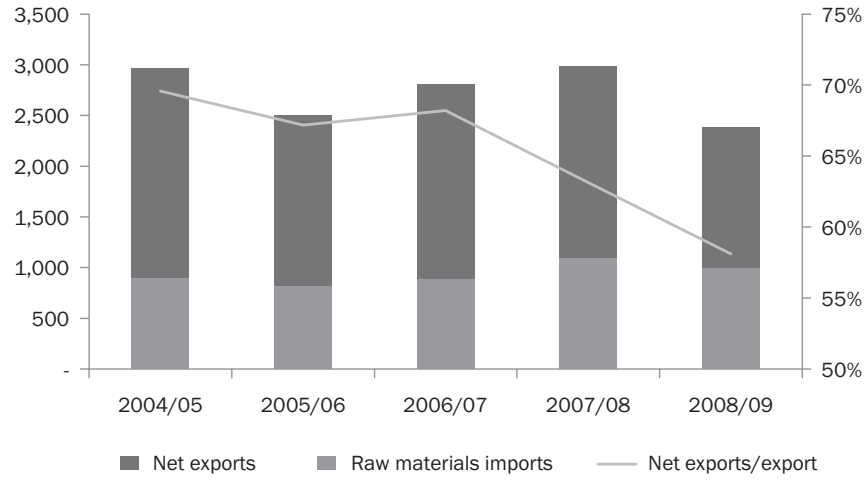
Kathmandu Valley with the objective of creating a sustainable source of medicinal and aromatic herbs.[50] Since 1998, a nursery in Banepa has been involved in conservation and research into several species of endangered ayurvedic herbs. As of 2008, Banepa alone used to produce 6 million saplings of medicinal plants per year, and these used to be distributed to 46 farmers' cooperatives in 19 districts across Nepal.[51] Going by the increased business volume (as discussed below), one could only guesstimate that these figures might have considerably increased in the recent period.

Back in 2008, the company claimed to have attained self-sufficiency in Akarkara (*Spilanthes acmella Murr.*) which used to be imported from Morocco,[52] and in the latest annual report of the company it claims to have attained self-sufficiency in Sahatavari (*Asparagus racemosus*)as well.[53] This has been made possible by rearing these plants in various parts of the country by engaging local farmers.

However, the company still imports a significant portion of its inputs from other countries, including its home country (India), and countries as far as Brazil, Morocco, and the United States. Therefore, it can be argued that one should not only look at the export revenue of DNPL, but at net exports by subtracting imports by exports. Although the export data is available for eight years between 2004–2005 and 2011–2012, data on the use of imported raw materials are available only for five years between 2004–2005 and 2008–2009. Based on available data, we calculate net exports, which are presented in Figure 6.7; also shown is net export as a percentage of total exports. Evidently, net export was satisfactory when it was 70% in 2004–2005, but has significantly reduced (to 58%) in 2008–09 suggesting that the dependence on imported inputs has increased.

50 Footnote 43.
51 Footnote 43.
52 Footnote 43.
53 DNPL. Annual Report 2012(1).

Figure 6.7: Exports, Imports, Net Exports (INR million) and Net Export as % of Total Exports



Source: Annual Reports, DNPL (2005–2010).

However, the figures on net exports do not tally with the claim of the company that indigenization has been growing in the company, which is also shown in Figure 6.7 above. One plausible explanation for this is that the company has become equally active in the domestic market. However, a detailed investigation is required to fully understand this discrepancy. This could be one of the reasons for some to argue that the company could have done much more to ensure domestic value addition.[54]

(e) Sustainability

DNPL has had its own share of problems—first due to armed insurgency that gripped the entire nation in the decade starting from 1996, then after 2006 and establishment of peace labor strikes by unruly trade unions on the instructions of their presiding political parties. However, the company does not seem to have been perturbed by such events and, if the indication of the former

54 Footnote 42.

Country Director is anything to go by, claiming to follow a different approach from what "fly-by-night" investors would do, DNPL is here for the long haul.[55] Such a commitment to continuity is itself an indicator of sustainability of its operation, creation of employment opportunities, use of local resources, and its contribution to other aspects of Nepalese economy.

The company is uniquely positioned to ensure environmental sustainability as well because it considers environment and nature as the lifeline of its business. "With a portfolio of Ayurveda and nature-based products, **conservation of nature & natural resources is deep rooted in our organizational DNA**, and in every aspect of our ever-growing business" reads the first paragraph of the Sustainability Report of the company posted on its website (emphasis in original).[56] Indeed, it has contributed to environmental sustainability in two distinct but interrelated areas.

First, its contribution to the sustainable use of biological resources is clear from its efforts to prevent extinction of such resources by uncontrolled harvesting in the wild. One might argue that this is in the company's own self-interest because it would be cheaper and a value-addition (freshness) to use local ingredients rather than importing them from distant places such as North Africa, North America or South America. However, it should also be understood that importing ingredients readily available at internationally competitive prices would be much easier than managing greenhouse projects and coordinating such activities with several local government offices and farmers' cooperatives, and thousands of farmers.

DNPL started on its path toward sustainability with its pioneering idea of domesticating wild plants—engaging farmers in the cultivation of herbal and medicinal plants by providing them with saplings and buying back the final harvest, and the establishment of the Medicinal Plants Project focussing on the mountainous region of the country. Under this project the company has also established satellite nursery centers at various

55 Footnote 41.
56 Dabur. Business Responsibility Report. http://www.dabur.com/About%20Dabur-Vision. Accessed 30 September 2012.

high altitude regions like Marpha, Manang, and Jumla with her plantations of different medicinal herbs like Taxus, Akarkara, and Chiraito.[57]

Another important scientific landmark is the establishment of the Greenhouse Project in Banepa, 30 km east of Kathmandu, designed to produce saplings of medicinal plants under controlled environmental conditions, where the entire environment is controlled by automatic computer systems that can constantly monitor any changes within the greenhouse. Operated under DNPL's "Plants for Life" project, this greenhouse maintains the highly critical environmental parameters required for the survival of such plants. The company is also developing and supplying quality saplings of more than 20 herbs, of which eight are endangered. At the same time, the company has also initiated a program to promote herbal gardens in schools, in collaboration with the International Center for Integrated Mountain Development (ICIMOD). The idea behind this initiative is to engage schoolchildren in making herbal gardens in their schools so that they can get first-hand information about various plants and their usage.[58]

Second, in keeping with its policy of providing sustainable sources of energy for its activities, DNPL has commissioned a new "gassifier" project to save energy costs in steam generation by using rice husk as fuel. Set up with an investment of close to INR 15 million, according to the company "this project involves modification of the existing boiler to permit dual fuel firing (furnace oil and gas) and installation of the 'gassifier' unit, piping and storage area for rice husk. This initiative—put in place in view of the rising fuel costs and the recent fuel crisis in Nepal—has already reduced the furnace oil consumption for steam generation by 50%."[59] Buoyed by the success of this initiative, the company is now moving toward setting up an effluent waste treatment unit and a second gassifier.[60]

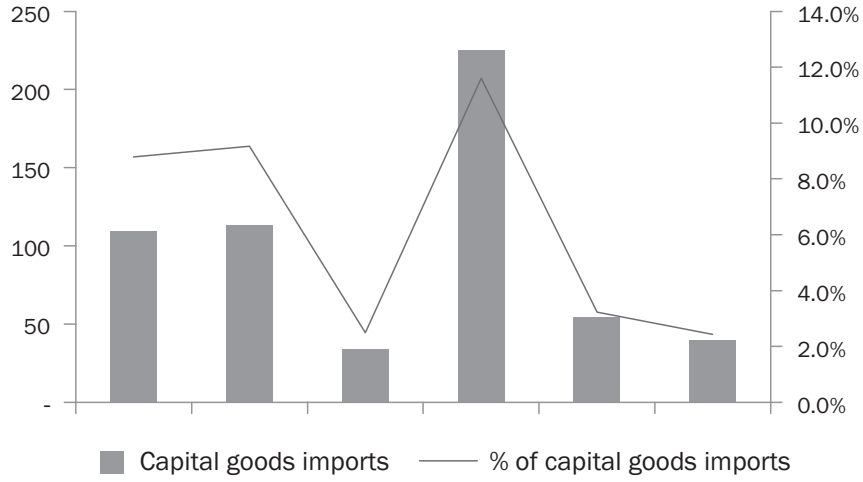
57 DIL. 2012(30).
58 DNPL. 2012(1–2).
59 DIL. 2012(31).
60 Footnote 59.

(f) Technology

Since there is no clear-cut methodology to measure the generation, acquisition, transfer, and application of technology for enhancing productivity, we need to make use of various approaches to analyze this component of DNPL's contribution to the Nepalese economy. Therefore, we make use of various quantitative as well as qualitative criteria such as import of capital goods, research and development (R&D) expenditure, and technological development for this aspect.

Figure 6.8 provides data on the imports of capital goods made by the company over six years between 2004–2005 and 2009–2010 for which data is available, which suggests that the import of capital goods has been erratic and reached its peak of 12% in 2007–2008. Following this there has been a massive decline. Although there is no clear benchmark available, an average of 6.3% with the lowest figures reaching 2.4% in certain years may not be considered sufficient to determine optimal import of capital goods for an agro-processing industry like DNPL. This is because, even at the macro level, Nepal's average import of capital goods during these six years was 12.3%.[61]

Figure 6.8: Imports of Capital Goods (INR million) and % of Capital Goods as Total Import



61 Footnote 35.

Similarly, the company's track record in reporting R&D is not very impressive. During the review period, the annual reports of year 2009 and 2010 are the only two reports which have made explicit disclosure of Technology Absorption and R&D. During both the years, however, DNPL has not shared information regarding benefits derived from R&D, future plan of action, expenditure on R&D capital, and total R&D expenditure as a percentage of total turnovers.[62]

However, DNPL seems to have made considerable efforts toward modernization of its factory, which can be gleaned from its annual reports as well as Form B of Annexure 3 of the reports. This seems to be a regulatory requirement introduced by the Government of India. According to the form, the company is required to report on technology upgradation in every annual report. While it has included such reporting in annual reports between 2006 and 2010, it has not done so in other years.

The company has separately reported major technological developments under the rubric of modernization/development. As reported in 2005, the company installed a new packing line for packing a new flex pack of 1 liter and 330 ml of fruit juice.[63] In 2006 the company introduced a new pack of herbal toothpaste and invested in automating its toothpaste manufacturing plant, which contributed to an increased packing capacity.[64] Similarly, certain other instances of energy-related technological upgradation were highlighted in its 2007 report.[65] Further, in 2008 it installed juice and glucose filling plants and introduced new blending line and packing facilities. In 2009, the company reported modest achievement in upgradation of laboratory equipment.[66] The gassifier unit which was installed for better operational efficiency and reduced the cost of boiler operation while enhancing environmental sustainability was highlighted as a major technological development in 2010.[67] Finally, both 2011 as well as 2012 annual reports emphasized that

62 DNPL. Annual Report 2009; 2010.
63 DNPL. Annual Report 2005.
64 DNPL. Annual Report 2006.
65 DNPL. Annual Report 2007.
66 DNPL. Annual Report 2009.
67 DNPL. Annual Report 2010.

the company invested in capital modernization and expansion projects.[68]

(g) Corporate Citizenship

Despite some good initiatives taken by the company to discharge its obligations as a good corporate citizen, particularly its positive contributions in several areas as highlighted above, the company has failed to live up to the expectations of some of its stakeholders—government, shareholders, and customers—on a number of counts.

The company declared an interim dividend of 40% in March 2005but refrained from declaring any dividend at the end of the financial year in 2006 and 2008 "in view of future business plans under considerations." Between 2009 to 2012, the company again did not declare any dividend on account of "low profit for the year." While not declaring any dividend might indicate ploughing back profits in the company thus making it stronger(and a multinational company like DNPL reinvesting in the country rather than repatriating profit should be seen in a positive light), not doing so on grounds of "low profit for the year", particularly from 2009 onward is something difficult to comprehend. The company is the market leader in the FMCG sector as well as one of the largest exporters of the country and it is witnessing a healthy growth in its turnover. It has been granted several fiscal incentives by the government including duty exemptions. Despite all this, the company failing to earn adequate profit rendering it unable to declare a dividend remains something of a mystery.

Although it is difficult to find an industry benchmark for profit as well as dividend, DNPL's competitor Unilever Nepal (UNL), which has only achieved close to 2/3rd turnover compared to DNPL has announced a 680% dividend for the fiscal year of 2011–12. This has been possible because the company earned a net profit of NPR 735 million during the year. One cannot deny that there is a difference between a public limited company such as UNL and a private limited company such as DNPL. However, in terms of disclosure

68 DNPL. Annual Report 2011; 2012.

requirement as well as transparency, the reluctance of DNPL staff even in disclosing sales figures, which can be downloaded freely from its parent company's website, and even a positive detail like the employment provided by DNPL creates suspicions about the company's opacity. The shareholders of the company, after all, are not investing in it with a philanthropic motive. Under normal circumstances, the inability to announce a dividend for seven years, not even equivalent to the opportunity costs of the investors' capital, should by now have led to an agitation against the company or its management, but that has not happened. The reason for the investors' silence is not fully known and it requires further investigation.

It is also part of DNPL's corporate responsibility to comply with the existing laws and regulations of the country in which it operates. However, a study done by Pro Public suggests that the company has not done enough to comply with these legal norms.[69] The following text from the report is worth noting:

a. According to the Company, after the termination of the agreement to collect 800 metric tonnes of Loth Salla (*Taxus baccata)* leaves annually, it has been fulfilling the need of such leaves through plantation in its nursery. Such a huge quantity of leaves being provided by the plantation is questionable. Besides, there are allegations that the Company has been collecting the leaves from forests in other districts, whereas there is no agreement that allows DNPL to carry out such activity.
b. The Company has a leasehold arrangement with the government authority in Mustang District. But due to the inaccessibility of the agreement, whether the Company has been complying with the terms and conditions set out in the agreement is unknown.
c. Saplings of Kutaki *(Piccorrhiza kurroa)* were found in Banepa Nursery. However, the source from where DNPL had accessed it initially could not be known. Even the source from where the Company had accessed Loth Salla for plantation in its nursery was not disclosed.

The above extract does not establish that the company is flouting

69 Footnote 42.

the laws and rules of the land, but it does raise some concerns which need to be further investigated.

There is a third issue relating to the protection of consumers' interests, in which DNPL has allegedly been less careful than what is expected of a company of international repute(although the company denies the charges). First, it was alleged that Real (juice), a popular brand of the company, was adulterated as some inedible substances were found in the juice packet. Second, there was also a controversy according to which the company allegedly postdated some of the juice packets before dispatching them to the market. This prompted the Commission for Investigation of Abuse of Authority (CIAA), the anti corruption watchdog of the country, to raid its factory.

It can then be concluded that

- although Indian FDI occupies a lion's share of overall FDI flow in the country, agriculture represents the least preferred sector in the eyes of Indian investors representing a measly 1.26% of the total FDI proposed by Indian investors and only 7 out of 501 FDIs registered with the Department of Industry are categorized under the agricultural sector.
- Examining Indian investment in Nepal's agro-processing sector with DNPL as the case study makes it clear that the benefit of FDIs to society as well as economy of the host country is ambiguous.
- DNPL has provided reasonably good employment opportunities (upto 2,000 direct and 20,000 indirect), generated close to 5% of the total merchandise export revenue for the country, established close linkages with the local economy, and helped in environmental sustainability. However, the company has not made significant contribution to the national treasury and has made very limited contribution in the area of technological advancement despite the significant potential in both the areas.
- Finally, going by the available information, it was found that DNPL has, at least in part, failed to live upto the expectations of some of its key stakeholders and there is a lot that the company can still do to establish itself as a good corporate citizen.

On the balance, the positive contribution of the company outweighs the negative, and with some improvement in the modality of

operation coupled with a renewed commitment to technological development and more efforts toward enhancing the transparency of operation, DNPL could prove to be a highly useful business venture for Nepal.

6.5 Summary and Conclusions

The presence of a fast growing economy in the region can lead to substantive growth spillovers to other countries through enhanced trade and investment opportunities. However, the presence of a fast growing economy itself may not make it a ¨growth pole" for the region. It must also integrate itself productively in the region, providing and making use of the productive capacities available in the region. India has emerged as one of the fastest growing economies in the world; it has the potential to achieve such productive integration for the region of South Asia, and provide growth and development opportunities for the entire region.

Given the analysis presented in this chapter of the development impact of bilateral trade and investments with India, it can be concluded that India has the potential to become a growth pole in the region, especially for the LDCs of the region, but it needs to integrate a lot more with targeted policies and strategies. The growing market in India can benefit the region and the cheaper resources available in the region can help India to improve its global competitiveness. Fostering regional value chains within South Asia can be one strategy. For instance, UNCTAD-ADB identify potential regional value chains in the leather sector as well as agro-processing industries in the region.[70] The studies also suggest policies and strategies to promote these regional supply chains to improve global competitiveness of the products from the region.

70 Footnote 5, Chapter 1.

7

Way Forward

7.2 Way Forward in Developmental Regionalism

It has been widely agreed that South Asia has not been able to tap its potential benefit from regional integration. Low levels of intra-regional trade and investments are difficult to justify economically, especially with increased growth in almost all countries of the region since the early 2000s. The search for bigger markets and opportunities for reaping economies of scale propels regional integration. Some of the changing dynamics and emerging needs in South Asia, which may play an important role in the future in boosting developmental regionalism, are as follows:

7.2.1 Changing Political Economy

The region is changing rapidly and so are the economic and political realities around it. Economic factors are increasingly determining political relationships. The EU, ASEAN, and other trading blocs are examples of how conflicts and national boundaries are being dispelled in favor of increased economic benefits and opportunities. Further with the decline of hegemonic powers like the US in the realm of global affairs, countries are likely to rely more on regional/bilateral solutions to collective problems. South Asian nations are also realizing the importance of promoting regional cooperation

and the need to give primacy to economic development, growth, poverty reduction and of pushing political issues and problems to the background. Given the increased competition (especially from PRC), the current world economic environment and protectionist tendencies of other regions, South Asian countries need to realize that holding on to historic differences could cost them their share of global GDP.

The region's importance is gradually being recognized by the rest of the world. The global recognition of SAARC is evidenced by the fact that the People's Republic of China, Japan, the Republic of Korea, EU, and US have shown keen participatory interest. These countries have been appointed observers at SAARC summits. The presence of other nations is seen as a balancing factor by South Asian countries. Their presence at SAARC meetings subjects South Asian countries to outside scrutiny and is also likely to enhance the process of integration. Such changing dynamics within the region and outside have created specific incentives for each SAARC member.

Over the past few years, India has made significant efforts toward improving relations with its neighbors. In 2011 India reduced the number of items from SAFTA's Sensitive List for LDCs from 480 to 25. It has also reduced peak tariff rate to 8% for Non-LDCs under SAFTA.[1] As India continues on a good growth trajectory and moves ahead to secure a more global position, it can no longer ignore the relevance of regional cooperation. With integration and cooperation within the region, India is likely to gain credibility in international forums. This is particularly relevant given India's ambition of securing a seat in the UN Security Council. India has also been observing PRC's growing strategic interests in South Asia. Aside from being a generous aid-giver, PRC is involved in infrastructure projects in the region, including building ports in Bangladesh, Sri Lanka (*Hambanthotta*) and Pakistan. It has recently opened an embassy in Maldives, built the foreign ministry, national museum buildings, and is currently working on the largest housing project in Maldives. PRC's observer status was a product of the push from Nepal, Bangladesh, and Pakistan. The

1 Notification no. 125/2011.Customs dated 30.12.2011.

People's Republic of China has also asked for a SAARC plus one meeting on the lines of ASEAN plus one and is thus clearly looking to gain a bigger voice in the region. In this context, it is most critical and strategically relevant for India to improve relations with its neighbors and encourage integration.

An important political step toward advancing regionalism has been Pakistan's commitment to grant India the MFN status[2]and reduce items on its negative list.[3] Apart from being in a constant state of turmoil due to political instability, Pakistan is at a crossroads in terms of its foreign policy options. Pakistan has over the past years tried to establish a relationship with the Gulf countries, PRC, and Central Asia. However, improving relations between India and PRC, support of states like Iran to India, and instability in Central Asia are some of the reasons why increased cooperation with India and integration in the region might be beneficial for Pakistan. It is also critical for Pakistan to seek India's cooperation in countering its own challenges such as ethnic conflicts, drug trafficking, and terrorism.

Bangladesh's core interests in increasing cooperation in the region are increasing investments, cooperative use of water resources, access to raw materials, and development of infrastructure. India needs Bangladesh's cooperation to further its security interests; it needs to use Chittagong Port to improve transit to northeast India; and it also needs Bangladesh's help for countering terrorism. The government of Bangladesh has been bridging the gap between India and Bangladesh since January 2009. One instance of this was when war crime trials were initiated against those who had collaborated with the Pakistan Army in its atrocities during the 1971 war. The 5th Amendment to the Constitution, which gave legitimacy to military dictatorships and removed secularism from state policy, has been repealed. Article 12 of the Constitution proscribing religious parties has also been deleted. These developments have brought Bangladesh closer

2 India granted Pakistan the MFN status in 1996.

3 *Chamber Head*, Economic Times. 2012. South Asia to gain when Pakistan frees trade with India. 21 March. http://articles.economictimes.indiatimes.com/2012-03-21/news/31220180_1_negative-list-pakistan-grants-grants-india-mfn-status

to democratic and secular governance. All these developments have created an environment which is conducive to increased participation by Bangladesh in regional economic integration initiatives.

Nepal has cordial relations with all its neighbors. As a least developed country in the region, Nepal is in serious need of economic development. Its other interests are ensuring security, and diversifying its trade and bilateral relations in the region to avoid absolute reliance on India for resources and development.[4] Nepal is also a landlocked country with an insignificant industrial sector and a narrow export base. Assistance from donor agencies like the World Bank has been reducing and Nepal generates very limited business. As a result of these factors, Nepal has very material incentives to promote cooperation and integration in South Asia.

Sri Lanka has generally supported regional integration in South Asia. Like Nepal, Sri Lanka also has only India as a neighbor. Dwindling demands from the rest of the world and decline in FDI due to its continued civil war have encouraged Sri Lanka to look to its neighbors. Bhutan views regional economic cooperation as a strategy to bring about economic self-reliance and mutual prosperity. As a landlocked country, Bhutan aims to improve air links and telecommunication between the member states, facilitate trade and joint economic ventures, and achieve greater liberalization in its economy while increasing security in the region. Therefore Bhutan has had an open and forthcoming approach toward SAARC and has entered into various bilateral agreements in the region.[5] Bhutan has also continued to maintain good relations with India.[6]

4 In March 1989, due to differences on trade and transit issues, there was a deadlock between Nepal and India. Nepal's extreme reliance on India and lack of autonomy became very apparent. There was a shortage of essential commodities, the tourism industry collapsed, and dwindling forest and natural resources made the situation worse.

5 With Bangladesh, Bhutan has signed a trade agreement, an agreement on air services and economic and technical cooperation. With India, Bhutan has entered a series of four agreements in 2009 covering energy, educational, and vocational needs. 10 hydropower projects are being proposed between the countries of which sixwill be financed through an intergovernmental model, in which India will supply 40% of the cost as grants and the remaining 60% as loans. Similarly, cooperation efforts have been made with the other countries as well. See *Economic and Political Relations between Bhutan and Neighboring Countries*, A Joint Research Project of the Center for Bhutan Studies and the Institute of Developing Economies, Japan External Trade Organization. http://archiv.ub.uni-heidelberg.de/savifadok/volltexte/2009/303/pdf/mono_Ecnmc_Pol_Rel_Bt_Nghbrng.pdf ,(2004).

6 With a renewed free trade agreement with India until 2015, there has been a rise in exports to India.

7.2.2 Trade Facilitation and Potential Economic Gains

Studies have shown that all countries in the region can gain substantially by trade facilitation measures. A big source of transaction costs in trade between India, Nepal, and Bhutan are complex customs and transit procedures. Customs clearances which comprise detailed verification procedures, labeling and testing requirements cause significant delays. As a result of such delays and costs, parties have resorted to informal trade and thus caused losses in government revenue collection. Increased cooperation between member-states will facilitate harmonization arrangements in areas such as customs procedures, arbitration, double taxation, and access to market information and legal systems. Such arrangements will increase efficiencies in the region and make businesses more profitable. Article 8(a) of SAFTA provides for such harmonization. SAARC member countries have signed the Agreement on Establishment of South Asian Regional Standards Organization that provides for setting up of a South Asian Standards Organization. This is an important step forward in terms of boosting developmental regionalism. If the organization is effective and functions as is being proposed, it will help reduce the administrative burden of national customs and standard setting organizations of the SAARC member-states.

Another incentive for regional cooperation and integration is the possibility as a "regional bloc" for setting uniform standards for products and harmonizing such standards with similar international standards. As was the case with EU, common standards would bring South Asia in the mainstream global marketplace. Harmonizing standards by adopting best practices would increase reliability and meet health, safety, and environment requirements, and consequently lead to a larger market and greater international acceptance of South Asian products. A more integrated South Asia would also have a stronger voice in multilateral standard-setting bodies.

Regional cooperation can greatly facilitate trade by improving infrastructure and transport linkages. Not only will this make trading in the region easier, it will open other trade opportunities

since the region is strategically situated at the crossroads of Asia between the oil-rich countries in West and Central Asia and the dynamic economies of Southeast Asia. The resource requirements for infrastructure development in South Asia are gigantic. In India alone, Planning Commission estimates put the resource requirement at $500 billion for the next few years to meet the needs of the growing population and rapid urbanization. Regional cooperation would create a larger market and offer multilateral agencies and the private sector attractive investment opportunities in developing the physical infrastructure in the region.

Due to reliance on the theory of self-sufficiency, trade complementarities have not been able to develop in the region and most of the intra-regional FDI has been horizontal in nature. Vertical specialization would allow countries to reap economies of scale by concentrating on a specific production process in the value addition chain. For instance, UNCTAD-ADB have identified potential regional supply chains that can be formed in the leather sector as well as agro-processing industries.[7] Many more industries like textiles and clothing have the potential of forming regional supply chains.[8] This would be an effective way to benefit from the economies of scale and expand the production base.

A related benefit is cooperation among the SAARC member countries to effectively utilize the rich river network in the region. The river network in the region comprising Ganga, Brahmaputra, Meghna, and Indus rivers has the potential to meet a portion of its energy needs and also create economic opportunities. Systematic cooperative management of water resources would contribute toward controlling floods, providing irrigation, generating electricity, and improving water transport facilities. Previous treaties like the Indus River Treaty in 1960 between India and Pakistan and the Farakka Treaty in 1996 between India and Bangladesh have attempted to devise methods of sharing water resources. However, a sound cooperative model is yet to be achieved. Effective management of water resources is a significant

7 Footnote 5 , Chapter 1.
8 See Potential Supply Chains in the Textiles and Clothing Sector in South Asia, UNCTAD-Commonwealth Secretariat and Centre for WTO Studies, 2011.

incentive to increase efforts toward the same. Another incentive is the urgency for energy security in the region. Nepal and Bhutan can be big sources of hydropower for the other countries. With Afghanistan as a new member, the region can also explore ways of engaging with central Asia to meet its energy needs. The South Asian states have also been contemplating a regional air services agreement, a motor vehicle agreement, and a railway agreement for the past few years.

7.2.3 Benefits of "One Asia"

Studies[9] have shown that South Asia–East Asia integration will provide significant benefits for both regions. East Asia will benefit largely from the participation of India, and other South Asian countries will benefit only if India takes its neighbors with it in the integration process with East Asia. An East Asia-India relationship, without other South Asian countries is likely to benefit India but may leave other South Asian countries behind. World Bank shows that India's gain from a larger East Asia Agreement is more than its gain from a regional agreement within South Asia.[10] On the other hand, the gains for other South Asian countries from a regional agreement in South Asia are more.

India has been slowly deepening its trade and economic relations with the ASEAN states, PRC, Japan, and Republic of Korea. It has signed an FTA with ASEAN. India has the potential of slowly becoming a bridge between South and East Asia.[11] Increasing cooperation and integration in the region would be a means for smaller South Asian economies to access East Asian markets through India. Therefore, over the years, strategic interests of the smaller South Asian economies are likely to become inextricably linked to successful integration with the Indian economy. Therefore in order to benefit from accessing greater markets of regions like

9 Francois, Joseph, Ganeshan, Wignaraja. 2008. *Economic Implications of Deeper Asian Integration*. Centre for Economic Policy Research.

10 Moving Up, Looking East.2010. World Bank South Asia Economic Update. http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1269620455636/6907265-1275784425763/SAREconomicUpdate7June2010.pdf

11 P.B Rana, G. Wignaraja, J.P Francois, 2009. *Pan Asian Integration: Linking East and South Asia*. ADB and Palgrave Macmillan. Manila.

East Asia, South Asian countries will be required to adopt more open policies toward each other.

7.3 Peace Dividend

Trust deficit, mutual suspicion and political differences are common in almost all regional relations and are not unique to South Asia. In both ASEAN and EU, longstanding political differences were kept aside while efforts toward regional integration were made. Eventually this led to greater peace and stability in the region. Increased integration provides formal and informal channels of communication and gradual building of trust among countries. When ASEAN came into being, every Southeast Asian nation[12] was fighting some form of insurgency and ethnic tension which also had spillover effects to embitter interstate relationships. However, the threat of instability in the region and the external threat of PRC brought the states together to create a unified regional entity and resolve disputes through peaceful dialog and consultations. Further, the ASEAN nations also recognized the need for Indonesia to maintain high levels of military resources and felt it was in their best interest to cooperate with Indonesia and focus on developing trust within the region. In the same way, South Asian nations also need to step beyond historic differences to achieve the end objective of stability.[13]

South Asian integration efforts have been mild and characterized by a lack of political will. By contrast, the signing of the Treaty of Rome in 1957 establishing the EU was preceded by strong sentiments for solidarity in the region. There was strong political will to unite and create a prosperous and peaceful bloc of European nations. Leaders realized that it was essential to look beyond their political differences and promote cooperation in key economic sectors (especially in key sectors like coal and steel in

12 For instance, Malaysia and Singapore had just had a difficult separation; Malaysia and Philippines had competing claims on Sabah in Borneo; and Indonesia was in the middle of disputes with Malaysia. Konfrontasi.

13 Other integration arrangements have also been establishedto reduce interstate tensions. For instance, the Mercosur was initiatedto reduce tensions between Argentina and Brazil. Also Egypt, Morocco, and Tunisia signed an agreement with EU to contain the threat of spreading fundamentalism.

the warring nations of France and Germany) for unified Europe. With respect to SAARC, an analysis of the country objectives at the time of its formation suggests that member states had their own respective agendas and regional cooperation was not the primary motive for joining the association. Merely placing an institutional structure in place is not enough. It is imperative that the political leadership in the member-states shares a common vision of an integrated regional bloc.

The strong political will demonstrated by EU was in fact able to unite the nations even to agree that a precondition to the membership of EU was similarity of political systems (i.e., democratic governance). South Asia is characterized by wildly divergent political systems—India and Sri Lanka are reasonably functioning democracies; Pakistan and Bangladesh still need to establish themselves as functioning democracies dissociated from military dominance; Nepal continues to fight threats of Maoists; Bhutan is a monarchy; while Afghanistan and Maldives also have struggling political systems. Experience shows that economic integration is more plausible and sustained when it is preceded by political harmonization.[14] The European Union set the rule of making only democracies eligible for membership. Consequently, Spain, Portugal, and Greece discarded their dictatorships and thereafter became members. Such preconditions can be set only when there is strong political will of all states. In the longer run, such preconditions would be beneficial since without political harmonization it is difficult to expect countries to surrender their sovereignty (in favor of regional association) on issues such as import policy or grant other economic concessions. However, while EU tried to facilitate common values and political security goals, ASEAN operated on the principle of non-interference in domestic matters focussing primarily on economic interests.

A serious commitment to integration, even if encouraged by economic incentives, is more likely to create a forum for peaceful resolutions of disputes than any of the isolated efforts have so far. In the context of India and Pakistan, SAARC summits have been the

14 D Bhatta Chandra. n.d. *Regional Integration and Peace in South Asia: An Analysis*. London School of Economics and Political Science (See more at: http://www.bradford.ac.uk/ssis/peace-conflict-and-development/issue-5/RegionalIntegration.pdf).

most critical forums to deliberate bilateral issues and achieve some limited progress. The 1986 SAARC Summit also helped improve the relationship between India and Sri Lanka. This is in fact the reason why member-states have always protected the institution of SAARC.[15]

Promoting regional integration in South Asia entails efforts in key areas such as infrastructure, trade facilitation, investment, governance, and implementation. The most critical element of the integration process in South Asia is building confidence and filling the huge trust deficit between the countries. Economic interests (i.e., the potential of increasing trade and investment) and strategic interests (i.e., better positioning to have a say in global governance) have the potential of uniting South Asian countries, while sidelining political differences to pursue regional integration.

Increased political will and commitment toward integration will have to be followed up with greater efforts toward integration. In this respect, India can offer to take on a disproportionately greater responsibility while the other South Asian countries to commit to cooperation and openness. SAARC needs to be reinforced and become a professionally staffed institution. Like ASEAN, SAARC needs to assume a central role in creating conditions for deeper integration by promoting investment, trade, transparency, harmonizing standards, and simplifying procedures through a multilateral process.

Additionally, measures of soft diplomacy should be adequately utilized to mold public opinion, bring South Asians closer, and create an understanding of the value of increasing regional integration and cooperation. Agreements such as the SAFTA need to be made more meaningful with appropriate emphasis on nontariff barriers and strict timelines for tariff reduction. Ideas such as focussing on priority industries to build complementarities need to be explored. The changing dynamics in the region and the world economic order make this an opportune time for South Asian countries to transform their approaches and strategies toward each other.

15 V.V. Desai.2010. *The Political Economy of Regional Integration*. Asian Development Bank.

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IMPACT OF TRADE AND FDI POLICIES ON INDUSTRIAL DEVELOPMENT IN SOUTH ASIA

Delineating the extent of trade and FDI liberalization that South Asia experienced between 1990 and 2012, this study identifies how liberalization has boosted industrial development and triggered structural changes in the manufacturing sector. It also assesses the implications of the presence of one of the fastest growing economies in the world, i.e., India, in the region. Further, the study suggests a way forward for developmental regionalism in South Asia, emphasizing the benefits of "One Asia" and the peace dividend.

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