

## *Chapter 1*

# **Introduction and Summary**

India and the People's Republic of China (PRC) were by far the richest countries in the world 2,000 years ago. Even in the early 19th century their share of global gross domestic product (GDP) was nearly 50%. However, by 1950 this share had fallen to a mere 8% as the industrialized countries in Europe, North America, and Australasia developed further. This balance persisted until the 1970s (Maddison, 2001). As India, after the mid-1980s and early 1990s, and the PRC, after 1978, began to open up and liberalize, their share of world income began to rise again. By 1998 it had risen to 16% and by 2005 to 21%. As the PRC and India continue to grow and integrate further into the global economy, their economic prospects will depend more and more on how they manage globalization. The much-quoted 2003 Goldman Sachs study (Wilson and Purushothaman, 2003) forecasts that by 2050 three of the four largest economies in the world will be in Asia and in this order: the PRC, the United States, India, and Japan. The 2007 Goldman Sachs report (Poddar and Yi, 2007) forecasts that India will overtake the United States faster than expected and be the second largest economy in the world by 2050 after the PRC. During the 1980s and 1990s, other South Asian countries also started to opt for greater openness and began the long process of realigning their economies with those of the rest of the world.<sup>1</sup>

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<sup>1</sup> South Asia in this book refers to the seven members of the South Asia Association for Regional Cooperation (SAARC), which are Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. Afghanistan, which became the eighth member of the SAARC in 2007, is not included here.

The benefits of globalization are many and varied. By opening up to international trade and investment, countries can acquire technology and some essential inputs that help to raise productivity and increase economic efficiency. Greater access to a wider market through globalization helps to reduce the risk of fluctuations in external demand and provides greater scope for exporting a broader range of exports. Greater openness also helps countries to attract foreign direct investment (FDI), which brings with it new technology and innovation and greater access to industrial country markets. In addition, globalization increases export demand, generates employment, and raises living standards. More open financial markets result in increased competition, lower costs of financial intermediation, better resource allocation, and deepening of financial markets. More open labor markets bring new flexibility, skills, and expertise. Skilled labor migration offers benefits to the economy as returning migrants bring improved skills and knowledge and a deeper understanding of science, engineering, technology, and business, which can make the local economy more productive and open new lines of international communication. But globalization also has associated costs. Maximizing the benefits and minimizing the potential costs of globalization requires implementing appropriate policies at the national, regional and global level. These require good governance, transparency, and a consistent policy environment.

An appropriate response to globalization requires a three-pronged approach. First, countries need to integrate with the world economy through the multilateral initiatives for trade and finance. De-linking is not an option, as multilateral initiatives provide frameworks that are fair and equitable for all countries and convey immense benefits. Domestic policies must be adjusted to take full advantage of the benefits of multilateral liberalization. This brings us to the second point. National policy reforms — in trade and finance, the exchange rate, industrial and financial sectors, and labor policies — have to be developed and implemented within the broad context of globalization. These will improve international competitiveness, productivity, and economic efficiency and resilience. Third, regional policies have to be considered, not only to increase the connectivity

of countries to regional groupings but also to bring smaller and perhaps isolated economies under the umbrella of a larger regional grouping. The greater economies of production and export diversification these smaller economies can thus achieve may not be possible otherwise, even within the broader framework of global integration. Such regional agreements can also be stepping-stones to wider globalization.

Hence, to respond to globalization, national, regional (interregional), and global policies and actions must be implemented. At the national level, a number of macroeconomic issues, such as exchange rates, monetary stabilization, and fiscal policies, need to be considered. Financial markets must also be developed, and the possible contagion effects of actions in other countries, contained. Capital account liberalization needs to be sequenced properly. Other structural reforms have to be addressed as well. Regional actions offer another effective way to address and manage globalization. These have become an important component of the development strategy in East Asia since the financial crisis of 1997 and 1998.<sup>2</sup> The Association of Southeast Asian Nations (ASEAN) and ASEAN+3 (ASEAN plus the PRC, Japan, and the Republic of Korea) have become more active, and several new initiatives have been started to stimulate trade and financial integration. There has also been a proliferation of bilateral and subregional free trade agreements (FTAs), both within the Asian region and between Asian economies and other regions. In the area of monetary and financial cooperation, regional policy dialogues have begun through various forums comprising ASEAN and ASEAN+3 finance ministers and their deputies. A regional resource-pooling scheme, the Chiang Mai Initiative, has been established and efforts are being made to develop multilateral swaps as well as bond markets denominated in local currencies. Bridges are also starting to be built across the Asian subregions especially between South Asia and East Asia. East Asia's momentum of integration with the global economy, including its role in various international forums, is also being strengthened.

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<sup>2</sup> See Chapter 5.

After independence from the British in 1947, both India and Pakistan (with what is now Bangladesh) had adopted import-substituting policies and erected high walls of protection on all sectors of the economy. This had meant not only high tariffs but also various forms of licensing to control entry into industries. The resulting “license raj” in both countries had created inefficiencies, promoted public sector corruption, and constrained the rate of economic growth. The smaller South Asian countries — Bhutan, Maldives, and Nepal — had also adopted a similar development strategy. It was basically only in the 1980s and the 1990s — the 1980s in the case of Sri Lanka, the mid 1980s in the case of India and Bangladesh, and the 1990s in the case of Pakistan and Nepal — that the South Asian countries started the reform process (Devarajan and Nabi, 2006). In many cases reforms have been proceeding in spurts because vested interests have applied pressures to slow the reform process.

Since its independence 60 years ago, India has consolidated a vibrant and competitive form of democracy, banished famine, more than halved its absolute poverty rate and dramatically improved literacy and health conditions. It has also achieved global competitiveness in information technology (IT), outsourcing, telecommunications, and pharmaceuticals; acquired de facto membership in the club of nuclear powers; created more billionaires than any other country in Asia and became one of the most dynamic and fastest-growing countries, ranked the world’s fourth-largest in purchasing power parity. It has also acquired a new geo-strategic importance.

On the economic side, however, India’s success is relatively recent. Some changes occurred slowly and the growth rate of the economy rose to 5% a year in the 1980s, much higher than during the earlier decades of independence (when the growth rate was 3% per year). But the decisive change occurred after the reforms of the early 1990s. During the period 1991–2005, the growth rate averaged 6%, compared to 4.9% in 1976–1990. The reforms of the 1980s in Sri Lanka and in the 1990s in other South Asian countries have also borne fruit, and other South Asian countries have also shown economic dynamism. The Bangladeshi economy grew by an average of 5% in 1991–2005, compared to 3.9% in 1976–1990, and the

Sri Lankan economy, by 4.8% and 4.6%, respectively. The economy of Nepal, which has been ravaged by political problems, grew by an average of 4.3% in 1991–2005. The Pakistani economy has, however slowed, from an average of 6.3% in 1976–1990 to 4.3% in 1991–2005. This economic dynamism of the South Asian countries is expected to continue in the future, and South Asia's share of global income is expected to increase further. For example, the Planning Commission projects that the Indian economy will grow by 10% per year in 2007–2012. However, as the East Asian crisis has shown, a financial crisis can be a major setback to an economy, entailing huge economic and social costs but without derailing it. The recovery of the crisis-affected countries in East Asia was swift, but the investment rates have not recovered yet and the post-crisis growth rates are significantly lower than the pre-crisis ones.

South Asia was spared from the contagion of the 1997 East Asian financial crisis mainly because it had not deregulated its capital account. However, in the future, as South Asia continues its economic reforms and deregulates its capital account and enhances its integration with the world, a financial crisis cannot be ruled out. Capital account deregulation is necessary in order to attract foreign capital into local stock and bond markets. Financial sectors in South Asia continue to be weak and the system of corporate governance is less than fully transparent. Like those in East Asia, banks continue to bear the brunt of the required financing, and capital markets are less developed. This could create the so-called “double mismatch” problem, which led to the Asian financial crisis. The region can also be buffeted by other types of real and financial shocks. A major lesson for South Asia from the post-crisis experience of East Asia is that globalization can convey large amounts of benefits but also presents some challenges, which have to be addressed effectively.

This book reviews how South Asia is rising to the challenge of globalization. How are South Asian countries maximizing the benefits of globalization while minimizing its costs? What actions have they taken at the national, regional (inter-regional), and global level? What lessons have the South Asian countries learned from the

East Asian financial crisis and how are they preparing for financial globalization?

This book comprises five chapters. This chapter contains the introduction and summary. In Chapter 2, the current status of the region is compared to that of countries in East Asia and the rest of the world, against a variety of globalization indicators. The chapter gives the reader a broad overview of progress, impact, and potential for globalization in South Asia. Since globalization has generally been a positive force for greater economic growth throughout the world, the chapter analyzes the globalization experience of South Asia using the various indices developed, among others, by Kearney (2006) and the Carnegie Endowment for International Peace (2006) and Dreher (2005). South Asia has opened up its economy to foreign investment and provided stimulus for growth in international trade since the 1980s and the 1990s and has become more globalized. There has been a shift in emphasis from an inward-looking import substitution strategy to more outward-looking international policies with a role for the private sector. A variety of indicators of economic growth and international trade and finance and others reflect this new look. Among these are the share of FDI in total investment and income, the share of trade in GDP, the growth in trade, and the inflow of portfolio capital into the stock market. Although the globalization scores for South Asia are increasing, they are lower than those for East Asia and the PRC mainly because of poor health and education, quality of labor force, and institutional strength indicators. By looking at how these indicators are related to economic growth, the chapter draws a clearer profile of the impact of globalization on economic growth and poverty reduction. Globalization initiatives in South Asia, such as lowered barriers to trade, FTAs signed and under negotiation, international migration, and FDI and capital flows, are examined.

The chapter ends with a discussion of an agenda for enhancing globalization — trade policy, improved competitiveness, policies to encourage inflows of FDI, increased financial integration, and an appropriate international migration policy. Integrating further into the global economy would benefit South Asia. Initiatives taken since the 1980s and 1990s have borne fruit, both in accelerating economic

growth and reducing poverty. South Asia must build on this foundation to become even more competitive internationally and to accelerate economic growth. South Asia can integrate further into the global community in several ways. Many of these initiatives relate to international trade in goods and services and in the flow of capital, such as reducing trade barriers, improving international competitiveness, attracting FDI, developing new trade agreements, and increasing capital account convertibility. The flow of labor and issues of financial integration must also be addressed. Recent data on FDI inflows into India are encouraging. According to the United Nations Conference on Trade and Development (UNCTAD), India ranked second only to the PRC as the most preferred destination for global FDI, receiving \$17 billion of FDI in 2006, an amount equivalent to the combined flows for the previous three years.

On the trade front, the chapter recommends further reductions in tariffs and nontariff barriers (NTBs). The overall assessment of various competitiveness indicators for South Asia is positive but there is scope for further improvement, through reforms in business and government efficiency by reducing bureaucratic procedures and increasing competition. In increasing competitiveness, infrastructure improvements are critical. Despite recent improvements, including efforts to involve the private sector, the lack of a modern and efficient infrastructure foundation continues to inhibit the growth of industry and the private sector in South Asia. The removal of road transportation bottlenecks can be extremely effective in increasing efficiency, by reducing costs and time to market as well as facilitating the movement of temporary labor throughout the country. Cross-border links should also be improved as part of the Asian highway network and the trans-Asian railway system.

Additional measures should be adopted to attract FDI. Among these are various institutional and procedural improvements that can demonstrate the attractiveness of South Asia as an FDI destination. First, measures can be taken to harmonize FDI regulations and incentives to stop a “race to the bottom,” develop regulations to stop double taxation, pool experience among South Asian countries to determine a strategy for attracting FDI into different sectors, and

establish a regional research center devoted to studying the pattern and effectiveness of FDI in the region and elsewhere and disseminating the results. Second, a series of procedures can be developed to simplify entry and exit procedures, set up a fast track for approvals of FDI investment, allow repatriation of profits, and encourage free flow of FDI within the region. Harmonization of financial regulations is another key area of need in South Asia. This should be combined with deepening of the financial infrastructure and financial markets, perhaps using the Asian Bond Market Initiative proposed for East Asia as a model. Capital account convertibility should not be eschewed; liberalization should, however, be sequenced properly.

Many impediments to increasing migration from South Asia rest with recipient countries in Europe, North America, and Australia. Bilateral negotiations to enhance personal safety and improve working conditions for short-term guest workers should be intensified. Given the increasing importance of remittances in South Asian countries, facilitation of these flows can also be improved. Further integration into the global information and telecommunications labor market can be encouraged and promoted in a number of ways. Giving support to the private sector by upgrading physical infrastructure in service sectors specializing in IT and communications should be a major priority as the demand for outsourcing and migration of skilled professionals in the IT industry continues to grow. Better coordination between shifting job openings in industrial countries and skill development in South Asian countries can be developed by encouraging private sector involvement in IT and communications training in South Asia as well as facilitating migration programs that allow skilled and professional workers to migrate for a year or two and then return to use their expertise at home.

Chapter 3 presents a comparative analysis of economic performance and policy reforms in the PRC and South Asia. There are several reasons for this. First, nearly half of the world's population has a stake in the ability of both to sustain high rates of growth and raise living standards. Second, the PRC and South Asia can benefit from each other's experiences. Their unique features make mutual dialogue and discussions important. The two are at similar stages of economic

development with diverse policy challenges. They both have huge land masses, diverse climates and geography, similar demands on the environment, and, of course, large populations. The major premise of this chapter is that policies are important. Good policies can help lift income growth rates and lower poverty, while poor policies retard growth and stall poverty reduction. The chain of events leading from policy reforms to growth is not the same for all economies. Special circumstances in each economy have to be analyzed as well. History, government, and institutions are also important because they serve as the background for policy adjustments.

In both India (and its neighbors in South Asia) and the PRC growth has been rapid in the past few years, faster than in most other developing countries in Asia and the rest of the developing world. The fact that living standards have swiftly improved for the more than 2 billion people in these countries is a major accomplishment to be lauded. While the PRC has grown rapidly for more than three decades, growth in India and the rest of South Asia has accelerated only recently. To provide a better grasp of the details of recent economic development, the chapter begins with a short review of economic performance indicators for South Asia and the PRC: the pattern of growth in per capita income; modifications in sector shares in agriculture, industry, and services; inflation, FDI, and current account balances, along with international reserves; and human resource indicators such as the incidence of poverty.

This review is followed by a discussion of why living standards have been rising faster in the PRC than in South Asia. PRC began the reform period with a lower per capita GDP than all the countries in South Asia with the exception of Nepal. But by 2005 per capita income was more than twice as high in the PRC than in all of South Asia with the exception of Sri Lanka. Furthermore, poverty reduction has been more dramatic and human development indicators have improved more rapidly. The differences in initial conditions as well as the design and sequencing of reforms explain this outcome. Reforms in agriculture and industry took center stage at the start of the reform process in the PRC. This facilitated the development of relatively efficient commodity markets and the encouragement of quick supply

responses early in the reform process. Macroeconomic reforms (e.g., fiscal, financial, trade and investment, and exchange rate reforms) and other microeconomic reforms (e.g., industrial policy and public enterprise, public administration, labor market, and infrastructure reforms) were undertaken later, sometimes in response to distortions and bottlenecks that resulted from reforms in the productive sector. South Asia, on the other hand, generally put macroeconomic reforms ahead of microeconomic reforms mainly because reforms were undertaken in response to adverse macroeconomic situation and required belt-tightening measures with high social costs.

Although South Asia put macroeconomic reforms ahead of microeconomic ones, more remains to be done at this level. Tariffs have been lowered, yet they are still higher than rates in Southeast Asia and East Asia. In India, export processing zones are relatively recent and small compared with those in the PRC, and they lack efficient and cheap connectivity with major ports. Regulations are still cumbersome and are a disincentive to foreign investors. In other countries in South Asia, similar reforms are needed in trade, foreign investment, and the financial sector, although the details differ from country to country. Additional reforms at the microeconomic level or the so-called second-generation reforms are needed to make markets work better. These comprise continued reforms of the agriculture and industrial sectors; reform of public institutions for improved governance (civil service, bureaucracy, and public administration); reform of institutions that create or maintain human capital (education and health); and, improving the environment affecting the private sector (regulatory environment, flexibility in labor markets, legal and physical infrastructure, and clearly-defined property rights). Unlike macroeconomic reforms, however, successful implementation of second-generation reforms requires a wider consensus in the countries. This chapter also provides a discussion of the unfinished agenda for South Asian countries at a country level and concludes with an analysis of future growth prospects for the region, which are fairly encouraging provided reforms remain on track. The unfinished agenda includes, among others, restructuring private enterprises in most countries, improving tax administration in Nepal and Pakistan, implementing

various standards and codes and best practices for the financial sector, improving labor market flexibility, and upgrading governance and infrastructure throughout the region (see Chapter 3, Appendix 3, for further details).

A review of the pattern of economic growth and sectoral changes in the PRC and India brings out several aspects that are important in assessing the future prospects for these two giant economies. First is the overwhelming importance of industrial growth in the PRC. Industry in 2005 accounted for 40% of the country's GDP, up from a negligible amount only 30 years ago. This growth has not only been spectacular but has been concentrated for the most part in a few sectors, primarily Standard International Trade Classification (SITC) categories 5–8 (office machinery, electrical machinery and appliances, telecommunications equipment, and miscellaneous manufactured goods).

Second, although it is starting to improve, the performance of the industrial sector in India has been anemic. The sector has not grown as fast as the rest of the economy and has therefore provided little impetus for economic expansion. The sector share is only 26% of GDP, versus 40% in the PRC. Even accounting for some estimation errors, this is still a very big difference. The acceleration in growth of the Indian economy since the mid-1990s has been led by the services sector, with a small contribution from agriculture. Since the middle of this decade, there has also been some turnaround in manufacturing productivity, mainly because of private sector activities and responses to reforms. FDI is only one-tenth the level of the PRC's and export growth has been slow. Merchandise exports are only about 10% of GDP and are not nearly as well focused on labor-intensive industries as they are in the PRC.

The PRC can easily continue to grow rapidly and increase its export domination in manufactured goods categories 75–77, and perhaps expand into 78 (road vehicles). By 2001–2004 this subsector's share of total manufactured output was already 34%, up from a negligible amount in the 1990s. Whether this continued growth in industry is in the best interest of the country is another matter, however. A more appropriate strategy would be to put less emphasis on industry

and more on services and the rural development of the backward interior provinces.

Much of the current emphasis in India is to leapfrog over the industrialization phase of development and focus on a wide variety of both high- and low-technology services, primarily in IT and communications. To sustain rapid growth, there has to be an added push to develop labor-intensive industry as in East Asia and the PRC. Such a strategy would also benefit rural areas as growth would trickle down to the poor. India has the potential to develop a vibrant, efficient, and internationally competitive industrial sector, but this requires better infrastructure as well as labor and industrial policies that are flexible and allow large-scale industry to operate in labor-intensive industries.

The recent Goldman Sachs report (Poddar and Yi, 2007) argues that growth acceleration in India since 2003 represents a structural increase rather than simply a cyclical upturn. India could grow by 8% yearly until 2020 (from the 5.7% forecast for 2003), the report adds. But to do this, India needs to address supply-side constraints on business, infrastructure development (health and education, among others), and the labor market.

There are encouraging signs that such a takeoff is near in India; however, FDI growth in manufacturing is still slow, labor markets are still constrained, and business investment in new plant and equipment is weak. For the outlook for the next decade to change, the Government will have to remove all of these bottlenecks. Then it will definitely be possible for the industrial sector to exhibit the dynamism that the IT and related service sectors have been showing in the last few years. If this materializes, India could well grow as fast as PRC in the next two decades, particularly if it is able to raise investment rates so that they are closer to the rates achieved by the PRC.

Chapter 4 looks at the evolving economic relationship between South Asia and East Asia. Recently, there has been growing interest in the economic relationships between these two regions. There are, at least, three reasons for this interest. First, two of the most dynamic countries in the world, namely, the PRC and India, are in these regions and the evolution of these giant economies, together with growing economic interrelations between the two, could have important

implications for other countries in the regions and the global economy. Second, with the surge in regionalism in post-crisis East Asia, a question that is frequently being asked is: will growing economic relations between South Asia and East Asia be the second phase and eventually lead to an integrated Pan-Asia similar to the integration achieved in Europe sometime in the future? Third, during the pre-colonial period, Asia not only dominated the global economy but was one of the most integrated regions in the world, will this happen once again? The chapter highlights the recent surge and the potential for increased integration in the future between the two regions. It also recommends a set of policies to further enhance integration between South Asia and East Asia.

The chapter begins by reviewing trends in economic integration between South Asia and East Asia. South Asia's merchandise trade with East Asia has grown significantly in absolute terms. This trade is the second-largest component of Pan-Asian trade, suggesting that South Asia–East Asia economic relations could be labeled as the “second phase of Pan-Asian integration.” The chapter also reviews quantitative measures of economic integration between South Asia and East Asia, and assesses economic complementarities between the two regions by looking at the pattern of exports and comparative advantage. A large part of the increase in South Asia–East Asia trade is accounted for by the bilateral trade between the two giant economies of India and the PRC; trade between them has also increased rapidly in recent years. The trends show as well that East Asia is a more important trading partner for South Asia than vice versa.

Trade shares are not sufficient to assess the extent to which countries prefer to trade with each other than with other trading partners. Trade intensity indices are a better way of measuring whether trade between two regions is greater relative to their importance in world trade. The trade intensity indices between South Asia and East Asia declined in the 1990s but have increased since then. This increase reflects mainly the increasing trade intensity between South Asia and ASEAN and the PRC. Despite overlaps, exports between the two regions have some complementarities. South Asia exports mainly agricultural, primary, and labor-intensive manufactured goods to

East Asia. East Asia's exports to South Asia, on the other hand, comprise mainly of capital- and knowledge-intensive products such as telecommunications and sound recording equipment, electrical machinery, road vehicles, and industrial machines.

Policies in South Asia, particularly in India, have recently sought to establish trade and investment links with ASEAN and East Asian countries. India's engagement with ASEAN began in 1992, and since 2005 India has also participated in various East Asia Summits as well as other meetings with European finance ministers. South Asia and East Asia have signed a number of FTAs as well.

Which policy actions would increase South Asia–East Asia integration? First, while tariffs and NTBs are already low in many East Asian countries and while South Asia has made encouraging progress in the same direction, further reductions can be made (especially in NTBs in East Asia, where tariffs are already low). Second, trade liberalization efforts need to be embedded in a wider program of economic reforms. South Asian countries and several East Asian countries need to make progress in implementing reforms at the microeconomic level and the so-called second-generation reforms to enhance transparency, good governance, and human capital. Among these reforms are reform of the civil service and of the delivery of public goods, to strengthen competition, regulations, and property rights and thus create an environment conducive to private sector opportunities. The reform of institutions that create human capital, in health and education among others, is also required. Third, South and East Asian countries need to consolidate their FTAs into an Asia-wide FTA. To make the proliferation of FTAs between South Asia and East Asia stepping-stones rather than stumbling blocks to multilateralism and to reduce economic inefficiencies due to overlapping rules of origin and others, policy makers in the region may wish to adopt the concept of “open regionalism” and broaden FTAs by creating as large and wide a market as possible. Deepening FTAs by extending their coverage beyond trade in goods into services, investment, technology, etc., may reduce the problem of trade diversion. Quantitative estimates suggest that a broad regional approach will, for the most part, forestall largely adverse effects on individual Asian countries that may follow

when countries and subregions are otherwise left out (Francois, Rana, Wignaraja, forthcoming). The fourth measure that could significantly affect trade between South Asia and East Asia is reduction of trading costs. This could be brought about by investment in trade-related infrastructure and the streamlining of cross-border procedures (such as customs procedures and logistic costs) to minimize delays in customs inspection, cargo handling and transfer, and processing of documents. Finally, trade promotion through skillful economic diplomacy, regular exchange of business delegations, and civil society participation could be given much more encouragement. People-to-people contacts can go a long way toward enhancing trade and investment between countries.

Chapter 5 considers the broad topic of regional integration within South Asia and draws lessons from the experience of East Asia. South Asia was a well-integrated region of the British Empire in the 19th and early 20th century before World War II. In 1947, when Pakistan and India became independent, more than half of Pakistan's imports came from India and nearly two-thirds of its exports went to India. Then, after Pakistan was partitioned, tensions between the two countries grew as they bickered over water rights, territory, and currency valuation. These, together with the adoption of international trade policies that emphasized import substitution, led to a dramatic reduction of trade among South Asian countries. Whatever limited international trade that took place was with industrial countries, particularly the United States. Consequently, after independence from British rule, trade among the South Asian countries fell from around 20% of total trade to about 4% by the end of the 1950s, and to 2% by 1967 (World Bank, 2004). The share of intra-regional trade in total trade began to increase only after the countries abandoned import substitution policies in the 1980s and the 1990s. It now stands at about 4% of total trade.

This chapter explores how the previous strong pattern of trade can be revitalized. There are several mechanisms and modalities for increasing intra-regional trade and fostering regional cooperation, such as developing cross-border infrastructure, fostering international trade and investment (including services), and increasing

cooperation in the financial sector. In infrastructure, under the South Asia Subregional Economic Cooperation (SASEC), six priority sectors have been identified: transport; energy and power; tourism; environment; trade, investment, and private sector cooperation; and information and communication technology. Progress is still in the early stages, although projects are being identified and preliminary work is being done.

The South Asian Association for Regional Cooperation (SAARC) with its trade initiatives — the SAARC Preferential Trading Arrangement (SAPTA) and the South Asia Free Trade Agreement (SAFTA) — is the major institutional entity charged with promoting free trade in South Asia. SAFTA aims to reduce tariffs among members to 0%–5% by 2016 and establish a free trade area. However, progress has also been slow. Each country has a list of products that are not part of the agenda for tariff reduction and these products are hard to eliminate. The hope is that all countries are more committed to free trade than they have been in the past and will be willing to make mutual concessions to make trade agreements work. With regard to free trade agreements, two current bilateral agreements involve South Asian countries — those between Sri Lanka and India and between Nepal and India. Although the World Bank (2004) argues that even with free trade the amount of trade within South Asia would be relatively small (although certainly bigger than the current flows), opportunities for more trade within South Asia are confirmed by a number of studies that consider comparative advantage and geographic proximity. The level of intra-regional trade is expected to increase in the future but not to the pre-partition level as patterns of comparative advantage have changed. Integration with East Asia (discussed in Chapter 4) will provide additional opportunities for both South Asia and other regions of Asia to reap the benefits of globalization. As Chandra and Kumar (2008) note, South Asia can benefit from a twin-track approach: integration within itself and better integration with the rest of the world. Integration within South Asia is more likely to succeed if undertaken as part of broader Pan-Asian cooperation. Increased integration in South Asia could also help build bridges between Central Asia and East Asia.

Regarding financial integration, several institutional developments in the past decade were designed to promote greater monetary and financial integration in South Asia. Among these is the recent formation of a network of central bank governors and finance secretaries of the SAARC region and a forum of SAARC finance ministers. These groups discuss and exchange views on macroeconomic issues, and possibilities for harmonizing strategies for the environment and natural disaster relief. A South Asian Development Fund (SADF) has been set up to identify regional projects in industry, energy, agriculture, and services, as well as infrastructure and social development projects. The SADF has also financed feasibility studies. For financial and monetary integration within South Asia to progress beyond these steps, more work must be done to assess whether enough macroeconomic convergence and political will has been developed before the idea of a common market can be entertained. This work is ongoing.

An important lesson for South Asia from East Asia's experience is that regionalism can help maximize the benefits of globalization while minimizing its costs. South Asia should strengthen its efforts to enhance cooperation within the region and with East Asia. The recent observer status given to the PRC and Japan in SAARC should have a catalytic impact on South Asian integration. Second, expeditious implementation of SAFTA is necessary. Nontariff barriers to trade should be removed. SAFTA should also be deepened to cover the service trade and the movement of labor. Third, efforts should be made to strengthen monetary and financial cooperation in South Asia. The region could join ongoing efforts in East Asia (such as the Chiang Mai Initiative and local currency bond markets).<sup>1</sup> Fourth, in infrastructure cooperation, the SASEC initiative could benefit from interaction with the Greater Mekong Subregion program.

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<sup>1</sup> Recently a \$3 billion bilateral swap agreement was signed between India and Japan.

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