CHAPTER III

ECONOMIC INTEGRATION IN SOUTH ASIA: A DESCRIPTIVE ANALYSIS

3.1 Introduction

Global economy has witnessed a rapid integration beginning in the early 1980s. As globalization and regionalism gained its momentum and the welfare gain from open trade is realized by the pioneer East Asian nations (especially, the ASEAN countries), the South Asian countries also tried to catch up with the movement under the banner of South Asian Association of Regional Cooperation (SAARC). Section 3.2 of the chapter illustrates the characteristics of South Asian economies and trends in sectoral composition of GDP. Trends in trade and investment and trade and investment policies in South Asian region will be presented in section 3.3. Further, some salient features of the SAFTA and bilateral trade agreements between Sri Lanka and India will be presented in section 3.4. Finally, section 3.5 reviews some characteristics of the ASEAN to understand the importance of ASEAN economic integration to South Asia's future economic integration.

3.2 Characteristics of South Asian Economies

3.2.1 Overview of South Asian Economies

SAARC countries differ enormously in terms of size, population and economic development. They share divergent economic, social, cultural and political arrangement. These divergences offer enormous opportunities as well as numerous difficulties and challenges in the formation of regional bloc. One of the structural characteristics of the region is the coexistence of least developed countries with relatively more developed country. India predominates the SAARC economic parameters including GDP and population. Some key economic indicators on South Asian countries are provided in Table 3.1.

Table 3.1 Key Economic Indicators of SAARC Countries: 2003

Economic Indicators	COUNTRY						
	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Surface Area (Thousands sq. km)	144	47	3288	0.3	147	796	66
Population (Millions)	138.1	0.874	1064.4	0.293	24.7	148.4	19.2
Density people per Sq. km	1061	19	358	977	172	193	297
GNP per capita US$	400	660	530	2300	240	470	930
PPP per capita US$	1870	-	2880	-	1420	2080	3730
% GDP growth (2002-2003)	3.5	4.0	6.4	6.1	0.7	3.3	4.3
Gini Index* *	31.8	-	32.5	-	37.7	33.0	34.4
% Population below US 1 a day*	36.0	-	34.7	-	36.7	13.4	6.6
Adult literacy rate %	41	-	61	97	44	-	92

Survey Years *: Bangladesh: 2000, India: 1999-2000, Nepal: 1995, Pakistan: 1998, Sri Lanka: 1995-96

**:Bangladesh:2000,India:1999-2000,Nepal:1995-96,Pakistan:1998-99,SriLanka:1995

Source : World Bank :World Development Report, 2005

In recent years, South Asia has been the second fastest growing region in the world. Yet it remains as the region with the largest number of people living in poverty. Having more than 22 percent of the world's population living on only 3.8 percent of the land total land area of the world. It is home for more than half a billion poor people, or 43 percent of world's poor people (Table 3.2). The World Bank classifies Maldives and Sri Lanka as lower middle income countries (LMC) and other five South Asian countries as low-income countries (LIC).

Among the SAARC countries India, Pakistan and Sri Lanka were colonies of imperial power at a certain stage in their political history. Although these countries have the democratically elected governments, armed forces of some of these countries have an over-bearing influence on policy making in this region.

Table 3.2 **South Asia in the World: A Comparison of Population, Land Area and GNP: 2003**

Region	Population Total (millions)	%	Number of Poor * Total (millions)	%	Surface Area (Sq Km thousands)	%	People Per Sq. km	GNP Billion US$	%	GNP (PPP) Billion US$	%	GNP Per Capita (US$)	GNP(PPP) Per Capita (US$)
Low & Middle Income	**5,300.3**	**84.5**	**1198.9**	**-**	**101,485**	**76.0**	**53**	**6,731**	**19.5**	**22,815**	**44.4**	**1,280**	**4,320**
East Asia & Pacific	1,854.5	29.5	278.3	23.2	16,384	12.3	117	2,011	5.8	8,675	16.9	1,080	4,680
Europe & Central Asia	472.7	7.5	24.0	2.0	24,208	18.1	20	1,217	3.5	3,579	7.0	2,570	7,570
Latin America & Caribbean	534.2	8.5	78.2	6.5	20,462	15.3	27	1,741	5.1	3,780	7.3	3,260	7,080
Mid East & North Africa	311.6	4.9	5.5	0.5	11,023	8.3	28	689	2.0	1,743	3.4	2,250	5,700
South Asia	1,424.7	22.8	522	43.5	5,140	3.8	298	726	2.1	3,795	7.4	510	2,660
Sub Saharan Africa	702.6	11.2	290.9	24.3	24,267	18.2	30	347	1.0	1,243	2.4	490	1,770
High Income	**971.4**	**15.5**	**0**	**0**	**32,082**	**24.0**	**31**	**27,760**	**80.5**	**28,603**	**55.6**	**28,550**	**29,450**
Total	**6,271.7**	**100**	**1198.9**	**100**	**133,567**	**100**	**48**	**34,491**	**100**	**51,418**	**100**	**-**	**-**

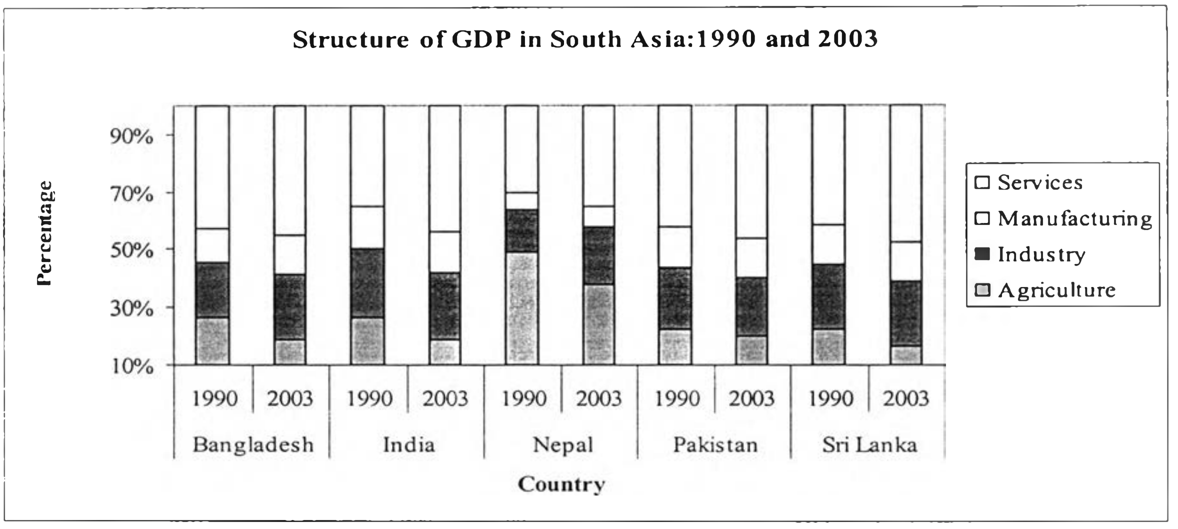
Note : Poor is measured as the person who lives with under US$ 1 per day

Source: World Bank: World Development Report, 2005

3.2.2 Trends in the Sectoral Composition of GDP

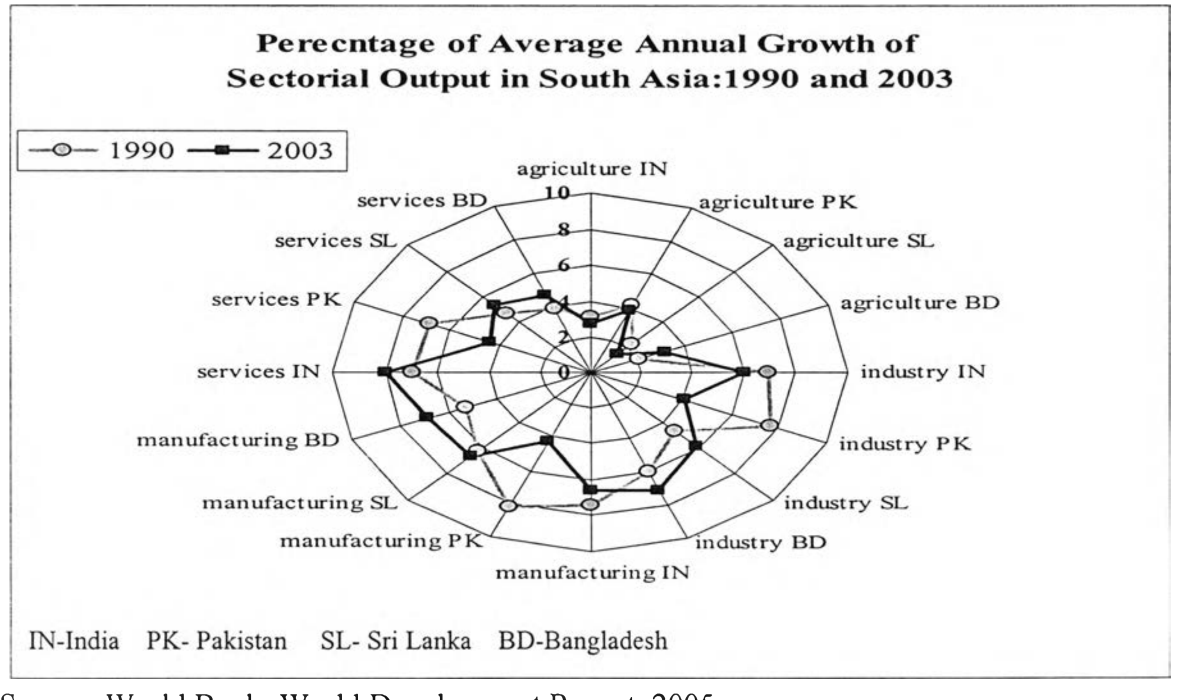
The figure 3.1 and figure 3.2 will illustrates the economic structure of the South Asian countries and its average annual growth rates in periods 1990 and 2003.

Figure 3.1 Contribution to GDP in South Asia



Source: World Bank: World Development Report, 2005

Figure 3.2 Average Annual Growth Rates of Sector of GDP



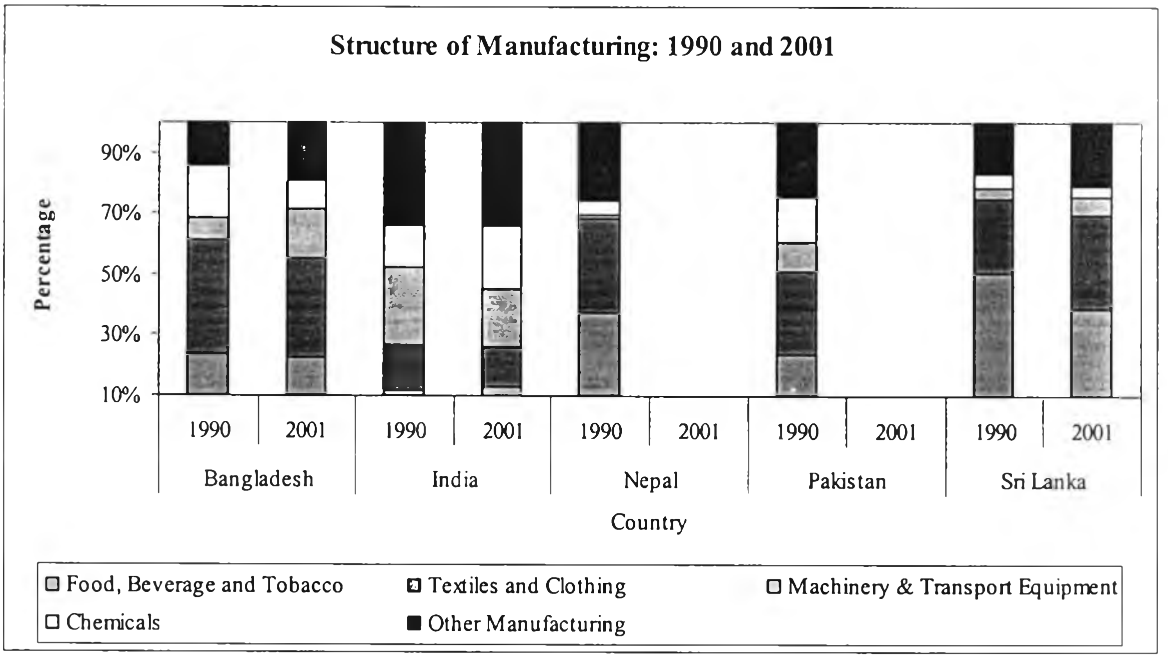
Source: World Bank: World Development Report, 2005

The above figures illustrates that all sectors have witnessed reasonable growth rates over the past years. In particular, the service sector has expanded greatly in India, Sri Lanka and Bangladesh. In Pakistan though the service sector is the major sector that contributes to GDP, its average growth rate has declined in year 2003, when comparing with the year 1990. From the figure 3.1 it is clear that there has also been significant structural transformation. The contribution of agriculture to GDP has decreased steadily over time. At the same time, the industrial and service sectors have become more important contributors to the economy.

In Sri Lanka the service sector contributes 54 percent to the GDP followed by the industrial and manufacturing sectors 28 and the agricultural sector at 18 per cent in 2003.

The diagram below illustrates the structure of manufacturing in South Asian countries.

Figure 3.3 Contribution to Manufacturing Sector

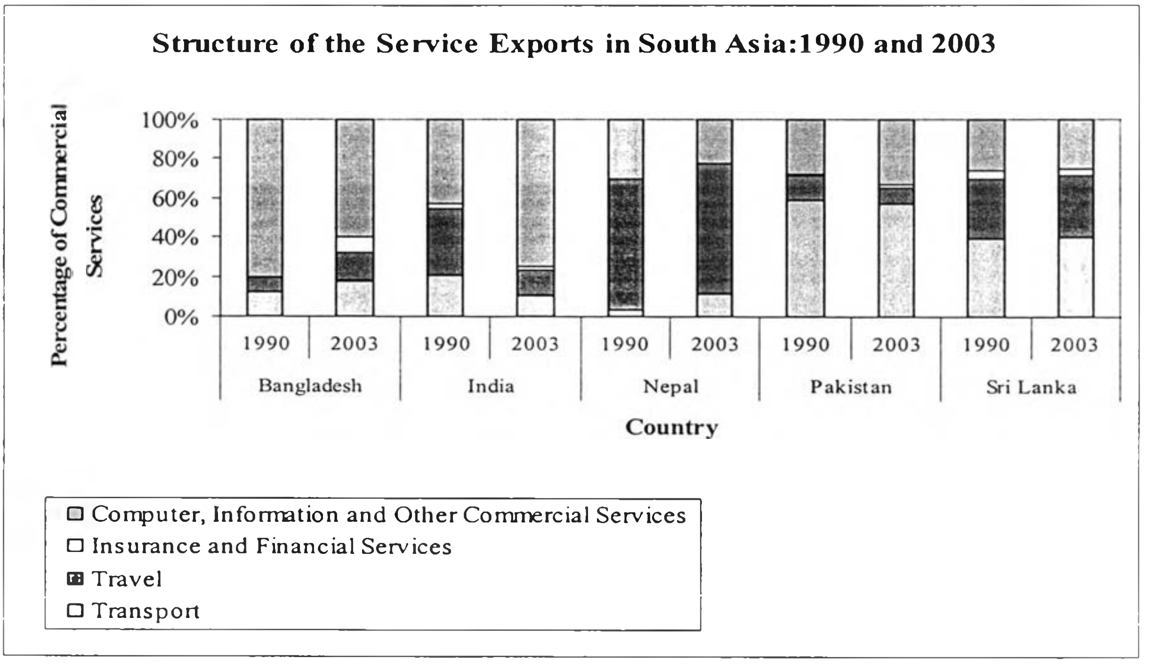


Source: World Bank Report, 2004

From the above diagram it could be seen that textiles and clothing sector dominates the manufacturing sector in most South Asian countries except in India where other manufacturing and machinery and transport equipment contributes mainly in the manufacturing sector. The trend towards increasing industrialization has also been largely responsible for improved growth rates in South Asian economies in recent past.

The diagram below illustrates the structure of the services export in South Asian countries between the periods of 1990 and 2003.

Figure 3.4 Structure of Service Exports in South Asia



Source: World Bank Report, 2004

It could be seen that in India computer and information technology dominates in the services sector, where as in Sri Lanka transport and travel sector play significantly to expand the service sector. Liberalization, private sector participation and increased competition have contributed to the expansion of the services sector in Sri Lanka, with buoyant performance in transportation, communications, financial services, trade and tourism.

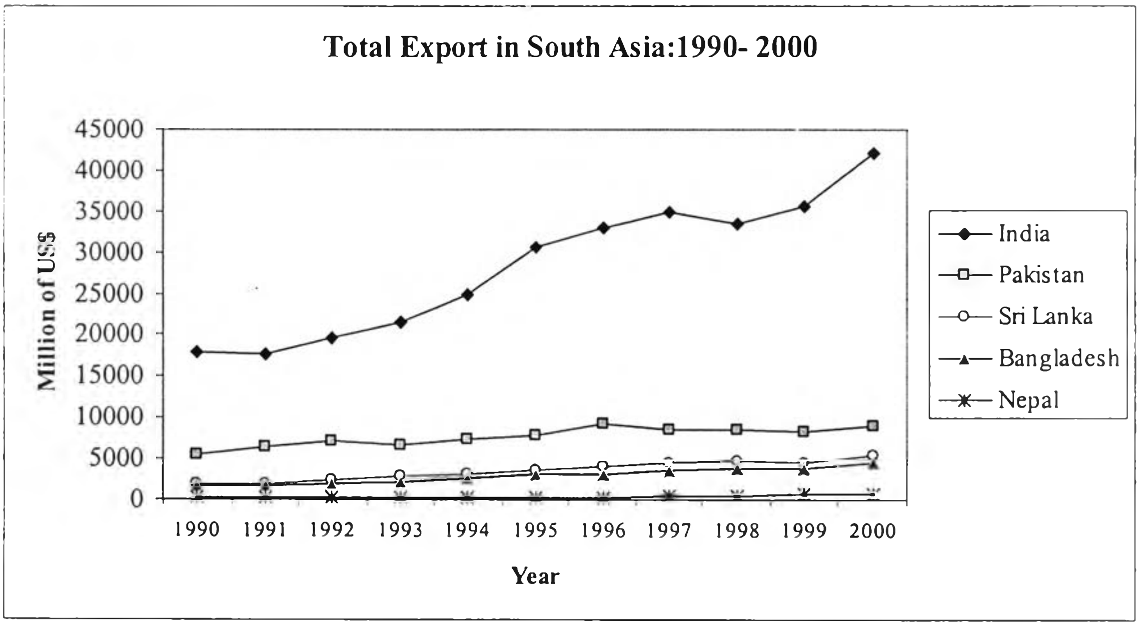
Even though the performance in the agricultural sector is on decreeing trend in Sri Lanka its role is important as a determinant of GDP, since this sector directly accounts for around one-fifth of national output and employs over one-third of the workforce. Its importance is larger than these figures indicate because of links between agriculture, manufacturing and services.

3.3 Trade Investments Trends and Policies in South Asia

3.3.1 Trade Trends in South Asia

Exports from South Asian countries increased on average by over 12 percent per annum during 1991 and 1995 with a large shift from primary agricultural products to manufactured goods and significant proportion of high-tech products from India (Regmi, 1991). The diagram below depicts exports from South Asian countries over the period of 1990 to 2000.

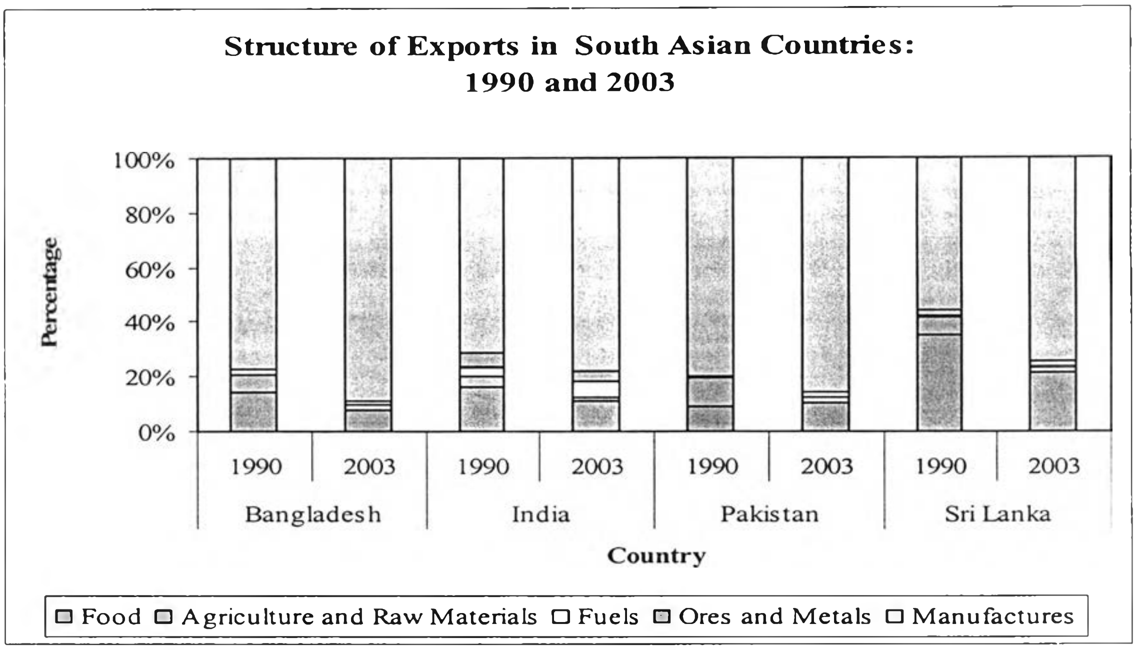
Figure 3.5 Export Performance of SAARC Countries



Source: World Bank database

From the above diagram it could be revealed that the exports from India is significantly higher than the other South Asian countries. Further, it is clear that all South Asian countries have recorded a positive rate of export growth over 1990 and 2000. The diagram 3.6 illustrates the structure of exports in South Asian countries.

Figure 3.6 Structure of Exports in South Asian Countries



Source: World Bank database

From the diagram it is revealed that in all major South Asian countries manufacturing goods contributes major share to export revenue. Textile and garments are one of the major exports item in most of SAARC countries.

Table 3.3 Import Performance of SAARC Countries

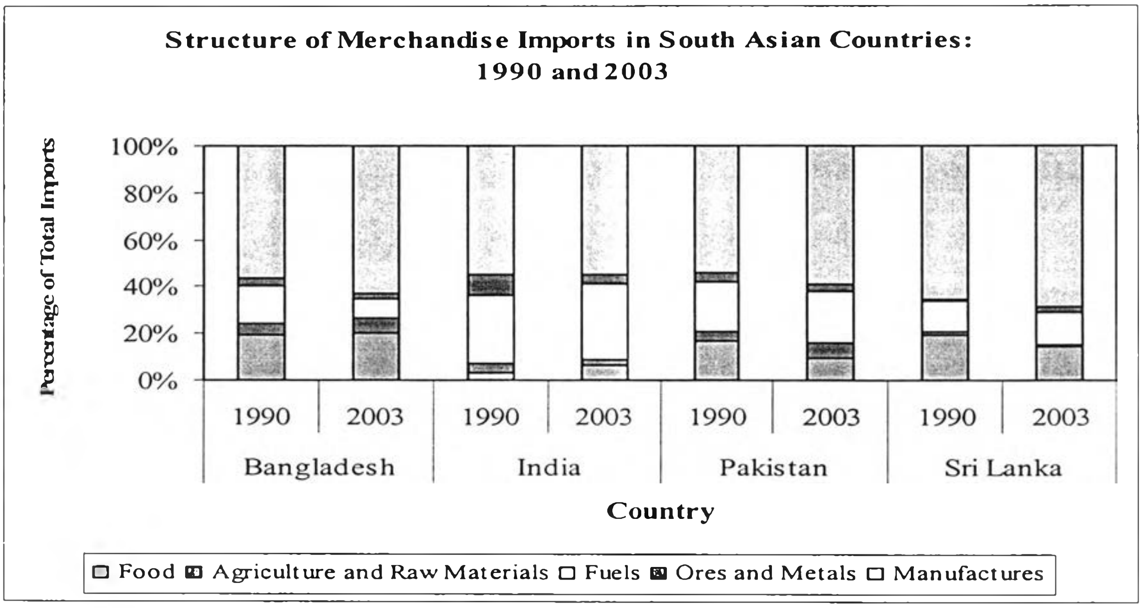
(Millions of US$)

Country	1997	1998	1999	2000	2001	2002	2003	Average annual growth rate (%)
Bangladesh	6587.6	6715.7	7420.4	8052.9	8133.4	7780.1	9349.3	5.9
India	45730	44828	45556	60268	57358	62742	-	6.2
Pakistan	10750	9834	9520	9896	9741	10428	11969	1.6
Sri Lanka	5278.3	5313.4	5365.5	6483.6	5974	6105.6	6004.8	1.9

Source: IMF, International Financial Statistics, various issues

All major SAARC countries recorded positive import growth ranging from about 1.9 percent to 6.2 percent over the periods of 1997 to 2003 as shown in table 3.5. Capital and intermediate goods represent the major imports by SAARC countries. These include petroleum and petroleum products, fertilizer, chemicals and machinery. The diagram 3.7 illustrates the structure of imports of South Asian countries.

Figure 3.7 Structure of Imports in South Asian Countries



Source: World Bank database

Due to relatively high share of manufacturing exports, the structure of imports dominates by manufacturing imports and the manufacturing imports mainly consists of intermediary inputs which require to manufacture finished goods. For instance in Sri Lanka manufacturing imports mainly consists of textiles which require for manufacturing garments.

Table 3.4 Destination of Exports from SAARC Countries: 2000

(Percentage of total Exports)

Country	US	UK	Germany	Italy	France	Japan	Hong Kong	Others
Bangladesh	31.8	7.9	10.9	4.1	5.1	1.2	1.6	37.4
India	23.7	5.6	4.8	3.2	2.5	5.7	5.9	48.6
Pakistan	25.2	6.6	5.7	2.5	3.1	2.7	6.0	48.2
Sri Lanka	40.4	13.6	4.2	1.3	2.1	4.2	1.3	32.9

Source: Constructed from IMF Direction of Trade Statistics Yearbook: 2001

Although South Asian countries' trading partners are diverse including Europe, United States, Hong Kong, Japan and Middle Eastern countries and European Union, United States remains as the major export destination for South Asia's exports.

Table 3.5 **Intra and Inter-Regional Trade by SAARC**

(Percentage)

Year	Exports 1995	Exports 2000	Imports 1995	Imports 2000
SAARC	4.1	4.5	3.8	3.9
NAFTA	20.9	26.7	10.7	7.3
European Union	29.3	27.2	24.5	21.1
ASEAN	6.5	4.7	13.8	13.7
North East Asia*	10.5	6.3	8.8	11.9
Rest of the World	28.7	30.6	38.4	42.1

Source: IMF, Direction of Trade Statistics Yearbook, various issues

Note : * China, Japan and the Republic of Korea

The table 3.5 indicates the intra and inter regional trade by the SAARC in recent years. Despite increasing growth in total exports and imports in SAARC members intra regional trade level remains at very low 4.2 percent of total trade in year 2002 under SAPTA. This is negligible when compared with other regional trade blocs such as EU and NAFTA and ASEAN. However, SAARC's total trade share with rest of the world increases significantly over 1995- 2000. SAARC's export to NAFTA increased despite a fall in imports share to the region. Imports from North East Asia to SAARC increased considerably whereas exports to both East Asia and ASEAN declined over the period.

The table A.4 depicted in appendix illustrates the bilateral trade balance of regional countries from 1990-2000. Further the share of intra regional exports and imports among SAARC member countries will be presented in the table 3.7 below. Intra regional trade matrix which is shown below indicates that both export and import flows are quite low within the region.

Table 3.6 The Matrix of Intra Regional Exports and Imports in South Asia in 1991-2001

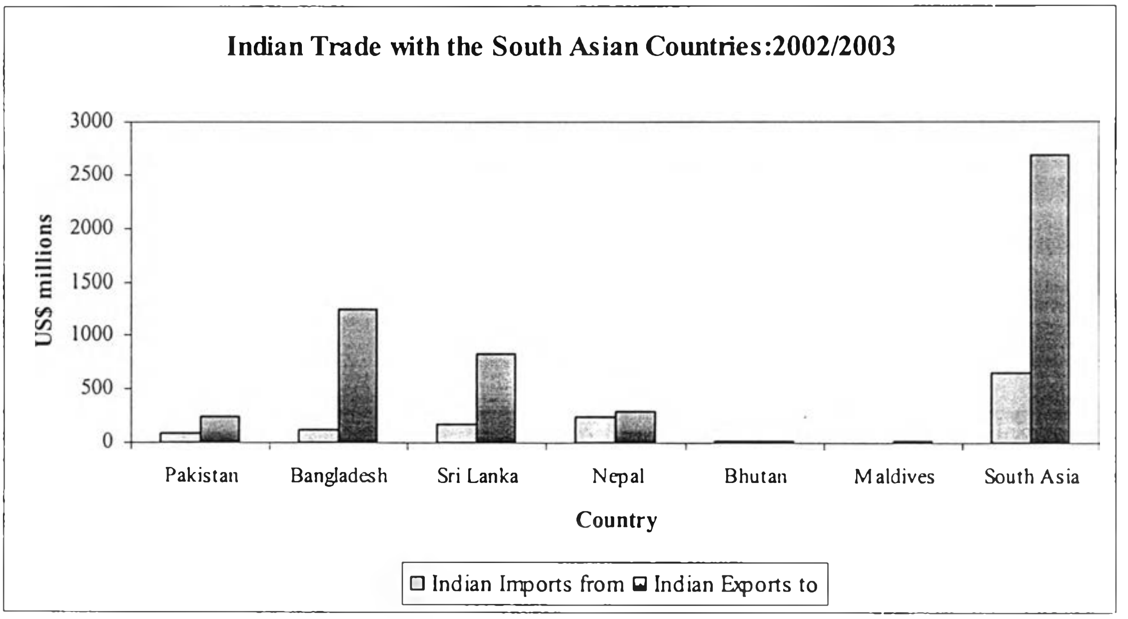
	Percentage of total Exports				Percentage of total Imports			
	Bangladesh	India	Pakistan	Sri Lanka	Bangladesh	India	Pakistan	Sri Lanka
Bangladesh								
1991	-	1.4	2.3	0.4	-	5.6	1.7	0.1
1995	-	1.2	0.8	0.4	-	15.3	2.1	0.2
2001	-	1.9	0.5	0.03	-	13.3	1.0	0.08
India								
1991	0.9	-	0.2	0.7	0.1	-	0.2	0.1
1995	3.1	-	0.2	1.3	0.2	-	0.008	0.1
2001	2.4	-	0.5	1.4	0.1	-	-	0.2
Pakistan								
1991	1.5	0.7	-	1.0	0.4	0.5	-	0.8
1995	1.9	0.5	-	0.7	0.3	0.7	-	0.4
2001	1.6	0.7	-	0.8	0.2	2.08	-	0.2
Sri Lanka								
1991	0.2	1.0	1.5	-	0.2	4.5	2.5	-
1995	0.3	0.8	1.1	-	0.1	10.5	1.2	-
2001	0.2	1.3	0.6	-	0.03	10.0	1.2	-

Source: Constructed from IMF, Direction of Trade Statistics Yearbook, various issues.

According to the figures in the matrix Bangladesh and Sri Lanka have fairly large proportion of imports from India. India and Pakistan are the major exporters while Bangladesh and Sri Lanka remain the major importers with in the region. India's intra-regional exports accounts for 72 percent of total intra SAARC exports whereas intra regional imports by Bangladesh and Sri Lanka accounts for more than 54 percent in 2000.

Further, it could be noted that regional trade dominated by bilateral trade with India accounted for 84 percent of its total regional trade in year 2003 and probably about three quarters of total regional trade. The below figure 3.8 depicts Indian trade with South Asian countries in year 2002/2003.

Figure 3.8 Indian Trade with the South Asian Countries



Source: The World Bank, Trade Policies in South Asia: 2004

There are number of reasons for the overwhelming predominance of Indian exports in the regional trade and the failure so far of the peripheral countries to substantively penetrate the Indian market.

- Most fundamentally, India has a far more diversified economy than other countries, especially in manufacturing, and many of its products-notably durable consumer goods, intermediate materials, components and certain kind of machinery are especially well suited to buyers in the region, in terms of price, quality and adaptation to South Asian conditions. At the same time tariff structures in the other South Asian countries have systematically been amended to increase the processing margins of established local industries by cutting the tariff applied to import of raw materials, intermediate components and machines that are not domestically produced.
- India is very competitive with the rest of the world in the production and export of a number of the above mentioned products and has been successfully supplying them notably to Bangladesh and Sri Lanka in competition with exporters with the rest of the world, and in nearly all cases without any assistance-or at least any substantive assistance from tariff preferences.
- The peripheral economies are far smaller than the India's in every dimension, and their export industries are appropriately much more specialized in producing labour

intensive consumer goods e.g. textiles, garments, leather goods, seafood, various agricultural products which are also low cost internationally competitive industries in India. The consequent basic difficulty of exporting these labour intensive products to India on any substantial scale is made even more difficult by high "just-in case" protection of these industries in India e.g. prohibitive high specific duties on low value textile fabrics and garments principally aimed at keeping out imports from China and other low cost developing country suppliers, and very high tariffs over wide range of agricultural products.

- Although under trade agreements which discussed in the next section (e.g. SAPTA, Indo-Lanka FTA) India has granted a large number of tariff preferences, many of them are on products which are either not produced and exported by the other South Asian countries, or which if they are produced (e.g. garments) are subject to special high protection treatment in India (see table 3.11 in section 3.3.1).
- Finally, the correction to many years of exchange rate overvaluation that resulted from the massive devaluation in India's bilateral real exchange rate Pakistan, Bangladesh and Sri Lanka. This provide an initial impetus to the expansion of Indian exports to these countries during the 1990s at the same time as their non-tariff barriers and tariffs were being reduced, while increasing the difficulty for exporters in these countries to profitably supply to India.

From the above analysis it is clear that India plays a significant role in South Asian region. In particular, if India substantially liberalizes its trade policies during the next few years, its action would be sure to have major impact and to reinforce trade liberalization in the countries around it. On the other hand, restrictive trade policies in India (such as current anti-dumping policies) increase the probability that other South Asian countries will adopt the same or similar policies. Therefore, initiatives to reinforce trade liberalization in India have an extra indirect benefit through their likely favourable regional impact. Neither, liberalizing nor restrictive trade policy changes in other South Asian countries, however, are likely to influence India. Therefore, a work programme aimed at reinforcing trade liberalization in South Asia should give India first priority.

3.3.2 Trade Policies in South Asia

The restricted trade and investment policies that prevailed in South Asia were identified as one of the significant factor that impedes intra regional trade level in section 1.2.1. Therefore, it is worth to investigate prevailing trade and investment policies in the South Asian region. Table A.5 in appendix presents the summary of trade policies in the region. These trade policies can be discussed as follows:

- **Non-tariff barriers to imports**

Since India phased out most of its quantitative restrictions (QRs) in year April 2001, Bangladesh is the sole holdout in South Asia using these traditional devices, some with the explicit purpose of protecting local industries. In addition, though India, Pakistan and Sri Lanka have done away with QRs except in regulating agricultural and food imports with sanitary and phytosanitary controls, all South Asian countries also still impose non-tariff barriers of various sorts.

- **Tariffs**

At present the general maximum custom duties that apply to most but not all products in the South Asian countries as follows: India 30 percent, Pakistan 25 percent, Bangladesh 25 percent, Sri Lanka 25 percent, Nepal 40 percent and Bhutan 30 percent. A major improvement on the situation ten years ago when tariffs in all these countries were much higher, change has brought an additional, great simplification of the structure of tariffs with far fewer tariff bands. Most countries in the region now have 3-5 of them as opposed to 15 or more in the early 1990s.

- **Other import taxes and levies**

At present India, Bangladesh, Sri Lanka and Nepal employ protective taxes on imports in addition to custom duties. The practice is major problem in Bangladesh, where three other protective taxes presently provide very high levels of nominal tariff protection to local producers in distinctly non-transparent ways. Because of import taxes other than custom duty that have protective implications, Bangladesh and India currently have de facto general maximum protective tariffs of 34 percent and as high as 100 percent (agriculture) respectively.

- **Anti-Dumping**

The anti-dumping cases already decided in India and the potential for unrestricted anti-dumping to undermine the liberalization of the trade regime that has been achieved so far suggest that a review of current anti-dumping policies and practices is urgently needed. An unfortunate consequence of anti-dumping activity in India is that producer groups looking for way of obtaining extra protection in the neighboring South Asian countries are using India's example as another reason why their government should introduce anti-dumping laws and develop technical capacity to implement them. So far there are no systematic economic evaluations of the consequences of India's anti-dumping.

- **Special Protective Treatment**

In all South Asian countries the announced, "maximum" general Custom tariffs are not actual maxima. In addition to and apart from the use of other protective import taxes on top of Customs duties, every country has industries that receive special high-tariff treatment. Many of these industries are large and have a public-sector production and/or regulatory presence. They often also benefit from exemptions from input tariffs, NTBs of various kinds and subsidies. As a result, if weighted by domestic production protected, average tariffs in most of South Asian countries (especially India) would be considerably higher than unweighted average tariff lines. Since they would rise as well above import weighted tariff averages, where high tariffs reduce or keep out imports, they therefore systematically understate the extent to which tariffs are protecting domestic industries.

As elsewhere, a number of industries in South Asia receive special treatment in various forms from the government. In addition to NTBs of various kinds, protection can come from especially high tariffs that exceed the country's highest normal tariff band, from a combination of high-to moderate output protection and especially low input protection, from direct and indirect subsidies, and by other means. By definition, since the industries receive special treatment, an influential interest is always involved, one which will have to be dealt with in any thorough ongoing trade liberalization process. The table 3.7 depicts the list (partial) of protective industries in South Asia.

Table 3.7 Protective Industries in Major South Asia Countries

India	Pakistan	Bangladesh	Sri Lanka
• Food grains • Oilseeds and edible oil processing • Sugar • Milk and milk products • Tea and Coffee • Natural Rubber • Basic Steel • Copper, lead , zinc • Petrochemicals • Fertilizers (urea) • Synthetic Fibers • Automobiles • Some Auto components • Textile Fabrics • Garments	• Sugar • Oilseeds and edible oil processing • Basic Steel • Fertilizers • Automobiles • Some Auto components • Some engineering industries	• Sugar • Jute Textiles • Oilseeds and e oilseeds processing • Textile Fabrics	• Rice • Potatoes

Source: The World Bank, Trade Policies in South Asia: An Overview -2004

Given the by now overwhelming accumulation of evidence across the globe suggesting that over the long haul trade openness is more trustworthy friend of the poor than protectionism, India and its neighbours should welcome further, liberalization. Hardly any evidence shows that a country has achieved rapid growth without expansion of trade. On the other hand, trade reform is only a necessary condition, not a sufficient one, for an improved growth performance. Reaching that goal requires other complementary policies and an improved overall investment climate.

Having scrapped most of its quantitative restrictions (QRs) in the course of its 1977 reforms and dropped others in the next two decades, Sri Lanka in 1998 retained only 3.7 percent of its tariff lines subject to import restrictions explicitly aimed at protecting local industries. The residual QRs, however, carried significantly weight. Not only did they apply (in the form of seasonal import licensing) to rice, potatoes, chilies and onions, the main import substitution food crops but also restricted imports of such industrial products as timber, chemicals, some drugs and motor vehicles. Losing its argument before a WTO panel that the GATT balance of payment clause justified such practices, Sri Lanka did away with QRs in May 1998 except for GATT sanctioned health and safety and technical standards and regulations and import monopoly over wheat (which is not grown in Sri Lanka) justified under the GATT state trading provision.

The role of protecting import substitution crops has not disappeared, but shifted to seasonally varying tariffs and specific duties. Still, its protective tariffs are markedly lower than those in India and Bangladesh. Subject to some qualifications, Sri Lanka is a relatively low tariff country by the general standards of developing countries. Its average total protective tariff was 10.5 percent, and its general protective maximum tariff in the year 2003 stood at 31 percent.

On the export side, Sri Lanka was a regional pioneer entrant in developing a garment industry aimed at foreign customers. Its practices are less advanced. However, in two other major export industries, tea and spices, where export taxes though few and minor nonetheless impede efficient development by disallowing imports of tea varieties for blending with local teas and spices for partial processing and re-export during periods when domestic spices are not available. Both restrictions appear to be responses to lobbing by domestic growers who object to the potential competition and the adjustments that would be required if the imports were allowed.

3.3.3 FDI Trends in South Asia

FDI flows to South Asia started to pick up in the mid 1990s largely as a result of progressive liberalization of FDI policies in most of the countries in the region, and adaptation of generally more outward-oriented policies. South Asia has improved its share in terms of total FDI inflows over the period of 1992 to 2003. The table 3.8 below illustrates the total FDI inflows to the South Asian region.

Table 3.8 FDI inflows to the South Asian Region

(Millions of US$)

Country	**1992-1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
Bangladesh	31	190	180	280	79	52	121
India	1676	2633	2168	2319	3403	3449	4269
Maldives	8	12	12	13	12	12	12
Nepal	11	12	4	-	21	2	30
Pakistan	577	507	530	305	385	823	1405
Sri Lanka	186	150	201	175	82	197	229
Total	**2489**	**3504**	**3095**	**3902**	**3982**	**4535**	**6066**

Source: UNCTAD, FDI/TNC database and World Investment Report, 2004

The table 3.9 illustrates the share of FDI inflow in South Asia comparison to the world FDI inflow.

Table 3.9 Share of South Asia in FDI Flows

(Percentage)

	1980-85	**1990**	**1995**	**1998**	**2000**	**2003**
World	0.36	0.23	0.83	0.53	0.28	1.08
Developing Countries	1.42	1.46	2.61	2.07	1.54	3.52
Asia	3.55	2.42	4.09	4.04	2.67	5.66

Source: Computed from figures in UNCTAD, FDI/TNC database

Until recently, most countries in South Asia have not been seen by international investors as attractive investment destinations and, in any case did not welcome foreign investments. Hence, until the 1990s, FDI flows were quite minimal. FDI flows to South Asia started to pick up in the mid-1990s largely as a result of progressive liberalization of FDI policies in most of the countries in the region (Table 3.8), and the adoption of generally more outward oriented policies. South Asia has improved its share in terms of total FDI inflows to the world, developing countries and Asia over the period 1980/85-2003 (Table 3.9). In 2003, it was only US $ 6.06 billion, a mere 1.08 percent of global flows. Even though, the total FDI inflow is on increasing trend it is still low and inconsequential in meeting the development needs of the countries in the region. The bulk of FDI to the SAARC region has come to India. .

The table 3.10 below demonstrates that FDI to the region is predominantly from outside the region in the year 1998.

Table 3.10 Country-wise Major Investors in South Asia: 1998

(Percentage of total FDI in individual country)

Source	Bangladesh	India	Nepal	Pakistan	Sri Lanka
USA	29.5	22.1	4.4	41.6	
Japan	7.6	4.4	6.1	14	11.6
Germany	1.9	3.8		6.2	7
UK	13.9	7.6	6.2	22.7	1.4
France		2.5		2.2	
Korea, Republic	2.8	4.5		1.6	32.7
Hong Kong	7.5		2.1		11.9
Malaysia		2.75			
Singapore	5.9				6.4
Australia	3.0				15
Mauritius		10.4			
China	1.3		7.5		
Bermuda			14.6		
Denmark			3.1		
New Zealand			2.1		

Source: "FDI and Economic Integration in the SAARC Region" Institute of Policy Studies, Colombo, Sri Lanka, and August 2000.

The sectors that have attracted most foreign investment vary between countries The textiles and garments sector – with garments being primarily produced for export - has attracted a high proportion of FDI into Bangladesh (28% of approvals) and Sri Lanka (16% of realized) 1998. In the case of India, infrastructure (including public utilities) has attracted the bulk (56%) of approved FDI, while in Pakistan, the power sector alone accounts for nearly 40 percent of approved investments. In many countries, as in Sri Lanka, the public utilities, such as telecommunications and gas, have received significant FDI, driven by the trend towards privatization of public utilities and other state owned economic enterprises.

Where economic prospects have dimmed because of political factors, and confidence in institutions and broader economic management weakens, as is the case in Pakistan and Sri Lanka, their attractiveness as investment destinations falls despite the existence of a favorable policy regime. While FDI from outside is far more important than intra-regional investments in most countries (with Nepal, where Indian investments dominate, a conspicuous exception), there are signs that intra-regional investments are increasing. The major outward FDI flows are from Indian firms, who have started to expand FDI both within the SAARC region (Bangladesh, Maldives, Nepal and Sri Lanka) and outside; particularly after the Government of India liberalized its policy governing Indian overseas investments in the early 1990s. The table 3.11 below illustrates FDI from SAARC countries in Sri Lanka between the period 2000-2002.

Table 3.11 FDI Inflows from the SAARC Countries and Rest of the World in Sri Lanka:2000-2002 **(Rs. Millions)**

Country	2000	2001	2002
India	2,695	4,728	8,530
Pakistan	267	469	485
Bangladesh	3	3	7
Maldives	105	348	572
Nepal	-	-	-
Bhutan	-	-	-
Total SAARC	**3,070**	**5,548**	**9,594**
Rest of the World	**124,494**	**32,513**	**154,922**
Total	**127,564**	**138,061**	**164,516**

Source: Board of Investment, Sri Lanka

There have been Indian companies with considerable involvement in joint ventures in Sri Lanka in the sectors such as satellite up linking/cable television, multi-specialty hospital, broadband hybrid fiber-coax nw, power plant (20mw), copper wire bars, copper enameled wire & cables pipes/tubes and rubber gloves/hot water bottles. Overall, as detailed earlier, SAARC region is not a top investor in Sri Lanka. India ranks in 10th place, and Pakistan, is 12th, while Maldives has some limited investments. Sri Lankan firms, marginal foreign investors in any case, have few investments in other SAARC countries. Political instability has played a key role in reducing overall FDI in the country, while at times tense political relationships with India have discouraged more active Indian involvement in the economy. Nevertheless, in some sectors there have been some important investments. The case of investments in the rubber sector are of interest in this respect because Sri Lanka, a net exporter of natural rubber, has been seeking greater access to the protected but growing Indian market, but with little success. On the other hand, the increased penetration of the transport equipment market by India has seen a large influx of Indian made vehicles, such as the ubiquitous 'three wheelers' – dominated by Bajaj vehicles, creating opportunities for firms to supply rubber products, such as tyres, for these vehicles. To the extent that further liberalization or preferential measures may ease Sri Lanka's access to Indian rubber and rubber goods markets, there is clearly an opportunity developing for export-oriented investments in Sri Lanka that can target the Indian market.

3.3.4 FDI Policies in South Asia

It could be seen that significant amounts of FDI are coming in to exploit the low labour cost advantages of South Asia, and to utilize them as export platforms. To the extent that import protection is coming down, the tariff hopping motive that attracts home market oriented investments weakens. On the other hand, the increasingly more FDI friendly environment and the perception of improved growth prospects following more liberal policies may make even some types of home market oriented investments more attractive, even though with a more liberal trade regime, import competition will be more intense and servicing the market from abroad may be less difficult. The FDI policies in the South Asian countries are illustrated in table A.6 in the appendix. Each South Asian country's FDI policies can be illustrated as follows:

- **Bangladesh**

Bangladesh initiated major industrial policy reforms in 1982 and further liberalization of FDI policy was carried out from 1986 with the assistance of the International Monetary Fund (IMF) under the Structural Adjustment Facility. Bangladesh also started to privatize the public sector enterprises. The stated policy of the Bangladesh Government (BDG) is to pursue foreign investment actively. It has enacted a number of liberal investment policies to this end. There are no distinctions between foreign and domestic private investors regarding investment incentives or export and import policies. Incentives for investors, which the BDG hails as the most liberal in Asia, include 100 per cent ownership in most sectors; tax holidays; reduced import duties on capital machinery and spares; duty-free imports for 100 per cent exporters; and tax exemptions on technology remittance fees, on interest on foreign loans, and on capital gains by portfolio investors. Officially, five sectors are reserved for public sector only. These are: (1) arms, ammunition, defense equipment, and machinery; (2) production of nuclear energy; (3) security printing and minting; (4) forestry in the reserved forest areas; (5) air transportation (except air cargo and domestic air transportation) and railways. There are few performance requirements, and these do not generally present a problem for foreign investors. The Foreign Private Investment Act also ensures legal protection to foreign investment in Bangladesh against nationalization and expropriation. It also guarantees repatriation of profit, capital and dividend and equitable treatment with local investors. Intellectual property rights, such as patents, designs and trademarks and copyrights, are protected. Bilateral Investment Guarantee Agreements have been signed with a number of countries. Bangladesh is signatory to the Settlement of Investment Dispute (ICSID), the Multilateral Investment Guarantee (MIGA), and member of World Intellectual Property Organization (WIPO). Trade has been liberalized and duties reduced. Customs bonded warehouses assist exporters. Free repatriation of profits is allowed, and the Taka is almost fully convertible on the current account. No prior approval is required for foreign direct investment except registration with the Board of Investment.

- **India**

India started deregulating the industrial sector in the mid-1980s. The process received considerable momentum in 1991 with the Indian government initiating a programme of macro-economic stabilization and structural adjustment supported by the IMF and the World Bank. As a part of this programme a New Industrial Policy was initiated that year and this lead to a full-scale liberalization process. The NIP and subsequent policy amendments have liberalized the industrial policy regime in the country, especially as it applies to FDI. The reforms abolished the industrial licensing system on most industrial products except for 18 strategic or environmentally sensitive industries. In the 48 high priority industries, FDI up to 51 per cent is approved automatically if certain norms are satisfied. Foreign investment exceeding 51 per cent and up to 100 per cent is allowed in several sectors. A new package for 100 per cent export-oriented projects and companies in the export processing zones was announced. A Foreign Investment Promotion Board (FIPB) authorized to provide a single window clearance has been set up. Companies with more than 40 per cent of foreign equity are now treated on par with fully Indian owned companies. New sectors such as mining, banking, telecommunications, highways, construction and management have been opened to private including foreign owned companies. These policy reforms have been accompanied by active courting of foreign investors at the highest level. The rupee was made convertible first on trade and finally on current account.

- **Nepal**

Nepal liberalized its policy on FDI with the New Industrial Policy of 1992 and the amendment of its Foreign Investment and Technology Act of 1980. The 1992 policy identifies FDI promotion as an important strategy in achieving the objectives of industrial development and employment creation, and the government is encouraging FDI in the country by providing attractive incentives and facilities within a liberal and open policy. The main features of investment policy are:

- Up to 100 per cent equity participation by foreigners is allowed into almost all the sectors except those in cottage industry, arms and ammunition industries, energy, real estate business, security printing, currency and coinage, retail business, travel and trekking agencies, consultative services;
- Non-discriminatory treatment for foreign investment;
- Full repatriation of equity, profits or dividends and interest on loans;
- A guarantee against nationalization;
- Generous and attractive income tax allowances with minimum five year tax holiday for most of the industries;
- No tax on dividends, export earnings and interest on foreign loans;
- Corporate tax rate of 33 per cent and income from royalty and technical management services is taxed at a standard rate of 15 per cent;
- Only 1 percent duty on import of capital goods;
- Residential and business visa is provided for foreign investors and their dependants;
- Bonded warehouse and duty-draw back facilities on export

- **Pakistan**

In Pakistan, the Foreign Private Investment Act of 1976 provides a legal framework for protecting FDI. Successive industrial policy statements have liberalized FDI policy and nearly all industrial fields, except for a few areas listed in a negative list are now open to foreign investors. Foreign investment is generally subject to the same rules as domestic investment, with the exception of certain sensitive areas. Key features of Pakistan's investment climate include the following:

- Relaxation of foreign exchange controls, and a general policy of permitting foreign investors to participate in local projects on a 100 per cent equity basis;
- Allowing of foreign companies registered in Pakistan to undertake export and import trade;
- Provision of full safeguards to protect foreign investment;
- Withdrawal of work permit restrictions on expatriate managers and technical personnel working in an industrial undertaking and ceasing of remittance restrictions;
- Abolition of the ceiling on payments of royalties and technical fees;
- Elimination of the requirement of obtaining a "No Objection Certificate" (NOC) from the appropriate provincial government, except for areas which are classified as negative areas;
- No requirement of government approval to set up an industry in any field, place and size, except for the following industries: Arms and ammunition; High explosives; Radio-active substances; Security printing, currency and mint.
- Exemptions or relief from import duties has been allowed on imported plant and machinery
- Tax relief in shape of first year allowance has been provided for a number of industries.

- **Sri Lanka**

Sri Lanka liberalized its FDI policy regime much earlier in 1977 when most of the controls over the industry were removed and incentives were provided to increase the export-orientation of the industry. In 1989 a second round of reforms were undertaken under the assistance of IMF's structural adjustment facility which prompted reform of public sector through privatization while continuing with a liberal policy towards FDI.

A Board of Investment (BOI) has been set up and it acts as a facilitator for investment and is structured to provide "one-stop" service for foreign investors, including approval of projects, granting licenses, establishing tax incentives, and assisting in procurement. The principal law affecting foreign investment is Law No. 4 of 1978 (known as the BOI Act) and amendments made in 1980, 1983 and 1992, and implementing regulations established under the Act. The BOI Act provides for two types of investment approvals. Under Section 17 of the Act, the BOI is empowered to grant concessions to companies satisfying certain eligibility criteria; a qualifying investor enters into an agreement with the BOI, which modifies, exempts, and waives applicable laws. Investment approval under Section 16 of the Act permits entry for foreign investment to operate under the "normal" laws of the country, and is applicable to investments, which do not satisfy eligibility criteria for BOI incentives.

The Government of Sri Lanka permits 100 per cent foreign ownership in almost all sectors of the economy. Investment in certain sectors is restricted and activities of several industries, particularly services, are regulated. Foreign investment is not permitted in the following businesses: non-bank money lending, pawn broking; certain retail; personal services other than for the export or tourism sectors; and coastal fishing. The BOI gives priority to the following sectors: infrastructure; electronics and new technologies; light engineering; tourism; agriculture, dairy and livestock projects; mining and processing of non-renewable resources; computer software; rubber products; gems and jewellery; textiles, garments and accessories; and, services such as healthcare and shipping related activities. There are no restrictions on repatriation of earnings, fees and capital and foreign exchange transactions. In 1994 Sri Lanka removed all foreign exchange restrictions on current account transactions. Article 157 of the Sri Lanka Constitution guarantees the safety of foreign investment. Sri Lanka also has entered into bilateral investment guarantee agreements with 22 countries. These agreements provide for protection against nationalization, free remittance of profit, capital and business fees, and settlement of disputes under the International Convention for Settlement of Investment Dispute (ICSID). Sri Lanka is also a founding member of the Multilateral Investment Guarantee (MIGA). Sri Lanka has a sophisticated legal and regulatory framework covering copyrights, designs, patents, trademarks etc. An Arbitration Centre has been set up in Colombo, which is affiliated to the Arbitration Institute of the Stockholm Chamber of Commerce, whose standards and norms will be followed by the Sri Lanka Centre. Sri Lanka offers tax holidays ranging from 5 to 20 years depending on the size of investment and employment provided by the project and the foreign exchange earned by the project. Capital goods and raw material can be imported free for projects approved by the Board of Investment.

3.4 RTAs in South Asia: An Analysis of Some Salient Features

The process of economic integration in South Asia gathered momentum with the implementation of the South Asian Preferential Trade Agreement (SAPTA) in 1995 under the broad framework of the South Asian Association for Regional Cooperation (SAARC).

3.4.1 South Asian Free Trade Agreement (SAFTA)

SAPTA has, however, come to be viewed as an interim platform in the move towards economic integration in South Asia. In 1996, South Asian governments committed themselves to the creation of a South Asian Free Trade Area (SAFTA) by the year 2001, but not later than 2005. One reason given for accelerating the timetable for regional free trade was that it would be a way of preparing for more global competition which would result from the new round of trade negotiations under the aegis of the WTO. In order to prepare, it was decided that the SAARC Council for Economic Co-operation (CEC) and the Inter-Governmental Expert Group (IGEG) should meet and discuss at length an action plan and terms of reference for SAFTA. The parameters set out for SAFTA in these discussions included the following:

- Tariff eliminations without any import restrictions
- Removal of "structural impediments" to regional trade
- Harmonizing of customs procedures and documentations
- Bank facilitation
- Port and transport facilitation
- Facilitation of trade-related services
- Establishment of a reviewing and monitoring mechanism and,
- Ensuring "equitable" benefits to all member countries.

For the same reasons that SAPTA made very slow progress, for many years it was difficult to obtain unequivocal commitment to SAFTA, but finally, on January 6th 2004, at the twelfth SAARC Summit held in Islamabad, the seven member countries of the SAARC signed a framework free trade agreement which will come into effect from 1st January 2006. SAPTA was envisaged primarily as the first step towards the transition to a South Asian Free Trade Area (SAFTA) leading subsequently towards a Customs Union, Common Market and Economic Union in future. The Committee of Experts proposed the tariff reduction schedule in two phases, which can be illustrated in the table 3.12 as follows:

Table 3.12 Tariff Reductions Proposed under SAFTA

Country	Existing Tariff Rate	Proposed SAFTA reduction	Timeline
First Phase			
Non Least Developed Countries : India, Pakistan and Sri Lanka	More than 20 %	Reduce Maximum Tariff rate to 20%	Within 2 years (January 1st 2006- 1st January 2008)
	Less than 20 %	Further annual reduction of 10%	Each of 2 years (January 1st 2006- 1st January 2008)
Least Developed Countries: Bangladesh, Nepal, Bhutan and Maldives	More than 30 %	Reduce Maximum Tariff rate to 30%	Within 2 years (January 1st 2006- 1st January 2008)
	Less than 30 %	Further annual reduction of 10%	Each of 2 years (January 1st 2006- 1st January 2008)
Second Phase			
Non Least Developed Countries	20% or below	0-5%	Within 5 years (1st January 2008- 1st January 2013, Sri Lanka: January 1st 2014)
Least Developed Countries	30% or below	0-5%	Within 8 years (1st January 2008- 1st January 2016): Primary products within 3 years and other products within 5 years)

Source: The World Bank, Trade Policies in South Asia: An Overview -2004

Under the trade liberalization programme, the member countries agreed to gradually and eventually bring down their import tariffs on trade at the end of SAFTA implementation to 0-5 percent range. However, it should be noted that the described tariff reduction schedule may not be applied to items on the "Sensitive List", which are to be negotiated among the contracting members.

In its current form, SAFTA has some weaknesses and therefore in order to achieve successful regional integration the following points are important.

- The "tariffs" for which reduction programme has been agreed are Custom duty only. But as discussed in section 3.3.2 protective para tariffs are also used by most of the South Asian countries. However, at this stage the agreement has no clear strategy for dealing with them, beyond requiring that they be notified and considered by the SAARC committee of experts.

- Under the agreement, all GATT incompatible NTBs are to be eliminated on regional trade. However, no mechanism has so far been established for dealing with NTBs beyond notification and consideration by the SAARC committee.

- On the other hand, if high external protection levels for many sectors continues, faster and more drastic regional tariff cuts could lead either to substantial trade diversion and economic welfare losses, or resistance to concessions, especially if the concessions would adversely affect highly protected industries (e.g many of Bangladesh's import substitution industries). Both of these possibilities would in turn create pressure to put these industries on sensitive lists and exclude them from the SAFTA.

- In this regard, agriculture (including livestock, fisheries and food processing industries) is especially important and sensitive throughout the region. There is no specific reference to agriculture in the agreement. However, as noted in the section 1.2.1 agricultural tariffs in the region are much higher on average than industrial tariffs. In particular, most of India's industrial tariffs are already below the SAFTA target for maximum tariff rate 20 percent to be achieved between January 2006 and January 2008, but average agricultural tariffs in both India and Bangladesh are currently about 40 percent. Likewise Sri Lanka's average agricultural tariffs are about 30 percent also much higher than its industrial tariffs. Further, agricultural subsidies and government market interventions are still very important in India's agriculture. Therefore, it is appropriate to design special treatment for agricultural sector under the trade liberalization programme in South Asia.

- In the agreement it is mentioned that each contracting party need to determine its own "sensitive lists" of individual countries, which are yet to be decided. According to the past experience of SAPTA is an indication, each country may present a long list of "restricted" items that will not be subject to concessions. If these lists are too long, they will quickly render SAFTA ineffective.

- The "Rules of Origin" are crucial and still have to be negotiated.

South Asian region is preparing to implement SAFTA on 1st January 2006 and therefore, it is too early to evaluate all possible impacts on member countries without knowing how the future negotiations will take place. However, if member countries pay attention to the above mention points and design the liberalization programme less harmful manner there is high possibility that member countries can benefit from the SAFTA. Removing regional barriers force firms from different member countries into closer competition with each other, inducing them to make efficiency improvements. If the SAFTA accelerates processes such as these, it could increase the confidence and interest of industry and government to lower tariff barriers against imports and increase the region's trading integration with the rest of the world.

According to the original form of the agreement it is clear that at the end of full SAFTA implementation all contracting parties will reduce their tariff from 0-5 percent and therefore, in this study an attempt is made to quantify the welfare impact on member countries after reducing the tariff on all commodities assuming that NTBs are absent. This is because in the agreement it is mentioned that all GATT incompatible NTBs are to be eliminated on regional trade. Further, the industries on which the efficiency gains are quantified will be presented in Table A.2 in appendix, so that the policy makers can initiate steps as to the direction of trade liberalization programme.

3.4.2 Indo-Lanka Free Trade Agreement (ILFTA)

I. Salient Features of the Agreement

Indian exporters to Sri Lanka were among the beneficiaries of the Sri Lankan general liberalization of its trade regime, which commenced in the late 1970s and continued during the 1980s and 1990s. Against this background, policy makers in Sri Lanka became increasingly concern about the growing bilateral trade deficit with India and looked for ways of reducing it. But they realized that, because of India QRs and complexities involving India-Pakistan relations, it would be futile to seek preferential reduction in Indian tariffs across a broad range of commodities of interest to Sri Lankan exporters, through SAPTA. They therefore pressed India for a separate trade agreement outside the SAPTA framework.

The conclusion of ILFTA in December 1988 at the highest political level and subsequent implementation in March 2000 marked an important milestone in India – Sri Lanka relations and in trade relations in particular, as it concretized and paved the way for closer economic integration.

Table 3.13 Indo-Lanka FTA: Position in March 2000

	No: of Tariff lines (by 6 digit HS code)	
Duty Category /Tariff Reduction	**Sri Lanka**	**India**
Nil- Negative list	1180	429
Zero Duty	319	1351
50% Duty (Zero in 3 years)	889	2799
Residual (Zero duty in 8 years)	2724	-
Textile (25% duty)	-	528
Garments (8 million pieces/yr): Quota items 50% duty		233*
Tea (15 mn. Kg/year)		5
Total	**5112**	**5112**

*Classified under Indian Negative List

Source: Ministry of Trade, Department of Commerce

Table 3.14 Tariff Reduction Commitment in post March 2003 period

Duty Category /Tariff Reduction	No: of Tariff lines (by 6 digit HS code)	
	Sri Lanka	**India**
Nil- Negative List	1180	196
50% (fixed) Garment Quota (Included in the India Negative List)	-	233
Zero Duty	1208	4150
50% (fixed) Tea Quota	-	05
25% (fixed) Textile items	-	528
35% (increased to 100% in 8 years)	2724	-
Total	**5112**	**5112**

Source: Ministry of Trade, Department of Commerce

The bilateral FTA imparted much needed impetus to Sri Lanka in her endeavour to project Sri Lanka as "gateway to huge Indian market". The general objective of the agreement is the elimination of tariffs on all goods except goods included in the specified negative lists according to agreed timetables.

The agreement does not explicitly refer to QRs, presumably because, by the time it was signed, India had already removed its balance of payments justified QRs for the SAPTA countries, and nearly all QRs had been eliminated in Sri Lanka long before. The agreement administered by a joint ministerial level committee. A working group on custom issues, including the harmonization of tariff categories had also been established, which reports to the joint ministerial committee.

Negative Lists

During the negotiations, both sides agreed to exclude a large number of products from the tariff reductions. There are 429 items on the Indian negative list. This is only about 8.5 percent of the India's complete set of tariff lines, but it includes products in which Sri Lanka appears to have a comparative advantage relative to India, at least in some specifications and varieties. The following are some of the products categories included in the negative lists of India and Sri Lanka, which are important for both countries.

a) Negative List of India

- **Garments (HS Chapters 61 and 62)**

Garments, which are by far Sri Lanka's largest and most dynamic exports and all garments were initially on India's negative list but, Sri Lanka was later able to negotiate a tariff rate quota (TRQ) by which market access is allowed for 8 million pieces per annum at tariff rate is fixed at 50 percent below the MFN rate. However, in the year 2000 the MFN tariffs for many garments in the lower price ranges were increased substantially by setting minimum specific duty. Other constraints are that 4 million of the 8 million pieces have to be manufactured from Indian fabrics and that the Indian government can fix maximum sub quotas of 1.5 million pieces for any category of garments, in addition to which the garments can only be imported through five specific ports (Mumbai and Chennai, Calcutta & JNPT, Navasheva, New Delhi, Bangalore and Cochin).

- **Textiles (HS Chapters 50-57)**

The general situation is that there are no tariff preferences for textiles, with the exception of a list of products have a 25 percent preference, and limited number of other specified items with a 50 percent preference.

- **Tea (HS chapter 9)**

Tea is another major Sri Lankan export industry. India agreed to a TRQ under which 15 million kilograms of Sri Lankan tea are subject to a 7.5 percent of tariff rate (General MFN custom duty rate applicable on the other countries -100 percent) applying to imports in excess of this. Imports can only through four specific ports (Cochin, Calcutta, Mumbai and Vizag).

- **Coconuts and Coconut oil (HS Chapter 53)**

Coconuts and coconut oil were excluded from the agreement; this was to sure that no breach in the prohibitive high protection of the coconut, copra, coconut oil industry in Kerala. This industry developed after Indian independence in 1947, when competing imports from Sri Lanka and other countries (mainly developing countries in South East

Asia) were first cut back and eventually excluded altogether by tariffs and QRs. For many years, copra and coconut oil prices in India have been about double and much as three times world prices. In 2004, the general coconut tariff was 70 percent and coconut oil tariff was 85 percent.

- **Natural Rubber (HS Chapter 40)**

This is a long established but declining export industry in Sri Lanka. As with copra and coconut oil, in India after independence domestic prices were supported by cutting back on imports from the rest of the world, principally from developing countries such as Malaysia, Indonesia and Sri Lanka. This policy was implemented by the Indian Rubber Board in order to develop rubber growing in Southern India, principally in Kerala. The Board also pays subsidies to rubber farmers. On average, for long periods in the past high tariffs and other protective measures kept domestic Indian prices for natural rubber (latex and smoked sheets) well above world prices. In 2004, there was still very high protection on latex (tariff 70 percent) but other natural rubber tariffs had been cut to 20 percent. However, rubber products including latex remained on India's negative list.

b) Negative List of Sri Lanka

There are 1180 items included in the Sri Lankan negative list and these items accounted for 56.5 percent of Sri Lanka's total imports in 1999 and for 25.5 percent of the India's total exports to Sri Lanka. The negative list products are spread across the tariff schedule and include agricultural, intermediate, and manufactured products. Apart from the agricultural products (e.g rice, potatoes, and onions) which are included in the sensitive list, the products which are important for government revenue (e,g. motor vehicles, tobacco and liquor), the other products in the negative list appear to mainly reflect the effectiveness of lobbying by local industries. Among the negative list 594 are food and agricultural products, 514 are manufactured products and 72 are minerals, metals and fuels. Rice is a major Indian exports and onions are potentially exportable, but onions from India have any case been prevented by import controls imposed to keep Indian domestic prices down. The Sri Lankan negative list also included wheat and wheat flour, both of which India's periodically exports.

II. Sri Lanka's Trade with India

a) Exports to India

India emerged as one of the leading buyer of Sri Lanka after implementing FTA in 2000. The table below illustrates the percentage of Sri Lanka's exports to India during the period 1996 to 2004.

Table 3.15 The Share of Sri Lanka's exports to India

(Value in Rs. Million)

Year	Sri Lanka's export to the world	Export to India	Share of Exports to India (percentage)
1996	226,801	2,256.1	1.0
1997	274,193	2,524.3	0.9
1998	310,398	2,279.4	0.8
1999	325,171	3,320.3	1.0
2000	420,114	4,217.3	1.0
2001	430,372	6,265.7	1.5
2002	449,850	16,152.9	3.6
2003	459,426	23,275.1	4.9
2004	583,967	39,616.0	6.8

Source: Central Bank of Sri Lanka, Annual Reports, Various Issues

India emerged as the 3rd largest buyer next to USA and UK

The table below illustrates major export items from Sri Lanka to India during the period 2000-2004.

Table 3.16 Sri Lanka's Exports to India

(Millions of US$)

HS	Description	2000	2001	2002	2003	2004
	Exports to India : Total	**54.44**	**69.67**	**168.26**	**240.83**	**383.38**
74	Copper and Articles Thereof, Basic metal products	1.07	2.37	70.74	118.31	122.02
85	Electrical Machinery, Etc.	0.31	0.41	1.32	19.30	52.14
09	Spices, Pepper, Tea	18.02	18.79	43.02	18.91	25.98
72	Iron and Steel	5.12	4.36	4.01	7.58	19.37
15	Fats and Oils	2.33	1.30	1.62	5.69	17.28
76	Aluminum and Articles Thereof	0.20	0.09	1.06	1.89	15.71
29	Organic Chemicals	0.00	0.15	0.37	0.87	12.43
08	Edible Fruit and Nuts	2.14	1.09	1.34	2.80	11.75
68	Stone, Plaster, Cement	0.13	1.25	0.80	3.99	11.10
47	Wood pulp, Etc.	3.68	4.09	4.69	7.60	10.09
40	Rubber products	1.17	1.25	2.30	4.11	9.75
44	Wood	0.02	0.01	1.15	4.16	8.73
84	Machinery; Reactors, Boilers	1.09	2.38	4.47	10.09	8.23
39	Plastic	2.77	2.77	4.68	4.68	6.46
28	Inorg Chem; Rare Earth Metals	0.00	0.15	0.35	3.48	5.57
79	Zinc and Articles Thereof	0.01	0.04	0.18	0.15	4.11
94	Furniture and Bedding	0.16	0.84	1.68	2.05	4.05
48	Paper, Paperboard	1.21	2.15	2.28	2.33	3.80
23	Food Waste	0.65	0.54	0.06	1.35	3.05
52	Cotton and Yarn, Fabric	0.26	0.18	0.62	1.54	3.01

Source: Sri Lanka Customs

Sri Lanka exports to India consist of 94 products. It has been observed that the Indo – Lanka Free Trade Agreement has played a key role in enhancing appreciably the quantum of exports both in terms of volume and value from Sri Lanka to India. However, it has also been observed that the bulk of preferential exports under the FTA is not for direct final consumption and can be considered as intermediate products which are required by the Indian industries.

The products which contributed to export growth include copper ingots, wire-bars and billets, tyres, H.D. fibre board, furniture etc. It is noteworthy that value of exports of Dual Inline Memory Modules (DIMMs), a part for computers has increased remarkably in 2002 posing an exponential growth rate of 8300%. DIMMs entered the Indian market subsequent to the implementation of the FTA. Furniture, next item featuring prominently among top ten of non-copper exports registered a remarkable upswing in its export earnings. It can be seen that new products such as multiwall paper sacks, marble slabs, ceramic ware, jewellery, ice cream machine, furniture etc. have shown a sustainable export capability during the period under review.

Table 3.17 Degree of Concentration of Exports in terms of Value in 2004

	% to total preferential Exports
(1) First Product (copper products)	31.8
(2) First ten products	77.6
(3) First twenty products	92.4
(4) All (94) products	100.0

Source: Computed from Sri Lanka Custom trade statistics

From the figures in the above table it could be observed that first ten products accounted for 77.6 percent and first 20 products have accounted for 92.4 percent of the total value of preferential exports, depicting a high degree of concentration on a few products.

Utilization of Quota for Readymade Garments and Tea

Utilization of quota for tea (15 Mn. Kgs.) and readymade garments (8 Mn. pieces) remained at a dismal level of below 5% of quotas available during last few years. Sri Lankan exporters need to take this opportunity and increase the export of garments to India. Further, it is important to negotiate with the policy makers in India to remove non tariff barriers and also increase export of value added tea as an example ready to drink tea to Indian market.

b) Imports from India

India has emerged as one of Sri Lanka's main suppliers in the recent past, even prior to the implementation of the FTA and particularly during the last decade India gradually emerged more as a supplier to Sri Lanka than a market for Sri Lanka's export products. The emergence of India culminated in the last few years with becoming the main supplier to Sri Lanka accounting for about 18 percent of the value of the Sri Lanka's total imports in 2004.

Table 3.18 The share of Sri Lanka's Imports from India

(Value in Rs. Million)

Year	Sri Lanka's import from the world	Imports from India	Share of Imports form India (percentage)
1996	227,897	31,055.6	13.6%
1997	332,730	33,023.5	9.9%
1998	369,014	35,837.7	9.7%
1999	378,509	36,012.9	9.5%
2000	554,290	45,477.1	8.2%
2001	532,964	53,750.0	10.1%
2002	584,491	79,847.1	13.7%
2003	643,749	103,871.7	16.1%
2004	811,138	145,625.0	18.0%

Source: Central Bank of Sri Lanka, Annual Report Various Issues

India emerged as the 1st largest supplier to Sri Lanka

The import pattern of Sri Lanka in the recent years suggests that the Indian imports will continue to increase substantially in the years to come since India is in a position to replace other suppliers to Sri Lanka with the advantage of concessions under the FTA. However, these imports are coming on the basis of "need to source from out side" and India is fitting into the need. It is inevitable that due to the FTA, some of the products, which would have been non-competitive otherwise, may enter the Sri Lanka market.

Table 3.19 **Sri Lanka – India Trade**

(Value in Rs. Million)

Year	Imports	Exports	Trade Balance	Import/Export Ratio	Import Coverage
1996	31,055.6	2,256.1	(28,799.9)	14 : 1	7.26%
1997	33,023.5	2,524.3	(30,499.2)	13 : 1	7.64%
1998	35,837.7	2,279.4	(33,558,3)	15.7 : 1	6.36%
1999	36,012.9	3,320.3	(32,692.6)	11 : 1	9.22%
2000	45,477.1	4,217.3	(41,259.8)	11 : 1	9.27%
2001	53,750.0	6,265.7	(47,484.3)	8.6 : 1	11.60%
2002	79,847.1	16,152.9	(63,694.2)	4.9 : 1	20.23%
2003	103,871.7	23,275.1	(80,596.6)	4.5 : 1	22.41%
2004	145,625	39,616.0	(106,009.0)	3.7 : 1	27.20%

Source: Sri Lanka Customs

As observed from the above table while imports from India grew from Rs 53,750 million in 2001 to Rs.145,625 million in 2004 by 170.9 percent, imports/export ratio improved from 8.6:1 to3.7 :1 and import coverage ratio which acts as the barometer to measure the extent to which export proceedings can cover the disbursement on imports, improved from 11.6 percent in 2001 to 27.2 percent in 2004. During the year 2004, value of exports from Sri Lanka recorded a 70.2 growth on year-on-year basis.

The main factors that cause a trade balance heavily in favour of India are; asymmetries of economies in terms of export base, excess capacity, raw material supply base, degree of industrialization, lower freight charges, availability of skilled manpower etc.

The table below illustrates major import items by Sri Lanka from India during the period 2000-2004.

Table 3.20 Sri Lanka's Imports from India

(Millions of US$)

HS	Description	2000	2001	2002	2003	2004
	Imports from India : Total	**590.47**	**600.39**	**833.19**	**1076.21**	**1353.91**
27	Mineral Fuel, Oil	0.56	11.24	64.11	196.26	282.95
87	Vehicles, Not Railway	68.97	43.06	83.38	136.38	200.90
10	Cereals	0.61	4.70	50.33	63.18	108.96
52	Cotton and Yarn, Fabric	77.92	70.70	66.07	65.56	76.90
84	Machinery; Reactors, Boilers	36.03	39.53	38.23	48.10	61.62
30	Pharmaceutical Products	34.79	33.11	42.15	47.10	50.84
72	Iron and Steel	30.89	31.96	37.17	52.37	47.65
48	Paper, Paperboard	26.78	26.35	30.51	34.62	39.39
73	Iron and Steel Products	18.04	15.29	25.45	24.53	38.07
39	Plastic	13.80	13.81	19.24	23.60	36.16
85	Electrical Machinery, Etc.	24.84	19.52	56.52	24.78	35.88
07	Vegetables	54.03	39.62	27.37	25.97	33.09
25	Salt; Sulfur; Earths and Stone	15.45	29.84	30.03	34.76	31.24
74	Copper and Articles Thereof	1.27	1.36	5.32	11.65	27.93
23	Food Waste	14.71	14.60	18.38	15.33	27.88
09	Spices, Coffee, Tea	21.38	21.45	22.90	24.50	24.09
28	Inorg Chem; Rare Earth Metals	10.92	12.52	14.32	16.74	22.06
40	Rubber	5.76	5.57	8.23	14.82	17.37
55	Manmade Staple Fibers	13.09	12.80	10.65	15.63	12.78
76	Aluminum and Articles Thereof	4.98	3.45	4.62	4.83	12.71

Source: Sri Lanka Customs

India is more a supplier to Sri Lanka in terms of consumer, intermediate and capital goods and therefore, an unfavourable trade balance with India is inevitable in the macro context as Sri Lanka is heavily depend on imported intermediate products and consumer products.

III. Recent Developments

The ILFTA between India and Sri Lanka is only a first step towards moving into higher stages of the economic integration. Therefore, a non-traditional route of the economic integration needs to be explored. A Comprehensive Economic Partnership Agreement (CEPA) that signed between India and Sri Lanka in 2003 encompasses trade in goods and services, investment promotion and economic cooperation would serve to strengthen trade liberalization considerably. However, since the ILFTA already exists, the CEPA could be implemented quickly to deepen economic cooperation between the two countries.

India is the third largest foreign investor in Sri Lanka with total investment over the last decade approximating US$ 400 million (Board of Investments, Sri Lanka). Sri Lanka's investment in India has also increased over the last decade. These investment trends clearly indicate strong potential for two-way investment flows between the two nations. Over half of Indian investments in SAARC are located in Sri Lanka, which has become the favoured destination for Indian investment in the region. India and Sri Lanka already have agreements on Avoidance of Double Taxation (1982) and Investment Promotion and Protection (1997).

Trade in services between the two countries has also seen a significant increase in recent years. There is considerable scope for further increase in trade in services between the two countries, especially in tourism, shipping, logistics, professional and airline services. Thus, the present bilateral environment is conducive not only for expanding trade in goods, but also for increase in trade in services and investment.

3.5 Importance of the ASEAN Economic Integration for the South Asian Future Economic Integration

The early history of preferential trading within the South Asian Association of Regional Cooperation (SAARC) closely parallel that with the Association for South East Asian Nations (ASEAN). ASEAN was founded in 1967 but the ASEAN Preferential Trade Area was launched only ten years later in 1977. Even then the effective sharing of trade preferences remained negligible. Much of the liberalization of the ASEAN members has proceeded along non-discriminatory line. In the same vein, the SAARC was founded in 1985 and had little success in promoting trade preferences among its members during the first decade of its existence. Though South Asian Preferential Trade Area (SAPTA) was created in 1995, the intra trade level in the region remains less than 5 percent until 2004. Meanwhile, the members in the SAARC commenced bilateral FTAs mainly with India and now appear poised for serious exchange of trade preferences.

3.5.1 Trade Liberalization Programme in ASEAN

The ASEAN has made significant progress in liberalizing its trade since its inception in 1967. In spite of the great cultural, political, religious and other diversities within the region, AFTA has been virtually completed in 2003.

The ASEAN Free Trade Area (AFTA) is such a collective strategic response to pursue ASEAN's goals of stimulating intra- and extra regional trade, improving the investment climate and enhancing the competitiveness of industrial performance of its member countries.

AFTA as an international entity was formulated in January 1992 at the Forth ASEAN Summit in Singapore. ASEAN declared then it would establish a free trade area in fifteen years (by the year 2008), beginning on 1st January 1993, by means of the Common Effective Preferential Tariff (CEPT) scheme.

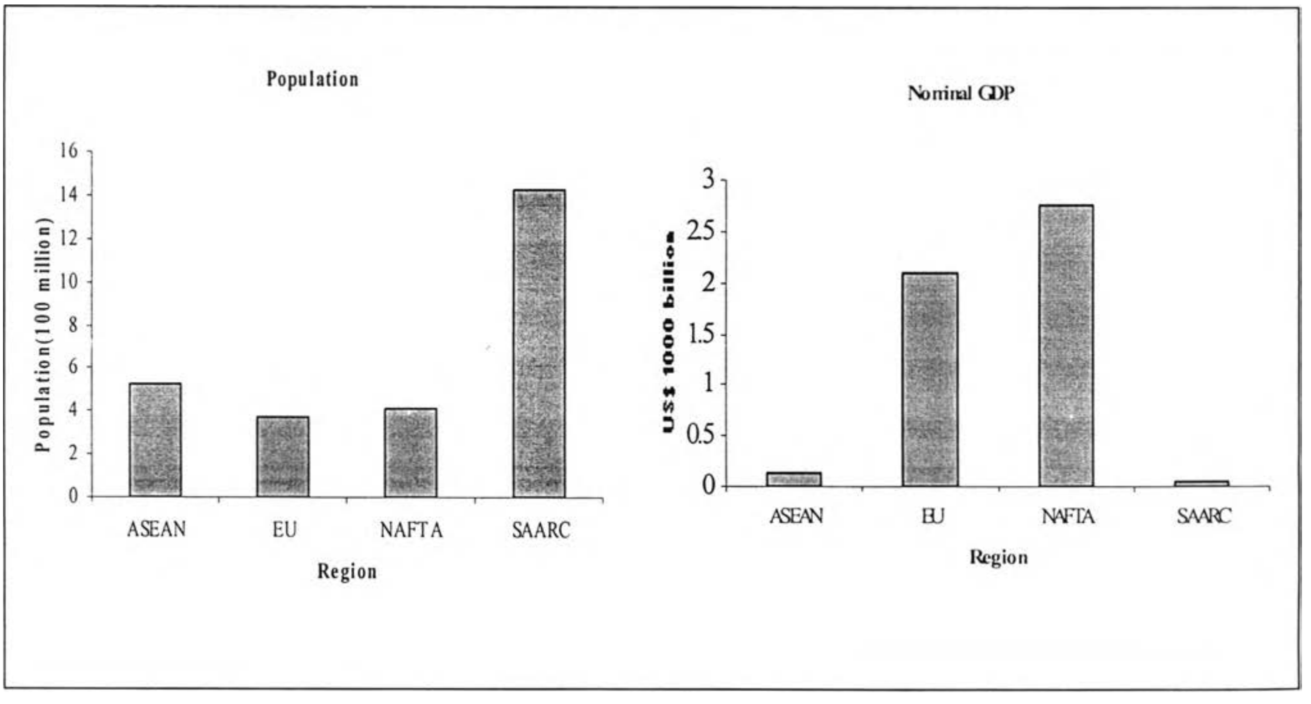
The six original signatories (Malaysia, Indonesia, Thailand, Philippines, Singapore and Viet Nam) have reduced tariffs on all products listed in their 2002 Inclusion List (IL) to 0-5 percent. Since 1 January 2003, tariffs on 99.55 percent

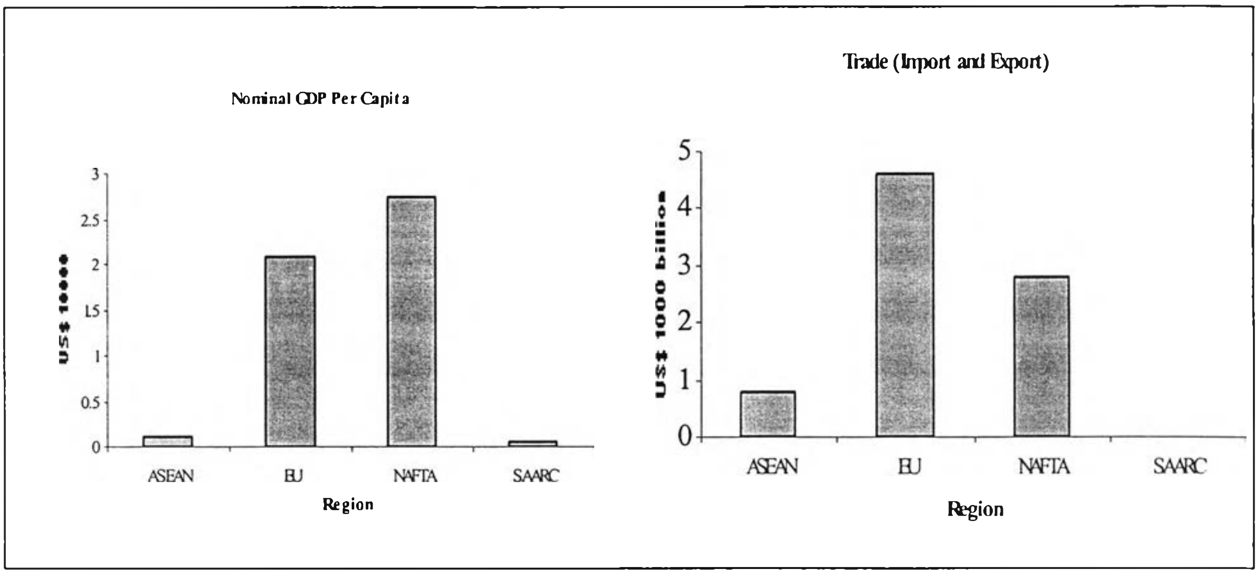
(44,160 tariff lines out of a total 44,361 tariff lines) of products in the 2003 IL of the ASEAN-6 have been reduced to the 0-5 percent tariff range. Products in their IL, which still have tariffs of above 5 percent, are those that have been transferred from the Sensitive List (SL) and General Exception List (GE) in 2003. The average tariff for ASEAN-6 under the CEPT Scheme is now down to 2.39 percent from 12.76 percent when the tariff-cutting exercise started in 1993. The newer members of ASEAN still have to reach the 0-5 percent tariffs for intra-ASEAN trade; Vietnam in 2006, Lao PDR and Myanmar in 2008, and Cambodia in 2010. Overall, in 2003, 87.85 percent of all products in the IL of the ten Member Countries tentatively have tariffs of between 0-5 percent and about 10.68 percent of these products have tariffs of above 5 percent. Ultimately, tariffs will be completely abolished by 2010 for ASEAN-6 and 2015 for the newer members with flexibility on some sensitive products until 2018.

3.5.2 Key Economic Indicators in Comparison with the ASEAN and the Other Regions

The following table illustrates some key economic indicators of the ASEAN in comparison with the other regional blocs.

Figure 3.9 **Key Economic Indicators: 2002**





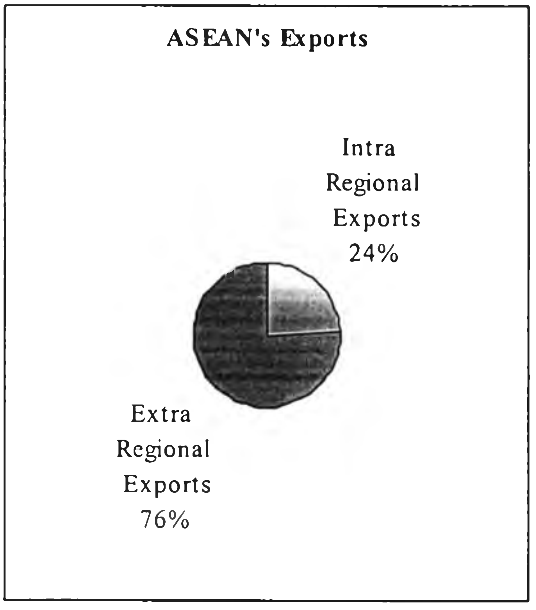
Source: World Development Indicators database by the World Bank

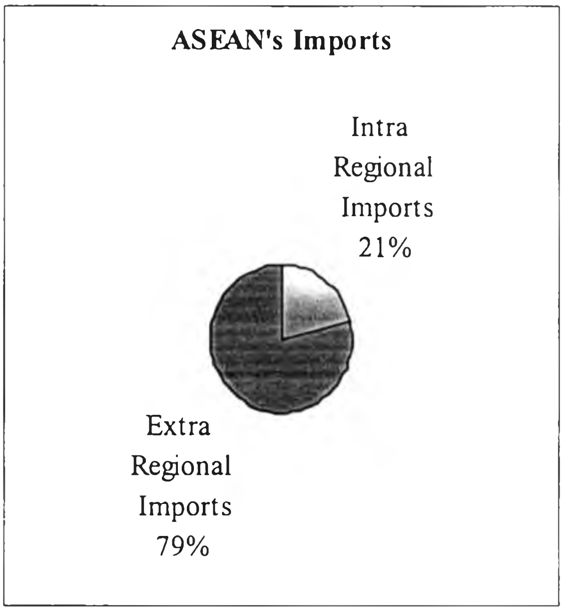
From the above figures it could be seen that nominal GDP in the ASEAN is significantly low in comparison with NAFTA and EU. However, its trade level is at satisfactory level and it can be noticed that the ASEAN's trade level is quiet higher than its GDP. This indicates that the ASEAN is highly trade dependent region. In comparing with other regional blocs SAARC has the highest population, and the ASEAN has higher population than the NAFTA and the EU. When examining the GDP per capita it could be identified that the ASEAN's per capita GDP is approximately twice higher than the SAARC region.

3.5.3 ASEAN Trade and Investment

Economic interdependence in the world's most dynamic Asia-Pacific region has progressed at a phenomenal pace, driven by the forces of rapidly increasing international trade and investment flows. Asia-Pacific economic interdependence has been propelled by market forces, which have been able to overcome official and private barriers to trade and investment. Asia-Pacific market integration evolved and prevailed "dramatically even in the absence of any preferential institutional arrangements". Intra ASEAN trade increased over the 1986-1992 period from 31 percent to 43 percent, whereas ASEAN exports to United States dropped sharply from 34 percent to 24 percent (Source: AFTA in the Changing International Economy, Joseph L.H Tan., Institute of Southeast Asian Studies, 1996). Intra-ASEAN trade continued to expand rapidly in 1995 as a result of ASEAN's commitment to the CEPT scheme. During 1993, its first year of implementation, the trade in CEPT products amounted to four-fifths of total intra-ASEAN exports or 80.27 percent. Intra-ASEAN exports as a percentage of total ASEAN exports increased from 18% in 1985 to 24 percent in 2003, while the share of intra-ASEAN imports in total ASEAN imports went up from 16 percent in 1985 to 21 percent in 2003.The sectors that contributed to by this were machinery and mechanical appliances, mineral products, textiles, chemicals and plastics (Source: http://www.aseansec.org/).

Figure 3.10 Intra and Extra Regional Trade in ASEAN: 2003





Source: ASEAN website (http://www.aseansec.org/)

To sustain its rapid economic growth and development into the decade of the 1990s, the Association of Southeast Asian Nations (ASEAN) has been responded to the external challenges of maintaining strong economic relations with major trading partners, thereby ensuring its market access to the United States, Japan, and Europe. ASEAN, as a whole and for its constituent member countries, also has to sustain international competitiveness in terms of attracting the flow of foreign direct investment and to maintain production costs and other advantages.

There are several major factors that contributed to increase in intra regional trade in the ASEAN Region.

- **The substantial income expansion arising from sustained economic growth**

Table 3.21 below illustrates the per capita income in some of the Southeast Asian countries. It can be seen from the figures that the per capita income in the members of the ASEAN-6 has been increasing over the period of 1996- 2003.

Table 3.21 Gross Domestic Per Capita

(US$ Millions)

Country	1996	1997	1998	1999	2000	2001	2002	2003
Brunei	17,096	16,227	11,961	12,670	12,751	12,121	12,070	12,971
Cambodia	317	320	265	295	291	283	296	310
Indonesia	1,167	1,128	488	693	731	688	820	973
Lao, PDR	396	360	259	285	332	328	333	362
Malaysia	4,766	4,672	3,257	3,485	3,881	3,698	3,924	4,198
Myanmar	109	100	144	189	210	162	175	179
Philippines	1,184	1,157	896	1,018	980	924	959	973
Singapore	25,127	25,147	20,892	20,611	22,757	20,553	20,823	20,987
Thailand	3,134	2,656	1,900	2,046	2,029	1,887	2,050	2,291
Viet Nam	337	361	361	374	403	415	439	481
ASEAN	**1,505**	**1,429**	**947**	**1,079**	**1,128**	**1,058**	**1,153**	**1,266**

Source: ASEAN Finance and Macroeconomic Surveillance Unit (FMSU) Database

- **The complementary formation of economic structures through foreign direct investment**

The table below illustrates the data on the scale of FDI to the ASEAN and its share in total investment. It could be seen that FDI is peaked in 1997 and fell between the period of 1997-1999. However, by international standards, at around 25 percent FDI has been an extremely high proportion of the total investment in several countries.

Table 3.22 Foreign Direct Investment in ASEAN

Country	FDI Flow (US$ million)							FDI as a % of Total Investment	
	1989	1996	1997	1998	1999	2000	2001	1980	1998
Cambodia	-	293.6	204.0	121.0	125.5	179.0	113.0	-	28.1
Indonesia	682.0	6194.0	4677.0	-356.0	-2745.0	-4550.0	-3277.0	1.0	-2.7
Lao, PDR	4.0	160.0	86.0	45.0	79.0	34.0	24.0	-	14.7
Malaysia	1667.9	5078.0	5136.5	2163.4	1552.9	3788.0	554.0	12.5	25.8
Philippines	563.0	1517.0	1222.0	2287.0	573.0	1241.0	1792.0	-1.1	12.8
Thailand	1775.5	2335.9	3894.7	7315.0	6213.0	2813.0	3759.0	2.0	24.7
Viet Nam	4.0	2455.0	2745.0	1972.0	1609.0	1289.0	1300.0	-	15.4
Singapore	2886.6	8984.1	8085.2	5492.9	6984.3	5407.0	8609.0	22.8	25.5
Myanmar	7.8	310.4	387.2	314.5	216.3	255.0	123.0	-	-
ASEAN	**7590.8**	**27328.0**	**26410.6**	**19354.8**	**14608.0**	**10456.0**	**12997.0**	-	-

Source: ASEAN Finance and Macroeconomic Surveillance Unit (FMSU) Database and UNCTAD database

The business friendly investment policies led to the ASEAN economies to increase the FDI flow in the region. Taking into consideration the increasing complementarity of production and assembly chains within the economies, the ASEAN has prioritized modernizing customs transit systems and other customs systems in managing temporary admission, export facilities and trade facilitating regimes. Furthermore, more efforts have been made at the regional and bilateral levels in the provision of facilities for the ASEAN Transport Corridor through liberalization and synchronization of border controls and management. In addition the ASEAN continued to intensify its work in phasing down non-tariff measures to support trade liberalization. These activities come to support the effective and practical operationalization of trade-facilitating measures. Partnership with the private sector has also been considered one of the essential programs to create an ASEAN Customs environment conducive to promoting efficiency. Businesses actively participate in the design and implementation of initiatives for regional customs integration. They also provide knowledge and information to policy makers and technicians in the configuration of new systems and models for information processing as well as in the standardization of business flows and systems of management.

- **Unilateral trade liberalization resulting in the reduction of official and private trade (and investment) barriers**

East Asia has long enjoyed a market-driven expansion of trade and foreign direct investment (FDI) and the resulting *de facto* integration of the regional economies, within a multilateral liberalization framework under the GATT/World Trade Organization (WTO) and open regionalism through Asia-Pacific Economic Cooperation (APEC). Several GATT liberalization rounds have reduced tariffs and non-tariff barriers to trade on a sustained basis. A key feature is that the region has avoided discriminatory trade practices.

- **The emergence and elaboration of various forms sub regional cooperation schemes (for example, growth triangles such as SIJORI; Singapore-Johor-Riau in ASEAN and Hong Kong-Southern China-Taipei nexus).**

Certainly the regional cooperation, and integration, among ASEAN countries, has benefited its members, not only in the form of greater intra-ASEAN trade but also in greater cross flows of foreign investment. ASEAN has successfully brought down the average tariff on intra-ASEAN trade, from 11.4 per cent in 1993 to 2.9 per cent in 2002, which will be further lowered to 2.38 per cent by 2003. Other initiatives are being implemented, to bring higher economic growth and integration among ASEAN member countries.

From the above analysis could be identified that trade liberalization and open regionalism led to increase in trade and investment in the ASEAN region. It is important for the SAARC countries to take these experiences from the ASEAN to boost up its intra trade level in the region. Moreover, it is highly appropriate that members in the SAARC initiate steps to further liberalize their economies and create conducive business climate to attract more foreign direct investments into the region.

3.6 Summary

In this chapter a descriptive analysis had been undertaken on the South Asian regionalism. At the outset of the chapter key economic indicators of the members of the South Asian region were presented to get an understanding of the character of each economy and comparison had been made with the other regional blocs to ascertain the position of the South Asian region in the global economy.

Further, the chapter discussed the trade and investment trends and policies of the members of the South Asian region to determine the causes for low intra trade share and foreign direct investment in the region. It could be understood that the majority of countries in South Asia use tariff and non-tariff barriers which impede intra trade share in the region. Hence, it is apparent that members of the South Asian region need to take steps to liberalize their economies and open up their economies to boost up the intra trade share and foreign direct investment in the region.

Moreover, the salient features of the SAFTA and Indo Lanka trade agreement had been examined to get insight into the analysis of the outcomes of the different trade policy options on the Sri Lankan economy.

Finally, key economic indicators of the ASEAN had been presented and examined the reasons that ASEAN could achieve high intra trade share among the members of the region. This is important to the SAARC members to take experience of the ASEAN economic integration for their future economic integration when the SAFTA implement in year 2006.