

III. GLOBAL REBALANCING AND INTEGRATION PROSPECTS

This chapter examines regional integration prospects and policies for South Asia—with East Asia and between countries within the region. This theme was selected, not to exclude other important topics that might be the subject of future outlooks, but because of its immediate relevance in the context of expected global rebalancing after the crisis and the expected shifts of global growth towards a more multi-polar world. Growing trade between South and East Asia, and that within the region—supported by an increasing number of regional trade agreements—makes this a matter of increasing reality.

The challenge for the South Asia region, as set out in the previous chapter, will be to make its recovery more durable, inclusive, and sustained in the medium-term. Part of that will require policy makers to reposition the region's trade and investment integration strategies after this crisis to a “new normal” in the global economy.¹⁴ The ongoing global recovery will likely involve a fundamental restructuring of the economic order, as described in chapter 1, where industrial country growth will be hesitant and slow to recover, whereas that in emerging markets will be much stronger. South Asia will correspondingly need to shift its market integration strategy, as developed countries start to save more and spend less and grow more slowly in North America and Europe, and as the East, especially Asia and emerging markets, overall look to become bigger drivers of global growth.

In that setting, the South Asia region faces three interrelated challenges, as well as opportunities: to enhance its Look East strategy, looking to integrate faster with East Asia (the gains are potentially large, some US\$450 billion of increased trade annually); to find opportunities among countries in the region to integrate more closely with each other (the gains also are potentially big, some US\$50 billion of additional trade); and to maintain its traditional links with industrial markets, which will continue to be important for labor-intensive exports and for the demand and supply of high-value services, capital, know-how, and foreign direct investment, in sectors (from manufacturing to infrastructure, finance, and logistics) that remain crucial to South Asia's growth.

The first section begins with an overview of the ongoing shift of global demand after this crisis to Asia and other emerging regions, and the relative decline of industrial country markets, and its implications for South Asia's trade prospects. The second section then analyzes the opportunities of expanding trade and investment links with East Asia. With a combined GDP of US\$6 trillion, it is South Asia's fastest-growing natural trade partner. Given complementary economic structures and specialization possibilities, trade and investment integration would not only help expand South Asia's services trade, but also its domestic manufacturing base, as East Asia looks to shift out of labor-intensive sectors. Although there remains some skepticism about the gains from such faster regional integration for faster growth in South Asia, analysis suggests that the gains could be substantial. Exports and trade would rise in sectors important for South Asia, and benefit growth, jobs and productivity. And among the most important side

¹⁴ The “new normal” anticipates several fundamental shifts: muted growth (1–2%, not 3%) with a shift away from the G-7 to emerging markets; slower consumption with debt-laden consumers and governments; financial markets facing greater regulatory burdens; banking being a shadow of its old self; a longer path of unemployment; and rising inflation expectations, currency, and sovereign risks (El-Erian 2009; Davis 2009; Galston 2010). Many agree on a global recovery led by emerging markets, while households and governments struggle with higher debt and unemployment.

benefits for South Asia, in particular, would be a reduction in large behind-the-border barriers, especially in trade related services, transport, and logistics, that would benefit growth in the region's economies as a whole.

These gains will be even bigger if countries in South Asia succeed in integrating more closely with each other which is examined in the third section. A bigger and integrated regional market will attract greater investment, improve scale economies and efficiency in manufacturing, allow the development of more efficient services, and lower real trade costs within the region. Private investment is likely to lead the way. India, the largest economy, has a vital role to play help carry its smaller regional neighbors with it, even as it grows faster and looks East, and as its neighbors respond (Kumar and Singh 2009, and Francois et al. 2009). Growing bilateral hub-and-spoke trade, manufacturing specialization, logistics, and private investment flows offer the most promising prospects to increase such intraregional trade—as recent successes and potential suggest (as in the case of Bhutan-India, Sri Lanka-India, and emerging possibilities for Bangladesh-India trade and investment, including transit trade arrangements with Nepal, Bhutan, and India's Northeast). The strengthening of intra-regional trade will facilitate the growth of South-Asian-East Asian integration as trade barriers within the region are lowered. There are also similar opportunities for Pakistan-India trade, regional trade with the Middle East, and improved regional energy trade and transit arrangements (Central Asia-Afghanistan-Pakistan-India, hydropower potential in Nepal and Bhutan, and in the East with Myanmar), as power shortages are a rising and critical bottleneck to growth.

A repositioning of trade and investment externally that is based on an accelerated regional and intra-regional integration can therefore be an important part of the adjustment in South Asia to the “new normal” in the global economy, in two important ways. First, as an instrument by which to achieve lower real trade costs, both at and behind the border, which will benefit producers and consumers throughout the economies, and overall trade more generally, Second, as a way to attract into South Asia accelerated investments in manufacturing and services and allow the region to specialize in particular niches and become more integrated with global value chains. The two are related: lower trade and input costs (including of services) are critical for improved competitiveness. The policy challenge will be to design regional cooperation and initiatives in ways that achieve these twin objectives.

GLOBAL REBALANCING AND THE RISE OF ASIA

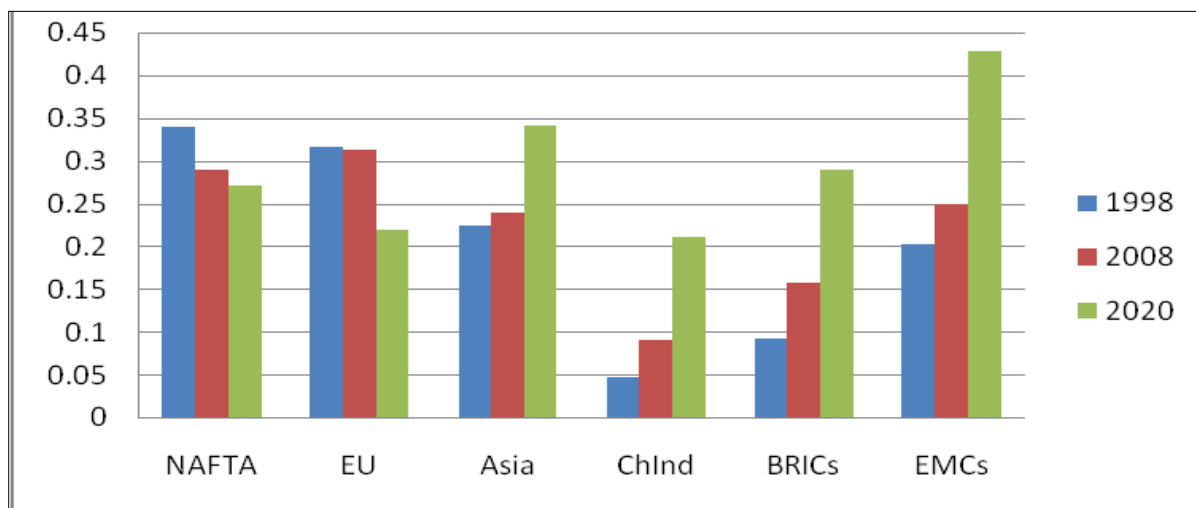
Global Rebalancing after the Crisis. Global rebalancing has two distinct connotations: one, the rebalancing of current account deficits between surplus and deficit countries; the other, the longer-term process whereby emerging countries are gaining much larger weights in the global economy as they grow faster. The concern with global rebalancing in this section is primarily with the latter process—although the former is also accelerating the latter after this crisis, as deficit developed countries such as the United States and others in Europe start to slow down and reduce their consumption, even as surplus countries, often developing ones such as China and India, grow faster from domestic sources after this crisis.

Forces were at work well before the crisis to increasingly question the sustainability of rising global current account imbalances. The global crisis has now sharply hastened the processes, marking a decisive

change to a “new normal”—with the contraction of growth in advanced countries, an unwinding of global current account imbalances, and a shifting of centers of economic activity. Countries with large current account deficits, such as the United States, are now reducing imports because of depressed domestic demand and are seeking to raise exports by improving competitiveness and shifting to new export markets, and countries with large surpluses have stimulated domestic demand, raising imports and reducing their surpluses. As a consequence, the contribution to global GDP growth of developing countries, including China, India, Brazil, and other big emerging markets, has risen—with Asia the fastest growing region of the world—whereas that of high-income countries has diminished sharply, as their economies were the epicenter of this crisis. This process is expected to continue, as the high-income countries grapple with the long-lasting effects of the current crisis and with the recovery in capital flows to developing countries, as investors seek to raise returns by investing in countries with stronger fundamentals and growth outcomes.

By 2020, Asia could become the largest center of economic activity, with its share of world GDP projected to reach close to 35 percent. Correspondingly, the share of the United States and NAFTA would shrink from 35 percent posted in the wake of the East Asian crisis in 1998 to 27 percent in 2020 (see figure 3.1). Driving this change is the projected increase in weights of China and India, but also of other emerging markets. Indeed, under this scenario, by 2020, the share of all large emerging market countries in the global economy would account for close to one-half of the global economy.

Figure 3.1: The Growing Role of Emerging Markets (Share of World GDP, in Current US\$)



Source: Authors' estimates, extrapolated from IMF, *World Economic Outlook to 2020*.

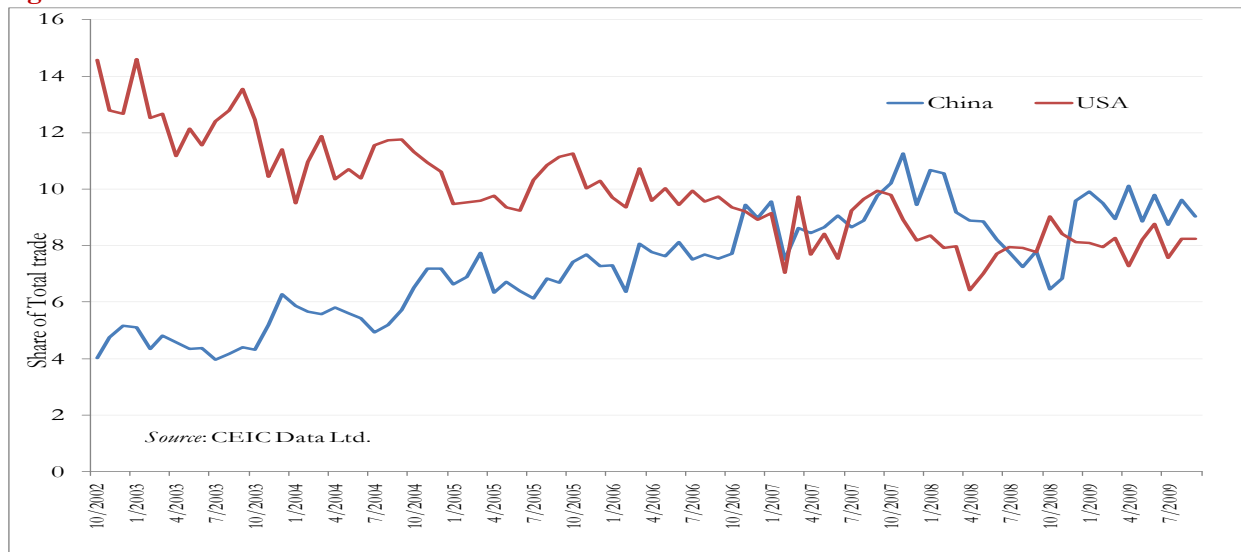
Global merchandise import -demand is shifting to China, East Asia, and other emerging markets.

Over the past few decades, the import share of China in world merchandise imports has increased rapidly, whereas the share of the United States has fallen—a consequence of differing growth rates and relocation of manufacturing. The secular decline in the share of world imports in high-income countries such as the United States has accelerated during this crisis and has been matched by the rise in import shares of emerging markets in Asia, such as China. This is also reflected in the relative importance of South Asia's main export markets: during and after the crisis, East Asia has become the biggest merchandise trade export market for South Asia, supplanting the markets in advanced countries. Together, developing

countries currently account for close to 70 percent of South Asia’s total merchandise exports, reversing the picture that prevailed only a decade ago in 2000.

In South Asia. As can be seen in figure 3.2, bilateral trade between India and China has been on the rise and has surpassed the bilateral trade between India and the United States since 2008. Furthermore, trade between India and China held up during the crisis, whereas that between India and the United States showed a declining trend. This provides initial evidence that South-South trade is becoming more important now (see Box 3.1) and has recovered much faster than South-North trade. There is similar evidence from other South Asian countries. Share of exports from Pakistan to the United Arab Emirates plus Afghanistan, for example, has surpassed the corresponding share from Pakistan to the United States. It is also worth noting that all the top four importing countries from Pakistan are developing countries or Middle Eastern countries. Similarly, for Bangladesh and Sri Lanka, China, and India are the two most important trading partners, accounting for 30 percent of their total imports for both countries.

Figure 3.2: Share of India’s Bilateral Trade with China and the United States



Box 3.1: Global Rebalancing Effects on Developing Country Exports after the Crisis

Two recent papers provide some analysis of the likely effects of global rebalancing on developing country exports after the crisis. The first (Canuto, Haddad, and Hanson 2010) suggests that a protracted contraction in final consumption in the United States and Europe, in the light of global rebalancing after the crisis, will hurt exports from low-income developing countries, especially in labor-intensive exports such as garments. However, South-South trade could play a powerful offsetting role. Such imports had been growing strongly even before this crisis, especially in the BRIC countries (Brazil, Russia, India, and China). After this crisis, these countries will play an increasingly important role, exceeding the contribution of the United States and Europe. These middle-income countries could also drive export diversification over time, with low-income countries occupying labor-intensive manufacturing niches as higher middle-income countries shift out of these sectors, diversify, and specialize.

A second paper (Milberg and Winkler 2010) looks more closely at global value chains (GVCs). It first analyzes the rapid growth in developing country exports and trade prior to this crisis, driven in part by GVCs and cutting up the production chain. It goes on to attribute, like others, the large downturn in world trade to the increasing role of GVCs, which magnified the effects of this crisis. The paper suggests that the recent global downturn in trade has been deeper and different from previous downturns and that it will likely lead to significant shifts—especially consolidation in “buyer-led” global chains, but also to “greater diversity” in producer-led global chains. The former will reduce opportunities, but the latter may well create others. It concludes that there are promising prospects for rapid growth in South-South trade after this crisis, especially if there are closer production ties between developing countries and regions, but that the prospects are more limited if consolidation in global value chains dominates.

East Asia represents the greatest potential for growth in merchandise trade for South Asia. Using an augmented gravity model, postcrisis medium-term estimates (with revised partner GDP growth estimates through 2014) of India’s global merchandise trade potential, for example, suggests that the increase in India’s trade potential will be highest with the Asia-Pacific region, followed by the European Union and NAFTA, and then by South Asia (De 2010).¹⁵ Potential for expansion of India’s trade in the postcrisis period is highest with countries such as China and ASEAN-6. However, India’s trade has remained unrealized with other large parts of the world, which presents further opportunities for expanding trade, despite a slowdown in global demand. The estimates of the gravity model suggest that trade with developing East Asia has the potential to increase 32 percent per annum by 2014 (or an incremental US\$360 billion in exports by 2014, compared to an actual of US\$126 billion in 2008). This is twice as high as the potential increase in trade with the EU-25 group (15 percent per annum growth potential and an incremental gain of US\$190 billion), and three times as large as with NAFTA (21 percent annual growth potential and an incremental export potential of US\$120 billion). Trade within South Asia also has strong potential to grow and is complementary to the above. If regional markets grow, it will attract greater trade and investment, and improve scale economies and efficiency, especially in manufacturing. Estimates suggest fast potential of about 36 percent annual growth—the fastest for all of India’s trade partners—although the absolute incremental gain in exports would be relatively small (US\$50 billion annually), given the small starting base.

¹⁵ The paper estimates trade potential between India and its partner countries for (1) the precrisis and (2) the postcrisis periods, using an augmented gravity model (Anderson–van Wincoop type), where bilateral trade is expected to be proportional to the product of economic sizes of country pairs and inversely related to the distance between them, among other factors.

High-Income Countries remain important for global services trade. In contrast to merchandise trade, high-income countries in the European Union and North America will continue to play much bigger roles in world trade in services. There are several fundamental reasons: higher incomes that generate greater demand for services, higher wages and the shift to knowledge-intensive activities in reflection of differences in relative skills and factor endowments, and demographics that favor the demand for services. Europe, for example, still accounts for about 50 percent of global service imports, followed by Asia with about 25 percent (of which Japan is a big contributor) and the United States with some 17 percent. The United States remains the primary market for India's service exports to the OECD countries, accounting for 51 percent of total Indian exports to these markets, and an even larger 60 percent share of its exports of IT and IT-enabled services. With service exports constituting about one-third of South Asia's exports—with information technology, business process outsourcing, and tourism and travel playing large roles—the potential markets in high-income countries remain the biggest, even as rising incomes in East Asia and elsewhere provide new, albeit smaller, sources of growth and dynamism. Services trade imports (and FDI) are also crucial for South Asia as it seeks to upgrade its own domestic manufacturing and services sectors, in transport, logistics, and financial services, among others. As a result, a nuanced approach will be useful: with merchandise trade shifting to neighboring Asia, the traditional high-income countries will remain important markets and sources of service sectors. Enhancing and opening FDI into service sectors is important to facilitate this process.

The Gains to Growth and Welfare from Faster Regional Integration with East Asia. A formal analysis using CGE modeling confirms that a broader South Asia–East Asia integration would provide large gains to exports and trade for South Asia and to overall welfare (Francois and Wignaraja 2008). Compared to a baseline scenario, exports from Bangladesh would be higher by 52 percent, for India by 23 percent, and between 6 and 7 percent for Sri Lanka and Pakistan. Sectorally, much of the gains from South Asia are in services, because no change is assumed for South Asia's potential for rising manufacturing exports. The aggregate welfare gains would also be significant, between 2 and 4 percent of base income. Typically, as with all such CGE models, these static gains considerably understate the growth impacts because of limited dynamic effects of higher cross-border investment decisions that follow the static gains. Conversely, the CGE modeling result also suggests most crucially that it is India's participation that provides most of the gains to East Asia. For the South Asian economies themselves, countries other than India gain significantly *only if* India carries its neighbors in South Asia with it. In its absence, the India–East Asia integration scenario produces significant trade and welfare losses for India's neighbors. The paper also models the impact of a subregional FTA within South Asia itself. The results suggest that India gains modestly from a South Asian subregional FTA, compared to that from a larger trade agreement targeting East Asia, even as the gains are bigger for its neighbors—again suggestive of the argument that South Asia–East Asia trade gains provided South Asian countries also open their markets to each other.

Gains to Growth from Reduced Behind-the-Border Barriers. The results above are only illustrative of the possible directions of static gains of trade. Dynamic gains from cross-border investment flows in support of trade would be much bigger. Moreover, the effects of such opening would potentially raise the economy-wide productivity and scale economies of domestic firms and industries, as suggested earlier. Finally, the biggest specific gain from a regional trade deepening with East Asia and within South Asia

may well be to lower what are currently very high trade-related service, transport, logistics, regulatory, and institutional barriers, with impacts on economy-wide domestic growth in South Asia. Regional trade agreements by themselves would do little to address these constraints, because such trade agreements are limited to shallow tariff reductions, with often large nontariff barriers and restrictive rules of origin. Instead, the true gains would emerge if the Look East and related initiatives induced improved policies and institutions in individual South Asian countries through unilateral and accelerated liberalization of trade and investment within the context of a regional framework. Behind-the-border barriers are important: high freight costs, delays in customs, slow port processing, transport bottlenecks, and bureaucratic and regulatory bottlenecks. Not only do they impede trade, but they work backwards throughout the economy and are one of the important reasons for the “missing middle” in South Asian manufacturing that was examined in chapter 2.

Gains to Growth from Exploiting Niches and Potential in Global Value Chains. As suggested in a recent paper (Sally 2010), unlike East Asia, South Asia has failed to insert itself into global manufacturing supply chains, processing trade supply chains, and other ICT supply chains other than in textiles and garments. One of the principal reasons is such behind-the-border constraints. Regional services and cross-border investment in services can be a powerful engine for easing these constraints endogenously. The effects can be as powerful as increasing trade impacts by a factor of two or more (Hoekman and Nicita 2008). East Asia, in particular, has developed specific expertise—its cost to export (in US\$ per container in 2006–07) was 773, versus 1,180 for South Asia, for example—and it would provide competition and learning gains to South Asia (Brooks and Stone 2010). The lowering of trade costs is one of the reasons why East Asia has become closely integrated and has been able to capitalize on its manufacturing potential in global value chains. South Asia might be able to do the same by integrating faster with East Asia, and a lowering of barriers would help generate the investments that are needed for countries and locations to specialize more in niches and product varieties and to become more integrated in the global value chains.

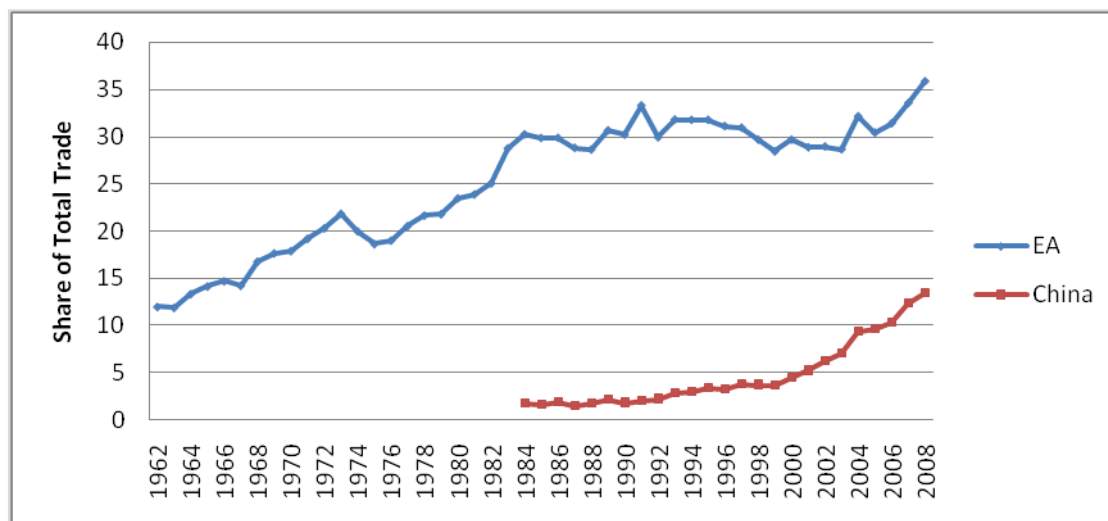
Repositioning South Asia’s Trade and Investment. The overall picture for South Asia’s strategy for repositioning its trade and investment integration after this crisis and with global rebalancing thus suggests three major priorities: a shift to closer integration with East Asia as its fastest-growing trading partner; still important trade and investment links with high-income countries, especially in services trade (and also as a source of longer-term capital flows and know-how in domestic services and manufacturing); and closer integration among the countries in its own region.

SOUTH ASIA LOOKING EAST

Against this setting, increasing trade with East Asia is becoming important (see figure 3.3). East Asia is now home to the third-largest regional market, with a combined GDP of US\$6 trillion (versus South Asia’s combined GDP of US\$1.5 trillion). It has already become the biggest partner for South Asia. We examine first the past performance and its drivers, and then turn to future prospects and policies that will help determine future trade.

Merchandise trade is growing rapidly. As its natural trading partner,¹⁶ East Asia's importance to South Asia (and the reverse) has grown since the 1970s, and especially in the past decade, even without formal preferential agreements.¹⁷ By 2008, East Asia constituted the largest trading partner, accounting for approximately 36 percent of South Asia's merchandise trade. Total merchandise trade grew from US\$25 billion to US\$148 billion (still a small share, 2.5 percent, of East Asia's world merchandise trade) (table 3.1). There were no apparent displacement effects, as South Asia's trade with other regions continued to expand rapidly (and faster than East Asia's).

Figure 3.3: South Asia's Rising Trade with East Asia



Source: World Trade Indicators.

Table 3.1: South Asia Trade Expanding Fastest with East Asia

	1977–1987		2002–2008	
	Imports	Exports	Imports	Exports
All	11.6	8.5	27.1	21.4
East Asia	16.8	10.7	29.8	27.5
European Union (25)	13.8	7.6	21.9	20.2
South Asia	4.3	5.7	21	19.6
United States	7.1	17.2	26.5	11.3
Rest of the World	4.3	1.2	27.9	27.3

Source: Authors' calculations using UN Comtrade.

¹⁶ Richard Lipsey (1960) and Larry Summers (1990) have put forward the hypothesis of “natural trading partners,” suggesting that a regional agreement is more likely to raise welfare effects, the higher is the proportion of trade with the region and the lower the proportion with the rest of the world.

¹⁷ East Asia is now home to the world's third-largest free trade association (FTA), with the launch of the ASEAN-China Free Trade Area (ACFTA) in 2002, and its full implementation since 2010. With its Look East policy, India also signed a free trade agreement with ASEAN in August 2009, which promises to expand the FTA further and deepen South Asia's trade with East Asia. Two prominent early RTAs were the Bangkok Agreement in 1975 by India, Bangladesh, Sri Lanka, Korea, and Lao PDR, and the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC)—comprising Bangladesh, Myanmar, India, Sri Lanka, Thailand, Nepal, and Bhutan—in 1997. Neither have provided significant market access due to unresolved issues with regard to “negative lists,” rules of origin, and dispute-settlement procedures (Pursell et al. 2001).

Complementarity of South Asian and East Asian Exports. Is the faster growth of South Asia trade with East Asia a result of being displaced in third-country markets, particularly in the United States and European Union? The answer seems to be no, as South Asia continued to export strongly to third-country markets and capture larger market shares of merchandise trade. And South Asia's exports to the rest of the world continued to diversify to industrial processed goods and parts and components, even as its industrial primary exports to East Asia rose. Following Freund and Ozden (2006), we more formally test for these effects,¹⁸ looking at the relationships between South Asia's exports and East Asia's exports in the same import markets.¹⁹ Results are reported in Annex table 3A.1. It allows a test of whether East Asia is affecting South Asian countries negatively or positively in third-country markets. The results suggest that South Asia's exports grew more slowly than the total imports in these markets (the export supply coefficient for all South Asian countries was lower than 1, around 0.4). This suggests losses in market share in third countries other than East Asia, which is partly to be expected, given that such market shares in goods include nonfuel commodities, where South Asia does not have a strong comparative advantage. By contrast, the positive coefficients on East Asia's specific exports to these same third-country markets suggest strong complementarities in manufacturing—India's export growth is higher when East Asian exports are large and growing. This is also true for Pakistan, Bangladesh, and Sri Lanka, whereas the impact is not significant for Nepal. Over time, the positive impact diminished during 2000–08, except for in India—suggesting the emergence of some competition at the margin (e.g., as in case of Bangladesh). This also highlights the importance of maintaining the competitiveness of export sectors (and real exchange rates), and reducing real trade costs at or behind-the-borders.

Shifting Composition of Trade. As we suggested in chapter 2, the growing trade between East Asia and South Asia is also enlarging the possibilities for domestic manufacturing. The composition of exports from South Asian countries to East Asia has, however, shifted toward industrial primary goods (see figure 3.4)—reflecting growing demand by China and other East Asian countries for such products in their manufacturing. They also reflect the effect of much higher trade costs in South Asia that prevent it from integrating with global value chains, as well as possible competitiveness issues. The major exports were metals, ores, and minerals (including petroleum products from India). The latter therefore requires closer attention and the discovery of possible ways to increase South Asia's ability to deepen its manufacturing trade potential with East Asia. The intensive margins (existing exports) still dominate for all major South Asian countries' exports to East Asia, although Sri Lanka, Pakistan, and Bangladesh have experienced limited success in extensive margins in industrial primary and processed goods.²⁰ Conversely, the composition of imports by South Asia shifted toward industrial processed goods, especially capital goods and machinery and parts. Evidence points to a significant impact on productivity improvements (Topalova 2007; Nataraj 2009).

¹⁸ Estimating the following regression equation:

$$dexports_{ijkt} = \alpha_{it} + \beta_0 dimports_{jkt} + \beta_1 dEastAsia_{jkt} + \varepsilon_{ijkt}$$

where $dEastAsia_{jkt}$ is growth of East Asia's export in country j in sector k . The advantage of this specification is that we are exploiting both cross-section and time-series variation to estimate how South Asian countries are affected by East Asia. If East Asia has roughly the same effect on all exporting countries, then the coefficient yielded from the regression on imports will be close to 1, and the coefficient on East Asia will be 0. A negative coefficient on East Asia indicates that East Asian export growth is correlated with a decline in South Asian export growth in a given industry. We estimate this equation using data from 1990 to 2008, with the four-digit classification.

¹⁹ Only nonfuel products are included; we also distinguish between industrial products (technology-intensive, skilled labor-intensive, unskilled labor-intensive) and nonindustrial products (agricultural products, minerals, raw materials).

²⁰ The intensive margin is typically thought to be more important for growth in exports between countries at similar levels of income (Brenton and Newfarmer 2007; Amurgo-Pacheco and Pierola 2008).

Rising Services. Services trade for South Asia has been growing rapidly during the past decade. But this trade with East Asia so far has been a relatively small part. Bilateral data flows are dominated by Indian exports (exports of US\$2.4 billion in services to Japan, Singapore, and Hong Kong, China, equivalent to 16 percent of its total, in 2007). Transportation services, professional services, IT, financial services, and insurance services follow. The rest of South Asia's exports were in the traditional segments, mainly transport services. Sri Lanka shows a surge in exports as an emerging transshipment hub between the East and West.

Tourism: The Brightest Spot? South Asia's overall tourism receipts have grown at 13.5 percent per annum between 2002 and 2007, compared to 8.1 percent in all developing countries. The impact reaches beyond direct expenditures on lodging, restaurants, entertainment, and retail, to include indirect impacts²¹ (ranging from 5.3 percent of GDP in India to as much as 66.6 percent of GDP in Maldives). East Asia now accounts for a significant and growing share of South Asia's tourism. East Asian arrivals account for 26.5 percent of tourism arrivals in Nepal, 24.2 percent in India, 19.8 percent in Bangladesh, and 18.5 percent in Maldives (see table 3.2), and they are growing.²²

Table 3.2: South Asia Tourism, Economic Contribution and Role of East Asia

	Share of GDP (2006)	Share of Exports (2006)	Share of Tourism Arrivals	
			East Asia	South Asia
South Asia	5.5	5.4	n.a.	n.a.
Bangladesh	n.a.	n.a.	19.8	35.4
India	5.3	4.7	24.2	5.5
Maldives	66.6	65.9	18.5	4.5
Nepal	8.2	22.6	26.5	31.9
Pakistan	n.a.	n.a.	9.2	n.a.
Sri Lanka	9.6	14.9	10.4	36.4

Sources: Share of GDP and share of exports from World Travel and Tourism Council; share of tourism arrivals derived from available national tourism statistics (2006 for India and Pakistan, 2007 for others).

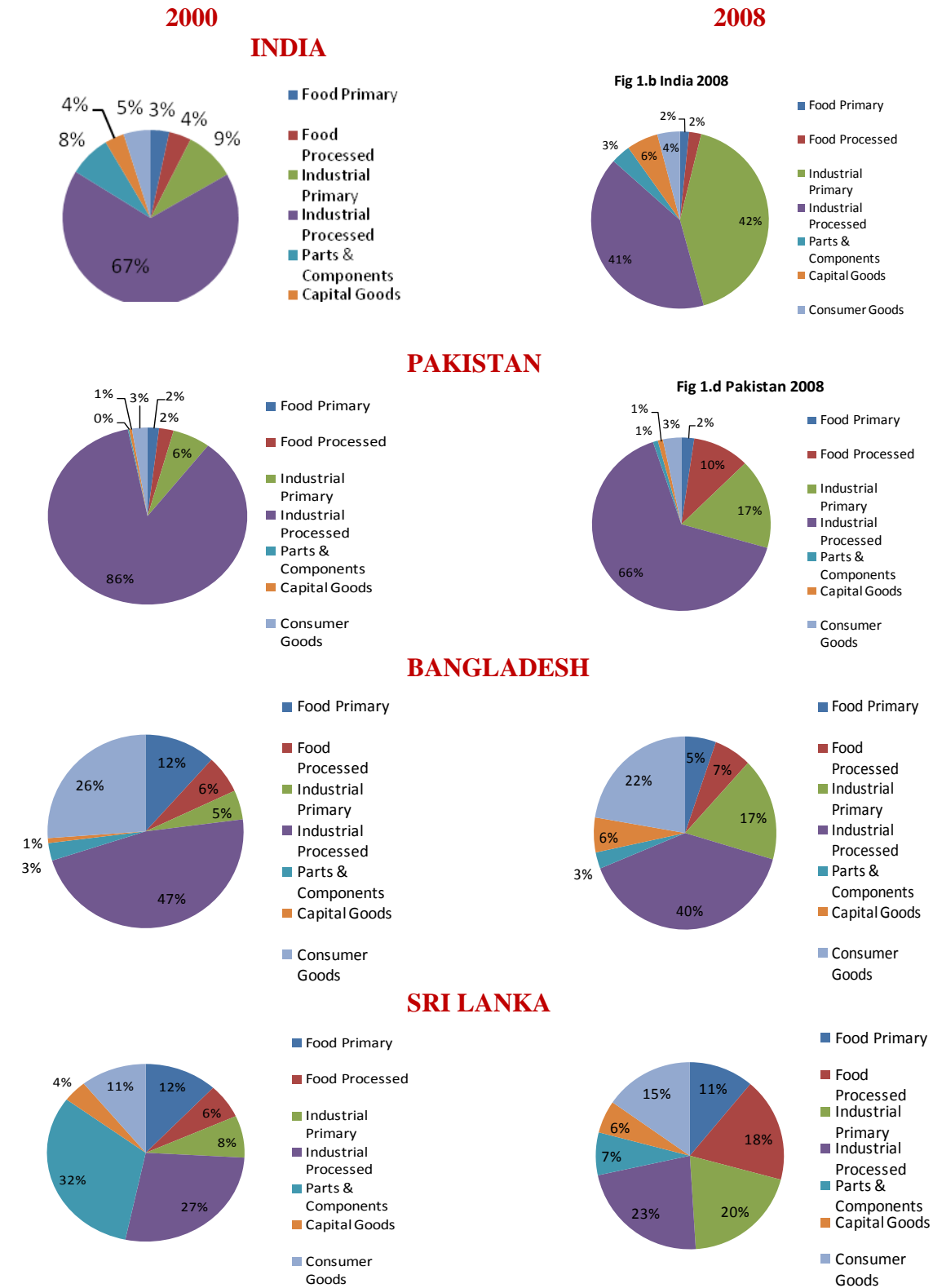
Prospects for Deeper Integration

Given the size of the East Asian region and South Asia, the faster growth prospects in both, and the increasing trade with each other along with mutual benefits, major gains are clearly to be realized from deepening trade and investment. Such trade would be complementary to each's strengths and changing development patterns, and the evidence for this is suggested next. East Asia is exporting capital-intensive manufactures; is beginning to shift out of labor-intensive manufacturing and is exporting transport, logistics, tourism, financial, health, and other services to South Asia; even as South Asia is exporting more industrial products, gaining in third-country markets, and is expanding its service exports, especially in tourism, transport, IT, and business processes. The pace of growth and the size of benefits are clearly large. Underpinning the prospects are fast-expanding cross-border investments, as well as formalization of free trade agreements (FTAs).

²¹ The World Travel and Tourism Council utilizes satellite accounting and input-output modeling to capture both direct and indirect impacts of travel and tourism.

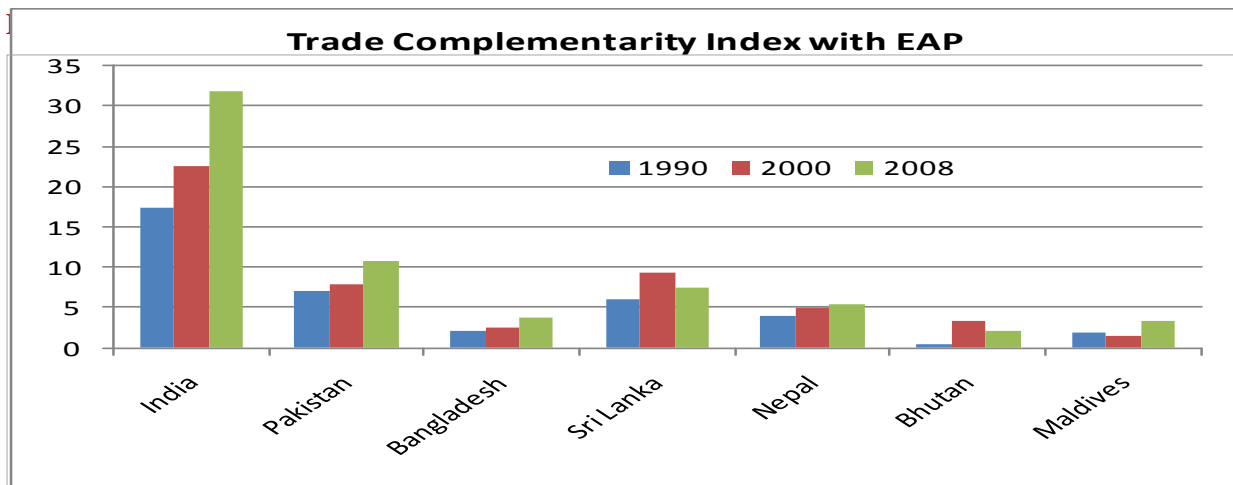
²² Data from India show that arrivals from East Asia grew 37 percent per annum between 2001 and 2006.

Figure 3.4: South Asia's Composition of Exports to East Asia



Source: World Integrated Trade Solution (WITS).

Rising Merchandise-Trade Complementarity. Trade has greater potential to grow if neighboring regions start growing trade in similar product lines—as they deepen their production relations. One way to assess this is by measuring so-called complementarity indexes, which correlate the countries’ exports in similar products. These indexes for the two regions suggest that trade complementarity is growing (see figure 3.5).²³ Current South Asian values with respect to East Asia are similar to those for countries such as the original European Union (6) members at the time of the formation of the European Economic Community—suggestive of the scope for further gains.



Note: Complementarity index correlates exports of South Asian countries with imports of East Asia at the HS-6 disaggregated level—with increasing values suggesting strong positive matches of the two over time. Intra-industry trade indexes could reinforce the qualitative conclusions here, but we choose TCI as a more relevant measure. Source: Authors estimates, World Bank. 2010.

Supportive Comparative Advantage. An alternative measure of trade potential is the so-called revealed comparative advantage (RCA), which calculates the share of one region’s exports to another partner region, relative to total world exports. If this is greater than unity, it means greater comparative advantages in the other’s market. Table 3.3 summarizes the picture on calculated revealed comparative advantage (RCA) indexes for East and South Asia, where they have such advantages, based at a disaggregated product level.²⁴ The results again suggest strong complementarities. The key categories, where either region has a comparative advantage, comprise as many as 2,843 products, or 64 percent of total trade, suggesting strong prospects for trade between East Asia and South Asia. Drilling down further to identify where South Asia’s comparative advantage lies suggests that (1) South Asia has outright comparative advantages in food, organic and inorganic materials, textiles, and metal products, and (2) the products where both region’s share positive revealed advantages in each others’ markets, but where South Asia has greater advantages than East Asia, are apparel, yarn and textiles, and other labor-intensive manufactures (footwear, parts, jewelry). Ultimately, the drivers of such advantages stem from relative factor endowments—and their changes over time—which we described in chapter 2. Similar analysis

²³ The trade complementarity, TC, between countries k and j , is defined as

$$TC_{ij} = 100 - \text{sum}(m_{ik} - x_{ij})/2$$

where x_{ij} is the share of good i in global exports of country j , and m_{ik} is the share of good i in all imports of country k . The index is 0 when no goods are exported by one country or imported by the other and 100 when the export and import shares exactly match. As such, it is assumed that higher index values indicate more favorable prospects for a successful trade arrangement between countries.

²⁴ At HS-6 level. However, RCA growth at country level and relative compositions may be more informative than levels. It is important to note, however, that the RCA index, as a measure of comparative advantage, does not discriminate between “inherent” comparative advantages and policy-induced comparative advantages. Any attempt to apply the concept of RCA to South Asian countries must therefore acknowledge the influence of distortions created by their policy regimes.

(UNCTAD 2009) supports growing differences in factor intensities between the two regions as one factor in trade driving this, and hence driving growing complementarity.

A more detailed look at China's imports from South Asia shows that products in which South Asia has both a comparative advantage, as defined by RCA, and a growing market share in China numbered some 166 (out of a total 1,594 products at Standard International Trade Classification five-digit level, exported by South Asia to China). Although small in number, those products together accounted for more than 47 percent of South Asia's merchandise exports to China. This finding bodes well for further export penetration. The exports remain concentrated in industrial primary products, with the exception of textiles.

Table 3.3: Revealed Comparative Advantage Favorable (2008)

	Category	Number of Lines	Percent of Lines
1	Both East Asia and South Asia have positive RCA, but RCA in East Asia is greater than RCA in South Asia	540	12.3
2	Only East Asia has positive RCA	846	19.3
3	Both East Asia and South Asia have negative RCA, but RCA in East Asia is greater than RCA in South Asia	800	18.3
4	Both East Asia and South Asia have positive RCA, but RCA in South Asia is greater than RCA in East Asia	637	14.5
5	Only South Asia has positive RCA	820	18.7
6	Both East Asia and South Asia have negative RCA, but RCA in South Asia is greater than RCA in East Asia	740	16.9
		4,383	

Source: Authors' calculations.

Large Production-Sharing Potential. Beyond the static comparisons of complementarity and revealed comparative advantage are, however, the much greater potential for South Asia to integrate with global manufacturing (and services) value chains, by driving down real trade costs and trade and transport logistics barriers. The drivers of such trade go beyond relative factor endowments, to factors such as complementary use of information and communication technologies and natural geographies (clustering, agglomeration, and scale effects). Manufacturing production sharing (or vertical specialization) is a key characteristic in East Asia's regional integration and export dynamism (Yeats 2008; Kimura 2006). So far, there has been a limited engagement with South Asia, but it is starting. Production-sharing in apparel and textiles is well established (Bangladesh and Sri Lanka with East Asia). India and Korea show greater production-sharing in automobiles and steel. A few projects in Sri Lanka supply truck parts, optical parts, telecommunications parts, and electrical parts manufactures that are exported to Japan, Korea, and Malaysia (Board of Investment, Sri Lanka). However, evidence suggests that the proportion of parts and components that constitute major activity in East Asia is only a small part of South Asia's trade with the East. By the same token, the room for growth is large if policies start to address the fundamental drivers, such as lowering the trade costs in South Asia.

Rising Foreign Direct Investment. Asian outward FDI is playing an important role in promoting South Asia's extraregional and interregional trade (see table 3.4). East Asian FDI was earlier key in transforming Bangladesh and Sri Lanka to labor-intensive textile and apparel exports. It is likely to prove

equally important in fostering the shift to other sectors. The recent rise in FDI is already starting to do this. Time-series data of bilateral FDI flows (or stocks) between Asian economies is not readily available, but the data presented below provide some insights. First, the sources of FDI are diversifying: China, Malaysia, and Thailand joined traditional high-income countries, such as Hong Kong, China; Korea; Japan; and Singapore. Second, service sectors are assuming increasing importance, helped by framework agreements, such as the Comprehensive Economic Cooperation Agreement (CECA) between India and Singapore; as a result, Singapore has climbed to become the second-ranked source in 2009, and India's service exports to Singapore have increased; there has also been a temporary movement of workers. Third, inflows of FDI are opening new sectors and directions. These are notable in sectors such as automobile manufacturing in India from Korea and Japan; electronics in India from Korea; Taiwan, China; and Singapore; infrastructure in India, Pakistan, Bangladesh, and Sri Lanka from China, Malaysia, and Singapore; and tourism and related aviation and freight and transshipping services across the region.

Table 3.4: FDI Inflows from East Asia

	India (2008)		Pakistan (2007)		Bangladesh (2005)		Sri Lanka (2008)	
	Flow (US\$ millions)	Rank	Flow (US\$ millions)	Rank	Flow (US\$ millions)	Rank	Flow (US\$ millions)	Rank
Cambodia	—	—	—	—	—	—	—	—
China	50.5	35	101.4	6	0.9	21	101.2	3
Hong Kong, China	493.7	19	156.1	5	47.4	9	—	—
Indonesia	72.9	29	—	—	5.4	15	—	—
Japan	3481.1	6	74.3	10	22.8	10	26	8
Korea, Rep.	513.3	15	2.3	13	53.9	7	—	—
Lao PDR	240.9	24	—	—	—	—	—	—
Malaysia	3.2	75	—	—	44.5	12	162.6	1
Myanmar	1.4	80	—	—	—	—	—	—
Philippines	0.7	90	—	—	0	26	—	—
Singapore	9146	2	—	—	35.9	13	20.6	10
Taiwan, China	33.2	37	—	—	2.4	19	—	—
Thailand	55.5	34	—	—	0.1	25	—	—
Vietnam	0.1	100	—	—	—	—	—	—
Total	102,058.7	—	3,719.9	—	792.4	—	888.9	—

Sources: India: Ministry of Finance; Pakistan: Board of Investment 2010; Sri Lanka: Board of Investment 2010; Bangladesh: Board of Investment.

FDI outflows to East Asia, in services and overall, were minimal prior to 2004. By the end of 2005, more than 300 Indian IT companies had set up software development operations in Singapore. There are around 1,500 Indian companies currently based in Singapore; on average, approximately 150 Indian companies

set up base in Singapore every year.²⁵ Anecdotal evidence also indicates that much cross-border investment from East Asia to South Asia has been in services (under Mode 3 of GATS). Recent trends also point to opportunities in transport services, including recent heavy investment by China in Pakistan's transport infrastructure following the implementation of their own bilateral agreement.

Findlay et al. (2009) point to a number of other growing opportunities to expand service exports from South Asia to East Asia, including health services (India), travel (Nepal), telecoms (Pakistan and Sri Lanka), financial services (Sri Lanka), and transport (Sri Lanka and Pakistan), among others. An established network of support services and a pool of trained workers (promoting agglomeration), along with lower-cost service links (to support fragmented activities), are crucial if South Asia is to encourage links "eastward" (Carruthers et al. 2003; Arvis et al. 2007).

Box 3.2: Improved Logistics: A Critical Precondition

The World Bank's Logistics Performance Index (LPI) provides assessment of logistics performance of countries. In the latest 2010 index, India, Bangladesh, and Pakistan scored better than new low-income members of ASEAN (Lao PDR, Myanmar, and Cambodia), but much lower than ASEAN original members Malaysia, Thailand, and the Philippines, as well as China. Sri Lanka scored marginally lower than Lao PDR, Maldives, Bhutan, Cambodia, and Myanmar, all low-income countries. If South Asian countries are to exploit the marginal advantage of the transportation costs or wages to Europe and the east coast of the United States, improving logistics performance will be critical, given the increasing time sensitivity of vertically linked production networks, including higher value-added apparel, and there will be spillover benefits to promote trade more broadly.

Lowering Real Trade Costs. A critical link to the success of a Look East trade integration strategy for South Asia will thus be to attract sizeable investments from East Asia and the rest of the world to the Region to become integrated into global production chains in both manufacturing and services. But in order to do so, the Region will also need to improve its trade logistics and lower substantial barriers at and behind the borders. Indeed, high trade costs are the biggest deterrent to expanded integration (see Box 3.2). Increased integration strategy with East Asia will help to attract these complementary investments (where East Asia has a decided comparative advantage) provided entry into services and trade logistics is encouraged by lowering policy and institutional barriers.

At the same time, closer intra-regional integration within South Asia will be another critical instrument to enlarge market size and attract more investment, and lower the substantial within-region trade costs—given a long coastline that surrounds a very large geographic hinterland and the difficulties of land-locked countries and cross-border trade within South Asia. A review of trade facilitation and transport logistics in the region illustrates weakness of South Asian countries in port and transport infrastructure, regulatory environments, and service-sector infrastructure (Wilson and Ostuki 2007). Delays at seaports due to congestion and outdated infrastructure raise costs for exporters throughout the region. Furthermore, landlocked countries in the region confront additional delays due congestion in road and transit caused by the poor road infrastructure and networks (De, Chaturvedi, and Khan 2007; Roy and Banerjee 2007). The study finds that very large gains from improved trade facilities are possible—much of which will accrue from intra-regional efforts at and gains from lower trade costs. Continued reform in regulation and

²⁵ India Brand Equity Foundation, CII, http://www.ibef.org/artdispview.aspx?art_id=4267&cat_id=400&page=3 (accessed July 15, 2009).

harmonization of standards, accelerating the diffusion of technology to lower transactions costs, and promoting efficiency in customs regimes within the region are thus needed. The next section discusses therefore the complementary approach to accelerate intra-regional integration as a critical instrument to lower these real trade costs within the region.

BOOSTING INTRAREGIONAL TRADE IN SOUTH ASIA

While the fast-expanding trade with East Asia (and with other regions) will open new avenues for South Asian countries individually, they are likely to gain even more by expanding trade and cross-border investments with each other—enlarging the South Asia market. A larger South Asian integration, if policies and institutions needed to do so can be improved, could also provide an important platform to reduce real trade costs and behind-the-border barriers in the region, which would then attract greater investment and integration with East Asia—enlarging dramatically the gains. In a similar vein, more closely integrated South Asian markets would improve the scale economies of domestic firms, especially in manufacturing (where the small size of domestic markets has been one big constraining factor²⁶); would increase competition, and hence efficiency; and would facilitate skills and technology spillovers (Kumar 2009), a process that is already starting in sectors such as IT and business process outsourcing. Industrial structures that are similar across the region (for example, apparel and textiles) would also gain from greater specialization and intraindustry trade, helping to strengthen comparative advantages with the rest of the world. Services, too, would gain, such as tourism, transport, energy, and shipping, with scale economies and competition. Such a bigger regional market would, in turn, attract greater trade and investment from East Asia (and the rest of the world), making the likelihood of gains even stronger. In reflection, quantitative studies (Francois et al. 2009) find consistently that the gains from greater trade integration for South Asia are much bigger and benefit all country members more, if countries of the region also trade more with each other, even as they integrate faster with East Asia and the rest of the world.

The potential for such intraregional trade is large—the current levels of about 5 percent share of intraregional trade, in total, could quadruple to about 20 percent with such supportive policies, by some estimates. The more likely and faster way to do so is by expanding bilateral trade and investment relations—helping support the eventual goal of formal intraregional trade cooperation arrangements (the SAPTA and its transition to SAFTA²⁷). The latter has had some difficulties in reducing binding barriers to intraregional trade and in producing results because of political-economic and other constraints to obtaining significant reciprocal concessions across member states. At the bilateral level, however, the pace of liberalization can be much faster, can help build confidence, and can induce competitive spillovers across the region. Some of the reasons why such bilateral agreements work better and faster include the practical aspects of the broader scope of liberalization in such bilateral FTAs, less restrictive

²⁶ Evidence across the world suggests that exporting plants overwhelmingly tend to be larger, to have higher levels of productivity and shipments, and to be more capital intensive and technologically more sophisticated (Wagner 2001), even if this is not true of all industries. In assessments of firm size and performance in South Asia, this appears to hold. Scale effects are consistently positive in exporting, whether in (1) highly clustered network industries such as garments (Cawthorne 1995) or (2) vertically integrated and R&D-intensive sectors such as IT and pharmaceuticals (Pradhan 2002). Evidence from China also suggests that scale economies are strong, with exporting firms distinctly larger, even after controlling for sectoral, regional, and ownership factors (Kraay 1997).

²⁷ SAPTA became operational in 1995, 10 years after the first SAARC summit, and it transitioned to SAFTA in 2004.

rules of origin, bigger and faster cuts in tariff and nontariff barriers, and features such as asymmetrical concessions (especially by larger countries to smaller ones) in the political-economy setting of the region (Aggarwal and Mukherji 2005). And, as the subsequent trade and business climate improves sharply in the wake of such bilateral trade, so do cross-border investments, helping to drive further gains faster and to build greater private-sector and business support. Sector-level agreements, as in energy, are another possibility, if they induce similar specificity and rapid mutual gains in confidence and cross-border investments.

There are signs that such bilateral trade and cross-border investment is starting to show greater vitality in South Asia—particularly in the post-2000 period, a time that saw key developments in growing trade relations between India and other member countries, and with East Asia. The latest developments in Indo-Bangladesh trade relations and Indo-Bhutan economic cooperation, along with the growth in Sri Lanka–India trade (and cross-border investment) and the potential for energy trade with neighbors, are some examples and possibilities described in boxes 3.3 to 3.6.

Box 3.3: Bhutan-India Cooperation

Bhutan is well endowed with mountainous, glaciated peaks that feed its four main rivers with potential hydroelectric power-generating capacity estimated at 30,000 megawatts (MW), of which about 26,000 MW are commercially viable. Bhutan and India signed a series of four agreements in 2009 that include energy, educational, and vocational needs. The four agreements are for the preparation of detailed project reports for 10 hydropower projects. Of the 10 projects, 6 will be financed through an intergovernmental model, whereby India will supply 40 percent of the cost as grants and the remaining 60 percent as loans. A free trade regime exists between Bhutan and India that expired in March 2005 but has been renewed for 10 years. Bhutan experienced a notable rise in its exports to India.

Box 3.4: India–Sri Lanka Free Trade Agreement (ISLFTA)

Sri Lanka’s regional trade, particularly with India, has undergone a significant increase compared to others. Sri Lanka’s share of intraregional imports rose from 11 percent in 2000 to 23 percent in 2008, while its export share rose proportionately faster from a very low 2.7 percent in 2000 to 8.5 percent in 2008 (Pitigala 2010). Traditionally, Sri Lanka’s exports to India have been relatively small, but since ISLFTA, Sri Lanka’s bilateral exports have soared compared to the other nonlandlocked countries, and relative to growth levels of Indian overall imports.

The reasons behind the success are (1) the ISLFTA, although principally an agreement in trade in goods, provided a boost to services trade and FDI—in air travel (the “open skies” agreement brought in several new carriers), in transshipment (70% from India), and in FDI (India joined the top five investors, with cumulative investment of US\$2.5 billion); (2) the scope of product coverage was enhanced through a “negative list” approach; (3) a faster pace of implementation was used—for example, duty-free access was granted by India within three years of signing on 81 percent of the agreed items, and similar reciprocity was pursued by Sri Lanka; and (4) rules of origin were simplified.

Box 3.5: Bangladesh-India Cooperation

Bangladesh and India have a long history of agreements to facilitate trade and economic cooperation. Although bilateral trade between the two countries has been growing steadily, exports from India far outweigh imports from Bangladesh, resulting in a wide and growing trade gap. Bangladesh and India signed a series of new agreements in January 2010 to address some of the barriers to bilateral trade through new trade and transit provisions:

- *Greater market access for Bangladesh.* India has extended duty-free access beyond its South Asian FTA commitments, broadening the scope of goods to benefit from duty-free access to India, with the aim of narrowing the large trade gap.
- *Promotion of transit links between Bangladesh and India.* India also agreed on transit rights for goods from India's northeastern state of Tripura to Chittagong, including a new rail link. The new links will benefit both countries by reducing transport costs for Indian exporters in the border regions and by gaining greater revenues for Bangladesh from transit and port fees.
- *Regional trade facilitation.* India also agreed to a long-pending request from Bangladesh to allow rail transit from Bangladesh to Nepal and Bhutan, thereby benefiting all three of India's regional trade partners as India expands its demand for underused port facilities and services, and as Bangladesh's, Bhutan's, and Nepal's landlocked regions gain greater market access for their exports.

Other agreements signed at the January meeting include India's extension of an infrastructure credit facility at highly preferential rates and new energy supplies to meet Bangladesh's shortfalls.

Box 3.6: An Energy Ring Trade for South Asia

Bangladesh, India, Pakistan, and Sri Lanka have a demand for energy that is in excess of their domestic capacity to varying degrees, and the gap will only become larger with future growth. Conversely, Bhutan and Nepal in the South Asia region; the Islamic Republic of Iran and Qatar in the Middle East and North Africa region; Kyrgyzstan, Tajikistan, and Turkmenistan in the Central Asia region; and Myanmar in the East Asia region have resource endowments considerably in excess of domestic demand.

The benefits from energy trade in South Asia can be enormous: The most obvious direct benefit would be in alleviating the energy constraint to growth for the potential energy-importing countries, India and Pakistan. In addition, transit countries would earn large fees, and grids could improve efficiency of supply and could attract private investment with better services, while potentially improving the environment. In India, the volume of unmet demand for electricity in 2007 is estimated to have been 55 terawatt hours (TWh), which can be valued at US\$12 billion on the basis of the short-term marginal cost in the Indian grid. The value of the forgone industrial value added would be considerably more. In Pakistan, unmet energy in 2007 is estimated to have been 18 TWh. When valued at the Pakistan system's average incremental cost of about US\$.07 per KWh, the direct cost of shortages is of the order of US\$1.9 billion. In Bangladesh, electricity shortages are forcing garment exporters to ship orders through chartered flights, while stoppages of production are reducing exports.

Raising the Game: Policy Directions

In positioning the South Asia region in the “new normal” of the global economy, as highlighted in this chapter, the region needs to redirect its market integration strategy. What does this imply in terms of the changes in the direction of policies?

The Look East Strategy. The most important policy initiatives would be to accelerate the lowering of tariff and nontariff barriers with respect to East Asia and the rest of the world, and then to expand to the opening of services and foreign direct investment.

Individual South Asian countries are already relatively well positioned and are making good progress, as far as formal trade agreements are concerned. India, for example, has already signed an FTA with ASEAN, while bilateral agreements with member states are enlarging the scope and pace of its trade and investment integration. Others, too, have similar bilateral and regional agreements, although not as encompassing as India’s. Although theory suggests that a single trade arrangement encompassing both South and East Asia may provide the optimal strategy within broader Asian integration, this is unlikely to happen, and a “noodle bowl” phenomenon of overlapping bilateral and regional agreements, with multiple rules of origin and market access provisions, is therefore likely to stay.

To lower trade and transactions costs within this setting, South Asia would benefit by lowering trade barriers to levels similar to East Asia (Annex table 3A.2) and extending them to all countries to reduce the potential for trade diversion. This would accelerate its South-South trade potential, in light of the global rebalancing. Relatively higher nominal tariffs above 15 percent still prevail; countries could decide to unilaterally reduce them closer to the norm in East Asia of below 9 percent (the rate that all developing countries face incidentally in high-income markets). Nontariff barriers, however, account for even bigger protection, and “para-tariffs” are often large. Import restrictions have often increased after the crisis. Liberalizing such nontariff protection unilaterally could be an even more important component of such open regionalism,²⁸ including cutting import restraints, protracted customs clearance processes, and often complicated and redundant documentation requirements. Complementary and similar approaches would be needed to boost intra-regional trade within South Asia.

South Asia could also more aggressively liberalize services trade and investment. Such liberalization should not be limited to more visible champions, such as IT and BPO sectors, but should also extend to backbone services—in finance, domestic transport, wholesale distribution, and other professional services—permitting entry on an MFN basis and encouraging competition. Indeed, the success stories emerging from the agreements between India and Singapore, Pakistan and China, and Sri Lanka and India may have been triggered by the “credibility” of their FTAs, but they are largely a consequence of such unilateral measures.

Improvement of *trade logistics* will be especially crucial for South Asia to better exploit its manufacturing potential and may prove decisive in tapping into East Asia’s global production sharing.

²⁸ In principle, reducing barriers at a multilateral level reduces negotiation costs, minimizes the risk of trade diversion, permits countries to reap gains from trade with the rest of the world, increases transparency for exporters and importers, and gives recourse to the enforcement mechanisms of the multilateral system (e.g., dispute settlement).

South Asia countries, as a result, needs to fast-track East Asian investment into the logistics chain: trucking, customs, brokerage, freight forwarding, shipping, aviation, port and airport operations, and others.

South Asia's Intra-regional Integration. The acceleration of bilateral trade and investment arrangements will be central, where India plays an important role, and private-sector cross-border investments will be key.

Similar considerations, as in the case of South East Asian trade, apply regarding why bilateral trade and investment integration will lead the way. How might this come about? The challenge will be for the region's largest and fastest-growing economy, India, to extend quickly such bilateral benefits of closer trade and investment with all its neighbors and to ensure that implementation is faster. But these agreements can go only so far, and a key role will need to be played by *private-sector, business-to-business transactions*, in expediting and enlarging such intra-regional trade, leveraging such bilateral agreements.

In a similar vein, within South Asia, too, *services complementarity* is expected to be greater than in just merchandise trade, such as in transport, travel, health, education, and other sectors, which will carry immediate and more visible benefits to people. Trade liberalization within the region might also start to consider agriculture, which remains untouched despite its potential, as well as energy trade, given the constraints across the region.

Given the landlocked nature of some countries in the region, *facilitating transit trade* will also be critical. The new agreements between India and Bangladesh, signed in January 2010, suggest a promising breakthrough, and they will benefit the neighboring landlocked countries of Nepal and Bhutan (as well as the northeastern border regions of India). Much more can be done. A quantitative test (De 2010) supports the above: a 10 percent reduction in the ad valorem price (transport and tariff), for example, would raise trade within South Asia by as much as 6 percent, a larger impact than the effects of standard reduction of at-the-border tariffs.

Maximizing Opportunities in High-Income and Other Markets. The main imperative will be, again, services liberalization. The high-income markets will continue to provide critical markets for outsourced services (IT, BPO) and labor-intensive exports from South Asia, even if at a slower pace than in the past. Increasingly, the high-income countries will also provide bigger sources of longer-term capital and know-how—from manufacturing to backbone services critical to South Asia's domestic growth. For both reasons, South Asian countries should accelerate liberalizing services on an MFN basis with all, including high-income countries, even as they pursue multilateral approaches in formal trade negotiations and agreements. While pursuing such market opportunities in high-income countries, South Asia would also do well to keep its trade and investment open to the rest of the world—to an increasingly multipolar world—including other regions and emerging markets that continue to be important, given long-standing and growing ties: the Middle East, Central Asia, Sub-Saharan Africa, and Latin America. Leveraging regional integration with these markets could also offer promising opportunities, as in energy, manufacturing, and services.

ANNEX

Table 3A.1: Displacement versus Complementarity of South Asian and East Asian Exports: Regression Results

	Export India		Pakistan		Bangladesh		Sri Lanka		Nepal	
Export supply effect (<i>dimports</i>)	0.4347a	0.4347a	0.3284a	0.3286a	0.4185a	0.4199a	0.4009a	0.4012a	0.2648a	0.2649a
	(89.89)	(89.89)	(26.98)	(26.99)	(15.59)	(15.63)	(22.12)	(22.13)	(7.28)	(7.29)
East Asia Export effect (<i>dEast Asia</i>)	0.0430a		0.0511a		0.0752a		0.0439a		0.0015	
	(20.94)		(8.66)		(5.1)		(4.7)		(0.09)	
East Asia Export effect: 1990-1999		0.0400a		0.0585a		0.1101a		0.0550a		0.0132
		(9.94)		(5.39)		(3.92)		(3.07)		(0.38)
East Asia Export effect: 2000-2008		0.0441a		0.0481a		0.0621a		0.0398a		-0.0026
		(18.48)		(6.87)		(3.6)		(3.65)		(0.12)
Constant	0.1162a	0.1162a	-0.0065	-0.0063	0.0635a	0.0642a	0.0185a	0.0186a	0.0451a	0.0452a
	(53.1)	(53.07)	(1.46)	(1.42)	(8.48)	(8.56)	(3.47)	(3.49)	(4.93)	(4.94)
Observations	591566	591566	166350	166350	61239	61239	113481	113481	35656	35656
R-squared	0.19	0.19	0.28	0.28	0.33	0.33	0.31	0.31	0.32	0.32

Source: Staff calculations.

Note: The regressions include two-digit product, importers, and year effects. The estimates thus rely entirely on cross-market variation in East Asian import penetration in a given product. Robust *t*-statistics are shown in brackets. The symbol *a* denotes significance at the 1 percent level.

Table 3A.2: Tariff Barriers in Asia: 2007*

Country/ Region	Binding Coverage	Simple Mean	Weighted Mean	Primary	Manufactured
India	73.8	16.4	10.4	25.2	15.9
Pakistan	98.7	14.9	11.4	14.2	15
Bangladesh	15.9	14.5	11	15.2	14.4
Sri Lanka	38.1	11	7.1	17.8	10.6
Nepal	..	12.6	13.7	12.4	12.7
Bhutan	..	18.2	17.8	43.7	15.5
Maldives*	97.1	21.4	21.1	18.1	22.2
Cambodia	..	12.5	10	14.8	12.1
China†	100	8.9	5.1	9	8.9
Hong Kong, China	45.6	0	0	0	0
Indonesia	96.6	5.9	3.9	6.6	5.8
Korea, Rep.	94.6	8.5	8	20.8	6.6
Lao PDR	..	5.8	8.3	9.9	5.3
Malaysia	83.7	5.9	3.1	2.8	6.5
Myanmar	17.4	4.1	3.9	5.8	3.9
Philippines	67	5	3.6	6	4.8
Singapore	69.7	0	0	0.2	0
Thailand*	75	10.8	4.6	13.6	10.4
Vietnam	..	11.7	10.6	14.5	11.3
Lower Middle Income	88.7	2.9	1.8	12.9	8.9

Source: World Bank, WDI.

Notes: * Available for 2006. Primary products are commodities classified in SITC revision 3 sections 0-4 plus division 68 (nonferrous metals). • Manufactured products are commodities SITC revision 3 sections 5-8 excluding division 68.