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# SAARC: Changing Realities, Opportunities and Challenges

*Rajiv Kumar*



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DIE Research Project “Anchor Countries as Drivers of Regional Economic Integration – Consequences for Regional and Global Governance, and for Developing Countries”

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## Abbreviations

ADB	Asian Development Bank
ASEAN	Association of Southeast Asian Nations
BIMSTEC	Bay of Bengal Initiative for MultiSectoral Technical and Economic Cooperation
CAREC	Central Asia Regional Economic Cooperation
DoTS	IMF Direction of Trade Statistics Database
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GMS	Greater Mekong Subregion
LDCs	Least Developed Countries
MFN	Most Favoured Nation
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asian Free Trade Area
SAPTA	South Asian Preferential Trade Area
WDI	World Bank World Development Indicators Database
WTO	World Trade Organization



## Abstract

This paper examines the changing realities in South Asia and takes a fresh look at the prospects and challenges for regional economic integration in the region. In this context, the two central arguments of this paper are, first that there have been and continue to be some very strong arguments in support of regional economic integration in South Asia. Second, in the face of the ongoing developments and changing realities, it is the right time to provide the needed push and impetus to this process to take it over the “tipping point”. Once over the tipping point, the stronger positive results from regional cooperation will push the region to a higher growth trajectory, thereby generating virtuous impulses in support of cooperation and integration. These will not only benefit South Asia but the rest of the world as the region, with its large population and markets, could well become one of the major engines for global growth in coming years.



## 1 Introduction

There is a perceptible change in the environment for promoting regional cooperation and economic integration in South Asia. The change is perhaps one of the positive outcomes of economic reforms that have been undertaken in nearly all of the South Asian economies since the beginning of the nineties. These reforms, most notably in India and Pakistan, have not only spurred economic growth in the region, especially in India, but also made the region generally more open to greater integration both within the region and with the rest of the world. India's growth has given it greater confidence in opening its markets to its neighbours and at the same time clearly brought home to its neighbours the advantages of greater access to India's large and growing market. Other factors that have contributed to this positive stance towards regional cooperation in South Asia are the positive demonstration effects of bilateral trade agreements in the region in recent years, for example the Indo-Sri Lankan Free Trade Agreement; recognition by India and other governments that a South Asia lagging in regional cooperation cannot expect to play its due role in the global community; and last but not least the growing impact of a resurgent Chinese economy that has necessitated a deep rethink of neighbourhood policies by region's governments, particularly by India.

These changing realities in South Asia necessitate a fresh look at the prospects and challenges for regional economic integration in the region. In this context, the two central arguments of this paper are, first that there have been and continue to be some very strong arguments in support of regional economic integration in South Asia. Second, in the context of the ongoing developments and changing realities mentioned above, it is the right time to provide the needed push and impetus to this process to take it over the "tipping point". Once over the tipping point, the stronger positive results from regional cooperation will push the region to a higher growth trajectory, thereby generating virtuous impulses in support of cooperation and integration. These will not only benefit South Asia but the rest of the world as the region, with its large population and markets could well become one of the major engines for global growth in coming years.

The next section provides a historical background for regional cooperation in South Asia including the formation of South Asian Association for Regional Cooperation (SAARC). Section 3 gives some explanations for the current low levels of intra-South Asian trade and economic cooperation. This has some significant implications for India's neighbourhood policies. The changing global and regional realities that are now providing fresh impetus to the regional dynamics are discussed in Section 4. Section 5 then looks at the motivations for regional cooperation in South Asia. It also discusses the reasons for which India, the dominant economy in South Asia, should support regional cooperation and economic integration in the region. The concluding section brings together the main arguments and summarises the discussion.

## 2 The background for regional cooperation in South Asia

South Asia is home to about one and half billion people or 23 % of the world population.<sup>1</sup> Its share in world gross domestic product (GDP) remains at barely 2.3 %. The eight countries in the region – Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka – have diverse economic features with India and Pakistan being the two largest economies in terms of the regional GDP and population. But India's dominance in nearly all respects is a central and special feature of the region that can be seen as both a positive and negative feature in the context of promoting greater economic cooperation. India has nearly 77.8 % of the region's GDP, accounts for 40.3 % of its trade and 75.8 % of incoming foreign direct investment (FDI). It is the only country in South Asia that has common borders with all others. India is both literally and otherwise central to South Asia. However, in terms of economic well-being, as measured by the human development index, Sri Lanka and Maldives are better off than the other six.<sup>2</sup> However, the region shares the dubious credit of having the second largest concentration of the world's poor after Sub-Saharan Africa, with 47 % of the South Asian population living on less than \$ 1/day. Recent estimates in India put the share of population with less than \$ 0.5 per day at more than 50 %.<sup>3</sup> Alleviating widespread poverty, sustaining employment generation, improving infrastructure, and sustaining rapid and inclusive economic growth remain the common and pressing challenges in all the countries of the region.

Countries in South Asia have had strong economic, trade and cultural ties for centuries. These were generally seen by their inhabitants and rulers as a connected land mass and integrated economic space well before they became part of the British Indian Empire. Thus, the three largest South Asian countries of India, Pakistan and Bangladesh had a common market with an integrated monetary and communication system until 1947, that is well ahead of the formation of the European Common Market in 1958. These ties were disrupted with independence from colonial rule, and significant political differences and conflicts characterised the region during the second-half of the twentieth century. The situation worsened further in the seventies and eighties with ethnic strife resulting in the break up of Pakistan and continued violence in Sri Lanka and parts of India and Pakistan. Afghanistan has also seen enormous instability and disruption over the last three decades. Thus, despite its common heritage going back centuries, South Asia has today emerged as the least integrated and one of the more unstable regions in the world.

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1 See World Development Indicators Database. Data on Afghanistan which joined in 2006 is not available.

2 Maldives has long moved beyond the threshold levels of income and quality of life for being part of the group of least developed countries (LDCs). In 2004, the UN General Assembly decided to graduate Maldives out of the LDC group, but revised the decision following the devastation caused by the tsunami a few days later. Maldives will be graduated out of the LDCs group in 2011 (UNCTAD 2006b, 47).

3 See the report of the National Commission for Enterprises in the Unorganised Sector (2007), also known as the Arjun Sengupta Commission Report.

The establishment of SAARC in 1985 was an attempt to reverse the conflicting tendencies of the post-independence era.<sup>4</sup> The move was initiated by Ziaur Rahman in Bangladesh and taken forward by young leaders like Benazir Bhutto in Pakistan and Rajiv Gandhi in India. It could be seen a premature and top-down attempt at promoting regional cooperation, since ground realities in terms of trade and investment flows, and political will were not really in place to support such an effort. In any case with the political demise of these leaders in the latter eighties, the SAARC process lost its champions and became somewhat directionless. This loss of political support at the top, combined with the usual degree of mutual mistrust and preoccupation with domestic fire-fighting has resulted in lack of real progress in the more than two decades since SAARC was established.

Today the region has emerged as perhaps one of the most troubled and unstable neighbourhoods. Six (Afghanistan, Bangladesh, India, Nepal, Pakistan and Sri Lanka) of the eight current members are grappling with racial, communal, extremist or regional strife. Some of this strife is now decades old and well entrenched. With two of the major powers being armed with nuclear weapons and armed conflict in several sub-regions, it will be fair for an outsider to characterise South Asia as a potential flashpoint for major conflagration. India cannot assume, as some tend to argue, that its own economic growth and prosperity will remain unaffected by the disturbed and unstable conditions in the region. India must ensure greater peace and stability in the region in order to achieve its objectives of rapid, inclusive and sustained growth and improvement in the people's living standards.

India's size and central location in South Asia makes the region quite unique and complicates the case for regional integration. For instance, in 2006 India accounted close to four-fifths of the regional GDP by value, while Bhutan and Maldives accounted for less than one-hundredth. Pakistan, the next largest economy after India, accounted for 11 % of the regional GDP, followed by Bangladesh and Sri Lanka (see Figure 1 and Table 1). Similarly, India accounts for 74 % of the regional population, Pakistan for 13 %, Bangladesh for 10 %, Nepal for 2 % and Sri Lanka for 1 %. The smaller South Asian countries are far less diversified and have a relatively under-developed industrial structure. This makes them reluctant to push forward with regional liberalisation due to (in my view a completely misplaced) fear of being swamped by Indian businesses, resulting in a possible de-industrialisation of their economies. India on the other hand, had so far held back on further regional liberalisation for two reasons. First due to a lack of full-reciprocity from partner countries. Second, and perhaps more important, due to a perception, which has only changed in the last few years, that regional cooperation is a mere euphemism for the smaller countries to "gang up" against India and not recognising its claims to be the pre-eminent regional power. This was reflected in the persistence of the Indian establishment on using the term the "Indian sub-continent" rather than the more neutral South Asia that has come to be used only in the last two to three years.<sup>5</sup>

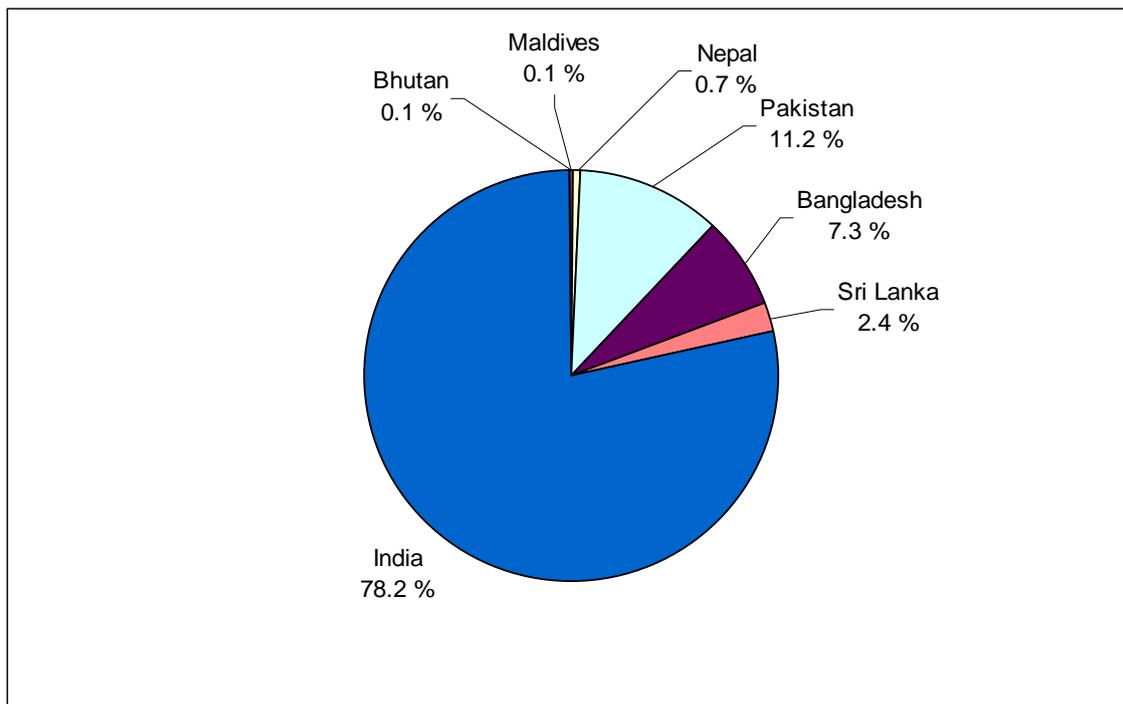
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4 SAARC was established by the seven countries of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. Afghanistan became the 8th member more recently in 2005.

5 Historically, this region has been referred to as the Indian sub-continent, which results in some level of apprehension in the smaller countries about their ability to retain their individual identity in the post SAARC context. This is now changing to a more common use of "South Asia" for describing the region.

However, India's stance has been changing in recent years. Presently, India recognises the advantages of an integrated South Asian economic space for all SAARC members, including itself, as equal partners in any regional cooperation initiative. This tendency needs to be further strengthened and can emerge as the major driver for regional cooperation in South Asia.

**Figure 1: SAARC country shares of regional gross domestic product, 2006**



Source: World Bank (2008)

Country	Composition of GDP (2007)			Per capita income, (2006)		GDP growth, (2001-07)	GDP as % of South Asia's total	Adult literacy rate	Life expectancy at birth		% of population below \$ 1 a day
	Agr.	Ind.	Ser.	US \$	US \$, PPP				Male	Female	
						(%)					
India	18	29	53	634	2,393	7.6	78.2	66	63	64	35.1 (2004)
Pakistan	20	27	54	635	2,288	5.7	11.2	55	65	66	9.8 (2004)
Bangladesh	19	29	53	419	1,119	5.8	7.3	54	63	65	36.3 (2005)
Sri Lanka	12	30	57	1,070	3,631	5.0	2.4	92	73	78	4.8 (2002)
Nepal	33	17	51	242	968	3.4	0.7	57	63	64	24.7 (2003)
Bhutan	22	38	40	1086	3,886	7.9	0.1	56	64	67	n.a.
Maldives	n.a.	n.a.	n.a.	3,251	4,854	7.0	0.1	97	68	67	< 2 (2004)
Afghanistan	33	28	40	n.a.	n.a.	8.5	n.a.	28	42	43	n.a.

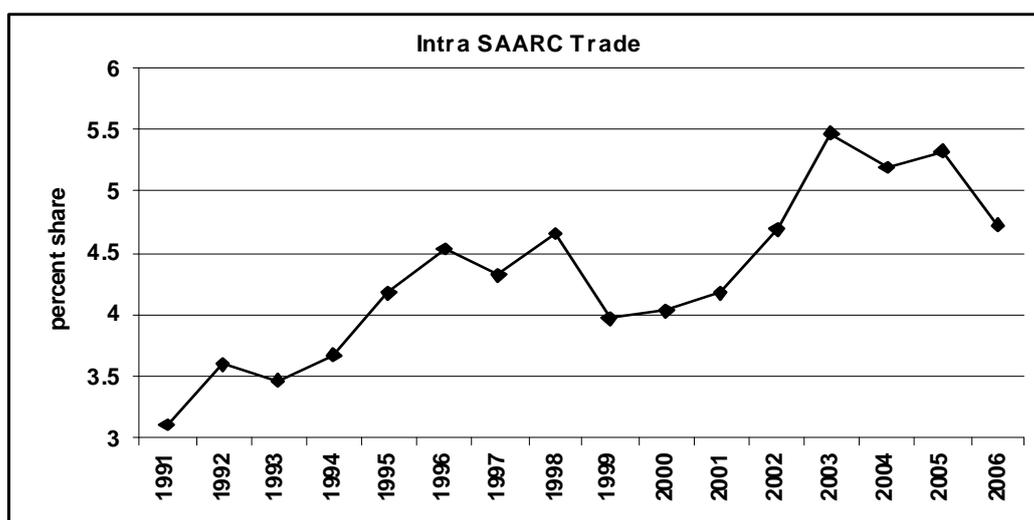
Note: Bhutan and Afghanistan data pertains to 2006  
Source: World Bank (2008) and Asian Development Bank (2008)

### 3 Low level of integration in South Asia: Some explanations

The South Asia region remains a small player in global markets, accounting for a little over 1 % of total global trade. During the period 1995 to 2006 South Asia's share in world merchandise exports marginally increased from 0.9% to 1.3%.<sup>6</sup> In commercial services exports, the region's share in total world exports has increased from 0.87 % in 1995 to 3.1 % in 2006.<sup>7</sup> Within the region too, the persistence of trade barriers has led to abysmally low levels of intra-SAARC trade.

In 2006, the total value of merchandise trade reported by the South Asian countries (excluding Bhutan) was US\$ 395.96 billion, of which only US\$ 18.61 billion was destined for SAARC Members states.<sup>8</sup> This implies that intra-regional trade in South Asia accounted for barely 4.7 % of its total world trade. During 1991 to 2006, the intra-SAARC merchandise trade has been stagnating between 3-5 % of the region's total world trade (Figure 2).

**Figure 2: Share of intra-regional trade in total trade of SAARC countries, 1991–2006**



Source: Calculated with data from IMF DoTS

While some studies using gravity models indicate that India's bilateral trade potential with its neighbours remains largely untapped (e.g., Batra 2004) and regional trade can increase

6 Estimated from WDI.

7 Indeed, while South Asia's share in total Asian merchandise exports was only 4 % in 2005, its share in Asian services exports was 11.6 % by value in the same year.

8 Based on IMF DOTS data on exports from Afghanistan, Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka.

significantly with regional cooperation, there are several explanations for the low levels of integration in South Asia.

Given the prospect of trade diversion and unequal sharing of benefits and the relatively high levels of protection in the region, several empirical studies have argued that gains from trade expansion in the framework of a regional free trade agreement (FTA) in South Asia could be expected to be minimal.<sup>9</sup> However, some researchers have also found that gains from regional economic cooperation, specially if it leads to greater investment flows, can yield substantial net benefits.<sup>10</sup> Regional integration agreements and FTAs in particular can also fail when the impact of liberalisation is asymmetric across partners and corrective redistribution mechanisms are lacking. Asymmetric benefits and costs associated with regional integration may create political tensions and result in defaults in commitment among the member countries (World Bank 2005). In South Asia, in particular, economic gains from integration are perceived to be asymmetric and potentially adverse for the smaller members.

Another notable feature of South Asia that could explain the low level of gains emerging from regional cooperation could be the substantial informal or border trade. In the case of some SAARC members this is reportedly even larger than the official trade flows.<sup>11</sup> The thriving illegal trade is mainly driven by differences in the tariff structures among the South Asian countries, as well as the incidence of high transactions costs in the formal routes. However, even if one takes into account the informal trade of the region, the total intra-regional trade would still remain less than a tenth of the region's total trade. Major reasons for this low level of intra-regional trade are as follows:

- (i) *Too small and too few with similar revealed comparative advantage:* The South Asian region comprises of only eight countries with a marked imbalance created by the dominance of the Indian economy. Large economies like India and the US tend to be less trade oriented (Newfarmer 2004), although this has not been the experience in the case of China. The North American Free Trade Agreement (NAFTA) has even less number of member countries than SAARC and is also dominated by a large country. However, a critical difference between the two regional formations has been the pro-active role played by the US in forging NAFTA compared to the passive and at times negative stance adopted in the past by India. Furthermore, an analysis of trade flows in South Asia indicates that the countries have almost identical pattern of revealed comparative advantage in a relatively low

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9 Bandara / Yu (2003) use a general equilibrium model to show that gains under the South Asian Free Trade Area (SAFTA) are skewed with only India gaining substantially, while Pitigala (2005) and Baysan / Panagariya / Pitigala (2006) argue that given the level of protection in South Asia vis-à-vis the rest of the world, risk of trade-diversion is rather high.

10 Using a gravity model, Hirantha (2004) finds evidence of significant trade creation under the South Asian Preferential Trade Area (SAPTA), which came into effect in December 1995, and no evidence of trade diversion effect with the rest of the world.

11 For instance Taneja (1999) shows that bilateral unofficial trade (exports plus imports) of India with Bhutan, Nepal, Pakistan, and Sri Lanka was estimated to be more than their respective official trade in the 1990s. Taneja provides a good overview of the causes, pattern and extent of informal trade among SAARC countries.

range of products, and bilateral trade exhibits low levels of trade complementarities (Kemal 2004). However, as will be discussed later, intra-industry trade should offer substantial potential also for SAARC, as has been the case in other regions.

- (ii) *Fear of India*: In some South Asian countries there is real fear of de-industrialisation if preferential market access is provided to the larger and better established Indian manufactures. For example, in Pakistan where the textiles and clothing sector is considered to be the major driving force for economic growth, and contributed more than 65 % in total export value in 2004 (State Bank of Pakistan 2006), there is widespread feeling that freer Indian imports could mortally harm the Pakistani textile industry.<sup>12</sup> This fear is actually more pronounced in the bureaucracies than among the entrepreneurial classes. These fears have weakened because of the positive outcomes of Indo-Sri Lankan bilateral FTA which has benefited both sides equally.<sup>13</sup>
- (iii) *Weak port and transport infrastructure*: The poor port and transport infrastructure is one of the major reasons for low-integration in the region (as well as an obstacle to growth for the region)<sup>14</sup>. Delays in transit due to road or port congestion, and customs procedures (non-tariff barriers) raise the costs for exporters. The limitations are in both physical (lack of cargo/ship handling equipment) as well as non-physical infrastructure (excessive and cumbersome border procedures). One estimate shows that if South Asia's infrastructure capacity is increased even halfway to East Asia's level, then intra-regional trade can increase by 60 % (Wilson / Ostuki 2005).
- (iv) *Persistence of high levels of overall protection*: The South Asian region as a whole has been one of the more heavily protected regions in the world. In particular, India is considered to be the least open among the group in terms of trade-weighted average applied tariff rate of 30.1 %, followed by Bangladesh with 21.3 %, Pakistan with 17.4 %, and Nepal with 15.5 %, while Sri Lanka is the most open with an average applied tariff of 6.2 % (UNCTAD 2005 ). These high tariffs are expected to decline under SAFTA when it is fully implemented. However, a wide range of non-tariff barriers are also used by these countries to protect their markets. These are more difficult to identify and remove. However, in this area too, there are signs of progress in the last two years.
- (v) *Difficult business environment*: Besides the high levels of protection in the region, procedural delays stemming from institutional requirements have been a major factor inhibiting trade and business across borders. In particular, South Asia ranks among the lowest (second last or 139th) among regions across the world in terms

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12 In Pakistan, as in most of the other SAARC nations, the export sector is far less diversified than that of India. Hence the threat of a more competitive partner (namely India) eroding competitiveness in their core export segments is a significant concern.

13 For an analysis of the effects of the Indo-Sri Lankan FTA see Das (2008).

14 De (2005).

of ease of trading across borders (the last being Sub-Saharan Africa).<sup>15</sup> In contrast, China's rank is a healthy 38th in the world.

- (vi) *Restrictive rules of origin and destination:* Rules of origin in preferential or free trade agreements help determine the products for tariff preferences, but tighter rules of origin often reflect protectionist intention. The co-existence of high tariff barriers and tight rules of origin raises the risk of trade-diversion.<sup>16</sup> SAARC members specify the port of entry sometimes for all imports and often for selective products. While this approach has been implemented to curb illegal imports, it also seems to be driven by inadequate administrative capacity. But the port-specific restrictions have increased transactions costs of formal trade and bolstered the informal border trade.
- (vii) *Lack of coverage and commitment in the merchandise trade agreement:* The liberalisation in merchandise trade as envisioned in SAFTA is much less ambitious than what the South Asian countries have themselves been autonomously pursuing under the regime of the World Trade Organization (WTO). The SAFTA tariff liberalisation programme also allows members to retain a negative list of items that are not offered for concessional treatment. Almost 53 % of the total imports between SAFTA members has been subject to the negative lists of the respective countries. Among the large member countries India and Sri Lanka have restricted up to 38 % and 52 % respectively of their total imports by value from the SAFTA members under the sensitive list category (Weerakoon / Thenakoon 2006). The negative lists thus continue to significantly limit the scope of the South Asian "Free Trade" regime.
- (viii) *Services not included in regional trade agreement:* The services sector accounts for more than half the GDP in most South Asian economies. However, trade in services is conspicuous by its absence under the SAFTA. This is paradoxical especially considering that the region as a whole is emerging as a strong exporter of commercial services worldwide. Most of the South Asian countries have been negotiating liberalisation of the services sector under the WTO, and a liberalisation exercise at the regional level would be a good testing ground for this dynamic sector.

#### 4 Changing realities in South Asia

Contrary to general expectations, SAARC managed to push through a new free-trade agreement – albeit SAFTA might be described as a watered down version of an FTA – in its twenty-first year. It indicates that there remains sufficient political will among partici-

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15 Cf. World Bank (2006).

16 Baysan / Panagariya / Pitigala (2006) contend that a persuasive case for SAFTA can be made if the countries in the region lower their overall tariff down to 5 % or below, along with easing of the restrictive rules of origin and sectoral exceptions.

pating countries to keep the forum alive. The coverage of the issues under the annual agenda in the past fourteen summits indicates that the focus has been right by giving priority for regional cooperation in sectors such as energy, security, water usage, counter-terrorism and tourism, among others. Moreover, the new trade pact (SAFTA), although imperfect, has potential to be nurtured into a more robust trade deal to ensure greater regional liberalisation and minimisation of risks of extra-regional trade diversion. With extra-regional partners like the US, Japan and China now apparently keen to join the forum, it seems that SAARC will get a new lease of life in the new century.

India's perception of SAARC's usefulness for its own national interests has undergone a marked change in recent years. This change has been due to several reasons. First, it is now evident to Indian policy makers that SAARC can hardly be used by its smaller neighbours as a forum for India baiting or even for achieving a better strategic balance vis-à-vis India. Experience over the past two decades has now demonstrated that coalition formation by neighbouring countries is not likely to be successful because of the dynamics between these countries themselves and their inevitable need to deal with India directly given the geographic and economic realities.

Second, major global powers, except perhaps China, have finally accepted India's relatively dominant position in South Asia, specially following the robust economic growth since 1991. There is consequently no significant on their part to "redress the asymmetry" within the region by building special relations with India's neighbours. This has also helped to bring about a change in India's perception about the possible threats from a successful SAARC.

Third, China's growing influence in South Asia is clearly visible and poses a clear challenge for India to maintain its own interests in the region. More significantly, bilateral trade volumes between some of the South Asian economies and China are larger than with India. This is despite China not having any preferential/free trade agreement with these countries as India has. Of course, China has long pushed for a strategic political-economic relationship with Pakistan, and finally signed a FTA in 2006 which envisages a multi-dimensional economic partnership on energy, communication, agriculture, technical cooperation, joint investment ventures, etc. (People's Daily 2006). This has finally caused the positive response within the Ministry of External Affairs in India to secure its own interests in South Asia and see SAARC as an instrumentality for bringing its neighbouring economies within a network of regional production network as China has successfully achieved with its Southeast Asian neighbours.

Fourth, Delhi seems to have realised that regional cooperation, through SAARC or other formations like the Bay of Bengal Initiative for MultiSectoral Technical and Economic Cooperation (BIMSTEC), is perhaps an effective instrument for securing India's territorial integrity in the peripheral regions and for fighting poverty in its border states. The change in India's perception about regional cooperation in South Asia is best seen by the Indian government's recent acceptance of a role of multilateral organisations in infrastructure development and improving connectivity in its border regions.

Fifth, until the Mumbai terrorist attack of 26 November 2008, Indo-Pak relations had shown a consistent improvement over the last four years. Given that the political tension between the two countries has hindered regional cooperation and continues to hold hos-

tage the full implementation of SAFTA today, this improvement contributed significantly to the prospect of pushing SAARC forward. Such terrorist actions are perpetrated by fringe extremist elements and their benefactors who see progress in regional cooperation and economic integration as threatening their own petty vested interests. It is, therefore, important that actions of religious and sectarian terrorist groups are not allowed to push the SAARC process backward. Indian establishment will do well to target these elements on the one hand for punitive action while promoting greater trade and other economic interaction across South Asian borders on the other. Successful economic integration will be one of the most effective responses to sectarian violence as it will contribute to eroding the economic and material base for such movements.

For all the above reasons, the India's perception of SAARC and attitude toward regional cooperation in South Asia has perceptibly changed. This is most clearly visible in India taking unilateral action of allowing duty free imports from its low income neighbours within South Asia and permitting multilateral organisations to participate in regional infrastructure projects, which it had not done in the past.

The changing realities of a globalising world have prompted India to accept countries from outside the region to become observers in SAARC and also stop treating South Asia as its exclusive backyard in which it would only pursue bilateral interaction and not brook any regional or multilateral intervention. The terrorist threat to India and Pakistan is prompting the ruling establishments (with the notable exception of the ISI in Pakistan which apparently has its own agenda) in the two countries to improve their relationship and support political dialogue to ensure political stability and social harmony. Moreover, there is pressure from the growing industrial and middle classes in emerging South Asian economies to expand business and social contacts within SAARC, especially to try and take advantage of the burgeoning Indian market.

The changing global context has made it clear to India and other countries like Bangladesh, Nepal, Sri Lanka, Maldives that they also stand to gain from any forward movement in SAARC. Pakistan remains a reluctant participant as revealed by its continued denial of Most Favoured Nation (MFN) status to India.<sup>17</sup> The biggest potential gainer today could be Afghanistan with better access to Indian investment and other resources and by reclaiming its historical role as the bridge between Central and South Asia. Thus, the changing realities not only make SAARC a viable undertaking but one with significant positive outcomes for its members both in the immediate and the longer term. It is perhaps for this reason that external members like China, Japan, the US and even the European Union (EU) have either already acquired or have expressed their desire to achieve observer status in SAARC.

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17 Implementation of SAFTA began 1 July 2006. Indian has provided MFN to Pakistan, however, the latter has refused to grant the MFN status to India, based on their continued territorial conflict over the state of Kashmir.

## 5 Motivations for regional cooperation in South Asia

The motivation for greater integration in the South Asian region follows from four distinct factors: First, pure economic gains through efficient use of capital and labour and freer cross-border movement of goods and services. Second, other non-traditional gains from greater regional integration like increased flow of FDI. Third, strategic gains when the South Asian countries negotiate as a unified group in multilateral fora. Fourth, developmental and environmental efficiency gains arising from adopting a regionally integrated approach towards provision of regional public goods like environmental protection, water conservation and other natural resources including the regional ecosystem and related biodiversity. These regional issues cannot be effectively addressed individually and are best addressed in a cooperative framework.

While the economic and less traditional economic gains that arise from intra-industry trade and investment flows are well discussed in the literature, it is useful to point to the political and security motivations for regional cooperation in South Asia. These considerations are often the main driving force behind the emergence of regional blocs (Crawford / Fiorentino 2005). For example, it was the fear of China's dominance that drove the South-east Asian economies to forming the Association of Southeast Asian Nations (ASEAN) and even the EU was seen as a response to the emergence of the East European bloc under the Union of Soviet Socialist Republics (USSR). In both these cases economic gains followed regional integration that was perhaps motivated initially by non-economic rationale. To the extent that political considerations dominate economic considerations in the formation of regional blocs, it is political commitment (or the lack thereof) that determines the success (or failure) of free trade agreements (Hossain / Duncan 1998). Greater regional and bilateral cooperation within emerging economies can also be seen as a response to the slow progress in multilateral trade regimes and increasing recourse to regionalism within developed economies.<sup>18</sup>

The other main driver of economic integration in South Asia is the need for greater energy security. All these countries are heavily dependent on energy imports and even more specifically on hydrocarbon imports from West Asia. At the greater Asian regional level the SAARC economies can be seen to offer a unified market for hydrocarbon imports from Central and West Asian gas and oil fields by overland pipelines. Energy trade in the region can also be seen as a confidence-building measure and a lock-in mechanism for irreversible economic interdependence (Pandian 2005). With Afghanistan's membership in the SAARC, the region can expect further potential gains through alliance with Central Asian countries. In particular, it provides greater connectivity with Central Asia and beyond, and brings in significant energy security payoffs.

Despite some recent changes, the Indian stance towards SAARC still remains somewhat equivocal and unclear. This is direct outcome of the perception that SAARC cannot really move forward because the Pakistani establishment will simply not let it progress. Therefore, it is argued that India's national interests are better served by supporting other initia-

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18 See Schott (2008).

tives like the BIMSTEC, the Indian Ocean Rim and the Swarnbhoomi initiatives. I find these arguments to be misplaced and argue for India to give its fullest and proactive support to making SAARC successful. The major reasons in support of my argument for India to actively support SAARC are as follows:

- i) *Make de facto the de jure*: De facto, India already has extensive informal interaction with its neighbours in the form of border trade. By activating SAFTA and following it with an agreement on trade in services, India will only convert the present de facto situation to a de jure one, which will have therefore no additional impact on the Indian industry or services sectors. It will permit India to better regulate and oversee the trade and prevent trafficking.
- ii) *Increase FDI*: South Asia's low level of regional integration is also reflected in the relatively low level of FDI inflows to the region. Although in recent years, FDI inflows have increased rapidly, with gross FDI reaching \$ 10 billion in 2005-06, it still continues to be below the potential, especially considering India's economic performance and policy changes (UNCTAD 2006a). There is no doubt that a more peaceful, stable and regionally integrated South Asia will attract greater volumes of FDI into South Asia and this will have significant positive implications for achieving rapid inclusive growth.<sup>19</sup>
- iii) *Dynamic trade gains*: The economic case for greater merchandise trade still holds, notwithstanding that econometric studies tend to highlight rather small gains from SAFTA. The Indo-Sri Lankan bilateral trade agreement shows that contrary to findings of quantitative models, trade between India and Sri-Lanka increased significantly following their bilateral free trade agreement.<sup>20</sup> Trade grew because of an increase in trade of new products that were not earlier traded and could not thereby be captured in the modelling exercises.<sup>21</sup> Moreover, these quantitative exercises singularly lack the ability to capture gains from intra-industry trade, the scope for which is significant in the region.
- iv) *Enhanced security*: Increasing inequity fuels insecurity and cross-border terrorism. Thus it is in India's interest to help improve the standard of living and reduce poverty in the smaller South Asian economies as she continues to pursue the path of high growth. India can hardly hope to remain an island of sustained economic growth if the growth impetus is not shared with or transferred to neighbouring countries (ADB 2006, 146).

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19 See the discussion by Kubny / Mölders / Nunnenkamp (2008).

20 The gravity model analysis of Batra (2004) found that India's bilateral trade with Sri Lanka and Nepal has gone far beyond the level of trade predicted on the basis of natural factors (distance, landlockedness, population, and income) based on 2000 data. For a discussion of trade-FDI-poverty alleviation effects of the Indo-Sri Lankan bilateral trade agreement see Das (2008).

21 How much of this trade expansion represents trade diversion or trade creation is still an open question (Baysan / Panagariya / Pitigala 2006).

- v) *Returns to scale*: Regional integration will provide a larger market and also scope for intra-industry trade. Both features will benefit the Indian and South Asian industry to lower costs and become more globally competitive by exploiting economies of scale and scope. Even small and medium-sized South Asian companies will benefit by improving their global competitiveness in a phased manner by initially producing for SAARC markets and then striking out for a greater share in global markets.
- vi) *Increased efficiency in the provision of public goods and services*: The South Asian subcontinent is an integrated geo-ecological system. In this context, it can be easily seen that some public goods and services like energy, water management and conservation, prevention against pandemics and maximising tourist earnings are best achieved on a regional basis. Given that India shares its borders with all SAARC members, it is in her interest to ensure that a cooperative approach is taken to address these issues of the delivery of regional public goods and markets.
- vii) *Connectivity payoffs with the rest of Asia*: Today, regional cooperation is gaining momentum in other sub-regions in Asia. Several Southeast Asian countries have come together under the Greater Mekong Subregion Cooperation (GMS) initiative, promoted largely by the Asian Development Bank (ADB). This is helping build the regional infrastructure from Myanmar eastwards and southwards. The Central Asian economies are coming together under the Central Asia Regional Economic Cooperation (CAREC) programme that is being actively pushed by China. A regionally integrated South Asian space will help realise trans-Asian connectivity and greater energy security as resources from Central and West Asia could be moved eastwards up to China. In such a scenario India along with its neighbours would benefit significantly from greater flow of trade, commerce and investment from West and Central Asia to East and Southeast Asia via South Asia.
- viii) *Achieving greater social cohesion within India*: By connecting the diverse ethnic groups within India with their counterparts across the borders, India's multi-religious, multi-ethnic and pluralistic society would be greatly strengthened. This pluralistic polity will be further preserved and nurtured if the various ethnic and religious communities within India can freely interact with their communities across the Indian borders and as a result feel less isolated or pressurised as a minority within India. This is an important reason for India to support SAARC as its functioning has the potential to facilitate India's on going modernisation. This would also contribute to a greater enrichment of the cultural diversity that is a hallmark of the South Asian subcontinent.
- ix) *Defining and defending India's regional space*: Regional integration has been used to achieve strategic objectives rather than simply economic gains. If India does not establish stronger ties with its immediate neighbours and thus secure its regional space, it will soon find itself isolated. China is now making significant efforts to improve its access to South Asian economies and markets. South Asian countries, acutely aware of China's advances in Tibet, Myanmar and Xingjian, see significant advantages in improving their ties with China rather than wait indefinitely for South Asia to move forward. For example, the China-Pakistan agreement signed in November 2006 envisions a multi-dimensional economic partnership on energy,

communication, agriculture, technical cooperation, joint investment company, etc, besides trade.<sup>22</sup> Therefore, it is important for India to ensure greater integration of the South Asian space. We should be open to all interested bilateral and multilateral agencies who may want to play a role in achieving this.

## 6 Conclusion

In the rapidly changing global environment, regional integration in South Asia has assumed a new strategic significance. Not surprisingly, the potential political-economic and strategic gains from SAARC for all member countries have increased significantly. As the largest economy of the region, it is imperative and an opportune time for India to take a lead in building an environment of trust among SAARC members, which would encourage greater commitment to regional integration by all. India stands to gain substantially from greater economic integration in the region, in terms of both economic and non-economic or strategic payoffs. Indeed, India's emergence in the world economic order in the twenty-first century will be greatly facilitated if she ensures a stable, peaceful, secure and thereby a prosperous South Asian region. South Asia, stretching from Kabul to Chittagong and from Kashmir to Colombo has historically been an integrated economic, cultural and environment space. The fragmentation of this space, at the time of the region's independence from colonial rule, needs to be reversed. This is a necessary condition for the region and its member countries to fully exploit their potential and achieve their objective of achieving rapid, sustainable and inclusive economic growth.

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22 The FTA will reduce or eliminate tariffs on all products in two phases beginning July 2007, and is expected to increase their bilateral trade from US\$ 4.3 billion (in 2005) to US\$ 15 billion in five years (cf. People's Daily 2006).



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