**ECONOMIC INTEGRATION IN SOUTH ASIA[[1]](#footnote-2)**

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 This paper is divided in two parts:- (a) What the countries in South Asia should do individually? (b) What these countries should do collectively? Most of the rhetoric on regional economic cooperation has been on the collective responsibility. It is my contention that the pre-requisite for collective action and successful outcome is the individual actions that have to be taken by each country in the region. It would be inconceivable to think of identical or uniform policy actions or institutional changes across the region. India is so vastly different from Bhutan or Maldives. These policy and institutional changes have to be embedded in the initial factor endowments, domestic economic, political, social and cultural environment of the concerned country and its weight in the regional economy. The relevance of each policy measure may also vary from country to country. Other policies may be needed but are not analyzed in this paper. The larger point is that to pave the way for Regional Economic Cooperation, prior actions have to be taken by each member country. We have to move from advocacy to analysis to action.

What should the countries be doing individually?

 Almost all South Asian countries have made a lot of progress in liberalizing and deregulating their economies and freeing them from controls of various kinds. However, effort should now turn to liberalization and deregulation being aimed at eliminating the incentives for rent seeking activities. Political patronage, favoritism in appointments and award of contracts, evasion of taxes, acquisition of state and private land allocation of spectrum and mining rights of oil and gas concessions have all facilitated accumulation of illicit wealth by a select group of individuals and companies to the detriment of the larger population. The growing trend of alliances between public office holders, bureaucrats and the big businesses has given rise to large scale corruption in South Asian countries. Frustration, resentment and disenchantment among the middle classes against these practices are putting at risk the policies that have unleashed the potential of South Asian countries. The economic performance record since the dismantling of licence raj, integration in the world economy, outward orientation, welcoming foreign direct investment and capital flows is indeed quite impressive. India, the largest country in the region has become one of the prime movers of the world economy within the last two decades from a position of supplicant for bilateral and multilateral foreign aid.

The benign neglect of the government towards I.T. sector proved a boon for the private entrepreneurs, venture capital firms, technology savvy businesses, skilled and highly trained human resources. In absence of any impediments from the State in its way, I.T. sector enabled India to become the world’s business process outsourcing centre. Indian I.T. firms have acquired dominant position in the global markets and their owners have also become billionaires.

The contrast between the ‘traditional’ means of capital accumulation where the largesse of the state is the main determinant and the ‘new’ means of capital accumulation where individual private effort, skills and competence make all the difference is crystal clear. I have been told by my colleagues in India that surveys of college graduates have shown that the owners of new capital such as Narayan Murthi, Azim Premji and Nilekani are held in high esteem compared to those who have either built on inherited or traditional capital.

The boat should not be allowed to rock and the present system ought to be preserved but with some modifications. Private sector should remain at the heart of production, distribution and exchange of goods and services but the State should promote competition and play the role of an unbiased umpire rather than an interested participant in the game bestowing favors on few individual groups.

Second, South Asia has remained relatively insulated from the onslaughts of the Asian crisis of 1996-97 and the Global crisis of 2008-09. The prudent regulation of the financial sector by the Central Banks and the capital market regulators was not very much appreciated at that time. Governors were taunted as being too timid, too conservative, and too much behind times. But today they stand tall in the eyes of their fellow citizens as their vigilance and sharp focus on safety and soundness of the financial system have averted huge misery to our countries. The policy of cautious liberalization, gradual and partial opening of controls and skeptical adoption of financial innovations have held the countries in good stead. There is no reason to blindly imitate all that is coming from the western countries without testing, trying and adapting them to suit the local conditions. The assumptions that markets are self correcting and self regulation can substitute for State regulation have proved wrong. South Asian countries should therefore avoid falling in this trap of global financial integration with no holds barred. As Jagdish Bhagwati has very rightly argued “Financial liberalization cannot be equated with Trade liberalization”.

Third, infrastructure bottlenecks, shortages, congestion in form of frequent power breakdowns, inadequate gas supplies, inordinate delays in the inland transportation of goods, backlog in clearance at the ports will have to be tackled effectively. Energy particularly alternate energy sources should be tapped to meet the growing needs of the households and businesses. Port, airports, roads and highways, terminal, oil and gas pipelines, railroad tracks and rolling stock, canals, reservoirs and dams are either in dilapidated condition or need to be expanded, upgraded or modernized. I.T. enabled solutions should be found for efficient maintenance and operations of these facilities. Mispricing, implicit subsidies in form of less than full cost recovery do make it difficult to invest in replacement of capital assets. Explicit budgetary subsidies targeted at the poor are welfare enhancing but across-the-board politically motivated populist measures that create wedge between cost and price charged should be discouraged. Most of the problems of congestion and shortages arise from this inadvisable pricing policy and also poor governance. Professional management with proper oversight and monitoring are required to make infrastructure services available efficiently and cost effectively to the users.

Fourth, none of the South Asian countries has so far become a part of global value chain and is participating in international supply chain arrangements. There is no single business model for participating in this chain and there can be many phases of transition and many modes of involvement. For example, joint ventures, franchising, purchase arrangements by international firms, licensing, sub-contracting, fully owned firm, fabricating components and parts for original equipment manufacturers, strategic partnership for technology transfer, acquisition of equity shares overseas are the diverse means whereby South Asian countries can gain wide access to international markets at their own level of capability. This would enable them to climb the technological ladder, expand their exports at above average rate, and maximize benefits from globalization. East Asia is a major participant in this global supply chain and produces parts and components for a variety of manufacturers, assemblers, aggregators located elsewhere in and outside the region. Consequently the intra-regional trade in East Asia has picked up and performed exceptionally well.

What should the South Asian countries do together?

 East Asian countries have pursued strategies of openness to trade and investment that have led to their having high trade shares with each other as well as with the rest of the world. Consequently, East Asia is one of the most economically integrated regions in the world. In contrast, South Asia is one of the least economically integrated regions in the world. Intra-regional trade in South Asia was 3.5 percent of total trade in 2009, compared to 19 percent in 1948. This increase in trade volume in recent years has taken place mainly due to almost $1 billion of exports from Pakistan to Afghanistan.

 Political tensions and disputes are the single most barrier to economic integration within our region. I would submit that promotion of trade and economic cooperation can in fact lead to thawing of the ice, building constituencies and coalitions that ultimately facilitate resolution of political disputes. By keeping the benefits of trade and economic cooperation away from the reaches of the population would only slow the efforts at poverty reduction. Having the largest number of poor people within its boundaries makes it incumbent upon the leadership of these countries to pursue all possible strategies that can lead towards the goal of poverty reduction. Trade performance of South Asian regional trade in 2006 was only 25 percent of its trade potential. East Asia has already realized 65 percent of its trade potential.

 A recent study by Shiro Armstrong at the Australian National University has found that the lower trade performance in South Asia can be explained by the political distance variable although the direction of causality between political distance and trade is not clear.[[2]](#footnote-3) While improved political relations, i.e. a narrowing of political distance is usually associated with an increase in trade, trade has been found to increase political amity and decrease enemity between countries.

 Political relations between China and Japan and between China and Taiwan have been quite difficult but these countries did not allow these tensions to come in the way of trading relations. They pursued active policies to promote bilateral trade and investment. The results show that in fact 62 percent of trade potential from Japan to China and 64 percent of trade from China to Japan is realized. Similarly, the potential trade from China to Taiwan has reached 67 percent by 2006 significantly higher than the world average. Political and economic relations between China and Taiwan have improved further since 2006 with a significant economic framework agreement.

 These lessons from East Asia should persuade us in India and Pakistan that the historical considerations and the political tensions and disputes between the two countries should not keep us from realizing our trade potential. The recent meetings between the Commerce Secretaries of the two countries augur well and if progress can be made on some of the facilitating mechanisms then the chances look bright for further increase in the trade performance ratios. These mechanisms are no different from what the leaders of the SAARC region had agreed five years ago when they set up the South Asian Free Trade Agreement (SAFTA).

Why hasn’t SAFTA taken so far. In my opinion, the main stumbling blocks are:

1. Measures to facilitate trade through expeditious border crossings, quick custom clearance, efficient port facilities, improved transport links have not yet been put in place.
2. Domestic tax, tariff and subsidy policies that affect production and trade incentives have not been harmonized to avoid recurrence of trade disputes and frequent use of anti-dumping laws.
3. Fiscal and monetary policies have to be put in place in each country that achieves a stable, non-discriminating macro-economic environment for all the countries in the region.
4. Supporting institutions to manage and facilitate integration, for example, setting standards, establishing regional development funds and for expeditious dispute resolution are yet to be created.
5. Communication and transport infrastructure between the bordering countries have not yet been improve and upgraded to facilitate increased trade and factor mobility.
6. Legal regulations for investor protection, intellectual property rights enforcement, anti-trust law, commercial law, labor relations, financial institutions have to be harmonized.
7. Financial markets widening and regulator changes have not taken place to promote cross-border investment, listings, syndication, bond issues, etc.

For fostering bilateral economic relations between the two large countries of the region – India and Pakistan – which are sour because of the political distance, some specific measures have to be taken:[[3]](#footnote-4)

1. Pakistan should grant MFN treatment to India, while India should reduce its tariffs on agriculture commodities, textiles, and other goods that are of potential value to Pakistan.
2. Both countries should agree on a phasing out of the sensitive list (of items that each country deems important for its economy) under SAFTA over next few years. A restrictive list would nullify all the potential gains of preferential trade access.
3. Technical barriers to Trade (TBT), Sanitary and Phyto Sanitary Measures (SPS) that are in fact, acting as powerful deterrents to exchange of goods should be rationalized and simplified. These are, in fact, non-tariff barriers that hinder the flow of goods.
4. Governor Y. Venugopal Reddy and the author had signed an agreement for opening of branches by two Indian banks in Pakistan and two Pakistani banks in India in 2005. This agreement has not yet been implemented as procedural difficulties have been allowed to overwhelm the substance of the agreement. Without banking services, opening of letters of credit, cross border transactions of funds, trade cannot take place.
5. The 2006 composite dialogue between India and Pakistan had on its agenda resumption of Rail Service between Khokhrapar and Monabao, bus service between Srinagar and Muzaffarabad, religious visits to Lahore and Nankana Sahib, a new shipping protocol, deregulation of air services, and joint registration of Basmati rice. This agenda should be revived and agreements reached to implement these measures.

 These measures, if implemented sincerely, can open a new vista for the two countries in the 21st Century. It is high time political leaderships of India and Pakistan demonstrate courage and conviction to open up trade between their countries for the benefit of their populations and the region.

To sum up, the journey towards South Asian Economic Union is long and ardous and the scope for Regional Economic Cooperation is quite vast and promising. But a beginning has to be made by implementing the agreements that have already been reached, i.e. SAFTA. Political disputes and tensions between India and Pakistan should not be allowed to dissipate the huge benefits that both countries can derive through increased bilateral trade. A set of practical recommendations is presented in this paper to revive the process of Regional Economic Cooperation and establish some credibility on the basis of which next steps can be initiated.

1. A paper presented at the First Meeting of South Asia Forum “Integration in South Asia: Moving towards a South Asian Economic Union”, held at New Delhi on September 8, 2011. [↑](#footnote-ref-2)
2. Shiro Armstrong, Paper presented at the EABER/SABER workshop held at Australian National University, Canberra, August 17, 2011. [↑](#footnote-ref-3)
3. For a detailed analysis of India-Pakistan Trade see the paper Ishrat Husain, “Prospects and Challenges for increased India-Pakistan Trade”. Key note address at FPCCI-FICCI Conference on Indo-Pakistan Trade held at Karachi on July 4, 2011. [↑](#footnote-ref-4)