Development Partnership Program
for South Asia

Study on Intraregional Trade and Investment in South Asia

Australian Government

AusAID

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Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4444
Fax +63 2 636 2444
www.adb.org

For orders, contact
Department of External Relations
Fax +63 2 636 2648
adbpub@adb.org

Foreword

It is encouraging that the Australia–Asian Development Bank South Asia Development Partnership Facility is financing this *Study on Intraregional Trade and Investment in South Asia,* under Regional Technical Assistance 6337: Development Partnership Program for South Asia, as its second project. The promotion of growth and the outlook for further reductions in poverty, through increased trade and investment and through deeper regional economic integration, hold much promise. South Asia is also moving with the world and is changing its perspective on globalization and is adopting a more outward economic orientation. While there is still resistance to South Asian regional cooperation because of the region's long history of political conflict and a somewhat unyielding protectionist stance, South Asia is now more open to the policies of liberalization and openness. Reforms are under way.

The establishment of the South Asian Association for Regional Cooperation in 1985 and the agreements on preferential trading (SAARC Preferential Trading Arrangement) signed in 1993 and free trade (South Asian Free Trade Area—SAFTA) signed in 2004 were serious attempts at regional cooperation. However, much more needs to be done to bring about the desired expansion in trade and investment, and to forge closer ties both within and outside the region. It is hoped that this study will generate some greater move toward these ends in its proposals on different sectors of the economy.

The objective of this study is to showcase the benefits of regional integration and to present policy recommendations to realize such gains. South Asia must go beyond its history and look instead toward the immense potential of regional cooperation and integration in the areas of economic growth, employment, and development.

To broaden and deepen existing cooperation and integration in regional trade and investment, three parallel initiatives are necessary: deepening SAFTA by reducing not only tariff barriers but also nontariff barriers; focusing on key industries to demonstrate the process and benefits of reforms more succinctly; and expanding the scope of SAFTA to include trade in services and investment. These are translated into six component studies (Chapters 2–3, and 5–8). While the current global financial turmoil will surely have an impact on South Asian economies, this is beyond the scope of this study.

In terms of structure, Chapter 1 provides the background and context of the study, as well as its justification and objectives. *The Role of Trade Facilitation in South Asian Economic Integration* (Chapter 2) shows that deeper economic cooperation and integration, made through increased intraregional trade and investment, require improved trade facilitation and a reduction of nontariff barriers. Thomas Hertel, with Tasneem Mirza, wrote this chapter.

The potential for intraregional trade and investment in the textiles and clothing industry in South Asia and the issues surrounding this sector are highlighted in the study by Meenu Tewari, *The Textiles and Clothing Industry* (Chapter 3).

Four parallel selected country investment studies were undertaken to address the issues surrounding foreign direct investment in four South Asian countries. Chapter 4 offers an introduction to these studies citing the objectives and providing a brief review of the current literature. Addressing specific constraints and assessing the potential for foreign direct investment in each country were: Khondaker Golam Moazzem with Md. Tariqur Rahman (Bangladesh, Chapter 5), Bindhya Nath Jha (India, Chapter 6), Ramesh Chandra Chitrakar (Nepal, Chapter 7), and Dushni Weerakoon with Jayanthi Thennakoon (Sri Lanka, Chapter 8). Chapter 9 closes the volume with a summary of the policy recommendations to be undertaken at the country and regional levels.

The Asian Development Bank is fortunate and honored to have gathered such a distinguished body of scholars who shared their expertise to complete the different components of this study. Their conscientious efforts are deeply appreciated.

This project was initiated by the Country Coordination and Regional Cooperation Division (SAOC) of the South Asia Department under the leadership of former Director Richard W.A. Vokes. The project was approved in 2006 and prospered with the continued support of then Deputy Director General Sultan Hafeez Rahman. Director Yukiko Kojima continued to lead the project when she assumed the directorship of SAOC. The study is being concluded under the guidance of Director Bruno Carrasco. Alain Borghijs, together with Naved Hamid, launched the project as its first implementers. Shunsuke Bando and Tadateru Hayashi took over and implemented the project toward its completion, with the assistance of Alice Martha A. Lee.

The Introduction and Executive Summary were written by Alice Martha A. Lee. Marissa Garcia provided the manuscript editing. Ma. Solita Mabaquiao, Aileen Pangilinan, and Mary Jane de Ocampo provided invaluable support and assistance. Colleagues from the different resident missions who provided valuable comments and inputs include Rezaul Khan (Bangladesh), Kavita S. Iyengar (India), Shreejana Rajbhandari and Paolo Spantigati (Nepal), and Johanna Boestel (Sri Lanka).

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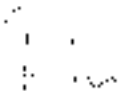

Kunio Senga
Director General
South Asia Department

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Abbreviations

BIMSTEC	–	Bay of Bengal Initiative of Multi-Sectoral Trade and Economic Cooperation
BOI	–	Board of Investment
CAGR	–	compound annual growth rate
CEPA	–	Comprehensive Economic Partnership Agreement
CGE	–	computable general equilibrium
CMT	–	cut, make, and trim
CoE	–	Committee of Experts
EPZ	–	export processing zone
FITTA	–	Foreign Investment and Technology Transfer Act
FTA	–	free trade agreement
GATS	–	General Agreement on Trade in Services
GSP	–	Generalized System of Preferences
GTAP	–	Global Trade Analysis Project
HS	–	Harmonized System
ISFTA	–	India–Sri Lanka Free Trade Agreement
IT	–	information technology
LPI	–	Logistics Performance Index
MFA	–	Multi-Fiber Arrangement
MFN	–	most-favored-nation
MRA	–	mutual recognition agreement
NTB	–	nontariff barrier
OLS	–	ordinary least squares
RTA	–	regional trade agreement
PRC	–	People's Republic of China
SAARC	–	South Asian Association for Regional Cooperation
SAFTA	–	South Asian Free Trade Area
SAPTA	–	SAARC Preferential Trading Arrangement
T&C	–	textiles and clothing
WTO	–	World Trade Organization

Executive Summary

The promotion of growth and the outlook for further reductions in poverty, through increased trade and investment and through deeper regional economic integration, hold much promise in South Asia. This is especially so now, since the region is increasing trade volumes and is moving toward a more outward economic orientation.

Introduction

South Asia's potential to take itself to greater heights is real. However, it still faces a regional poverty situation that is nothing short of severe. The region is home to 40% of the world's poor, with 29.5% of its population living on less than $1 a day. While almost a quarter of the world's population lives in the region, South Asia accounts for only 3% of global gross domestic product (GDP), 1.9% of world exports, and 1.7% of world foreign direct investment (FDI).

As with globalization, regional economic cooperation and integration are seen as a route to economic prosperity. This is the direction that this study pursues. Present data on South Asia show so much untapped economic opportunity: of the region's total trade volume of $517.5 billion in 2007, only 4% was intraregional trade. Given the advantages of proximity, and the similarity in production structures and levels of technology, plus the familiarity of cultures, it is likely that a more pronounced set of benefits will accrue from intraregional trade and investment, taken alongside their extraregional counterpart.

Despite the establishment of the South Asian Association for Regional Cooperation (SAARC) in 1985 to promote economic growth and development through active regional collaboration and cooperation, and even as the SAARC Preferential Trading Arrangement (SAPTA) and the South Asian Free Trade Area (SAFTA) took effect in 1995 and 2006, respectively, to stimulate trade and foster deeper integration and regional cooperation, full liberalization and cooperation did not take off. High levels of protection persist. South Asia still suffers from prohibitive tariffs and the distinction of having the highest interstate barriers to trade. SAFTA's annexed negative lists remain substantial. Interstate mobility is hampered by visa rules. Moreover, the exclusion of services and investment from SAFTA renders the agreement toothless in significant areas. Intraregional investment within the region, as well as trade, remains meager.

It is the objective of this volume both to showcase the benefits of regional integration, and to present policy recommendations to realize such gains and maximize the full potential of South Asia in the area of regional cooperation and integration. To broaden and deepen existing agreements and strategies, three parallel initiatives are necessary: deepening SAFTA by reducing not only tariff barriers but also nontariff barriers (NTBs); focusing on key industries to demonstrate the process and benefits of reforms more succinctly; and expanding the scope of SAFTA to include trade in services and investment. These translated into six component studies in this volume: *The Role of Trade Facilitation in South Asian Economic Integration*, *The Textiles and Clothing Industry*, and four selected country investment studies on Bangladesh, India, Nepal, and Sri Lanka. While the first chapter provides the background and context of the study, the last chapter summarizes reforms recommended to be undertaken at the country and regional level. These recommendations are taken from the textiles and clothing component study and the country investment studies.

The Role of Trade Facilitation in South Asian Economic Integration

South Asia is the least integrated region in the world. During the past decade SAARC has launched

notable initiatives for greater integration through liberalization, but has achieved little in terms of intraregional trade. For deeper integration in trade and investment, governments need not only reduce restrictive tariffs and duties, but also to minimize import restraints, protracted customs requirements, and excessive documentation, and to develop cross-border infrastructure. Further, a growing number of studies have established that with the declining importance of tariffs, the quality of trade facilitation has a significant impact on determining the pattern of trade flows in the world today. Trade facilitation reforms can have significant trade and welfare gains, particularly for developing countries suffering from large nontariff border costs.

This component study builds on the existing literature to obtain a deeper understanding of the impacts of trade facilitation around the world, with special emphasis on South Asia. Using a two-stage econometric model, it first estimates the effects of reforms on global trade flows of agricultural and manufacturing goods for 95 countries. This model improves on established results in two ways: it accounts for the issue of endogeneity and spurious correlation, thereby obtaining unbiased estimates; and it uses a new dataset developed by the World Bank, the Logistics Perceptions Index, with improved quality and coverage to measure the quality of trade facilitation, by including detailed information such as the quality of customs, infrastructure, ease of shipment, and timeliness. Estimates from the model indicate that trade gains from trade facilitation reforms are even larger than those projected in the literature, and larger than those from tariff liberalization efforts. Trade facilitation also has greater impacts on increasing exports than imports, which shows potential for export-led growth.

Estimates made by the econometric model are then used to calibrate a Global Trade Analysis Project-based computable general equilibrium (CGE) model. This facilitates analysis within a general equilibrium setting that strengthens realistic predictions by implementing particular model assumptions. The effects of enhancing trade facilitation in South Asia were simulated to half-way that of the world average. The following paragraphs summarize the findings.

i. South Asia experiences large gains in global trade, with proportionately larger increases in intraregional trade, confirming the belief that trade facilitation is consistent with open regionalism.

ii. Increases in demand for South Asian exports boost export prices, which in turn lead to the real appreciation of exchange rates and increased real wages of labor and returns to capital, leading to an improvement in the standard of living and a rise in domestic consumption.

iii. Trade facilitation reforms lead to increases in regional income and significant welfare gains in South Asia, with major gains accruing to Bangladesh and Pakistan.

iv. Significant gains from trade facilitation are observed for industries including textiles and clothing (T&C), automobiles and parts, and other manufacturing goods.

v. The expansion of T&C exports impacts positively on women's employment, and is expected to decrease the gender wage gap in South Asia.

vi. Much of the intraregional trade gain is seen in intermediates. This indicates scope for vertical integration. Since countries in the region specialize in similar goods, lower border costs will allow them to more easily obtain raw materials and intermediate inputs from their South Asian neighbors. This further feeds back into expanding exports of finished products to the rest of the world, particularly Europe and North America. Thus, lowering NTBs in the region will allow countries to help each other by engaging in greater intraregional trade that further contributes to expanding exports and regional growth.

Textiles and Clothing Industry

T&C combined are a core export of South Asia. Every country in the region has a demonstrated comparative advantage in T&C. In most South Asian countries, this industry is the leading earner of foreign exchange and the primary contributor to manufacturing employment and output. Despite this comparative advantage, South Asia's T&C industry is among the

most fragmented and least integrated of all regional groupings globally.

The following factors may explain the preference to trade with the more distant economies in East and Southeast Asia:

i. Given the long history of business ties, it is easier and cheaper to continue to conduct business with existing business partners. At the time when Bangladesh and Sri Lanka were expanding their clothing industries, India and Pakistan were still relatively closed to trade, and East Asia was ready to provide the buyers, intermediaries, and sourcing networks that the expanding industries required.

ii. As cut, make, and trim assemblers, Bangladesh and Sri Lanka clothing manufacturers are constrained in their ability to move from the East Asian suppliers designated by their Western buyers.

iii. With the limited diversity in textile and fiber range, and the virtual absence of noncotton blends, South Asia's textile producers cannot take part in the emerging market networks.

iv. Years of conflict and tension have moved against regional cooperation and integration—the "burden of history."

v. Taking all costs together, including energy, sourcing, and transportation, as well as the myriad tariff and NTB costs, it is still cheaper to source from the People's Republic of China (PRC) and the rest of East Asia than from India and Pakistan.

High total costs in South Asia stem from low productivity; low scales of production; high energy costs; transportation costs; specific duties, tariffs, and customs duties; and high NTB costs.

While SAARC members share common markets abroad and broad similarities in their output, there are subtle but important differences. The region's varying specializations suggest that conditions hospitable to the formation of regional production networks might be in place. The underlying regional specialization, where India and Pakistan are net exporters of textiles, and where Bangladesh and Sri Lanka are net exporters of clothing and net importers of fabric and textiles, should be analyzed.

There is general enthusiasm for intra-SAARC investment as this will likely bring about economies of scale, shorter delivery times, lower inventory costs, and fewer risks.

Specific recommendations for the T&C industry include the following:

i. Identify key turning points—such as the expiration of the United States (US) and European Union (EU) safeguards on the PRC in 2008—that could potentially create demand for pan-South Asian collaboration in the T&C industry.

ii. Nurture interstate collaborative ties among the next generation of professional entrepreneurs in South Asia.

iii. With the nascent development of cross-border manufacturing services and interpenetrated labor markets, the problem of interstate mobility (especially visa problems) should be addressed immediately.

iv. Create conditions for industry actors and officials to address common problems and priorities, such as the issue of seeking intellectual property protection (via geographic indication) of some weaves, designs, and processes that are a common heritage of the region, and are being copied by competitor countries.

Bangladesh Country Investment Study

Along with the structural changes in the last three and a half decades, when agriculture's share in GDP declined and that of industry increased, GDP growth in Bangladesh rose from 3.7% in the 1980s to 6.5% in FY2007, due mostly to productivity increases in manufacturing and services.

With the trade liberalization that was initiated in the 1980s, the trade-to-GDP ratio has been on an increasing trend and reached 47% in FY2008, from a mere 17% in FY1991. Export growth in FY2008 was 15.9% and valued at $14.0 billion. But exports are concentrated: 77% of them come from clothing.

Export destinations are also concentrated in few economies, including US, EU, and Canada. Trade with South Asian neighbors is meager, accounting for only 2.3% of total exports and 15.5% of total imports in 2007. Most regional trade is with India.

Bangladesh is party to various trading arrangements at the bilateral, regional, and subregional levels, including SAFTA. However, no substantial change in trading patterns was seen as a result of these agreements, mostly because of large negative lists, which also include Bangladesh's major trading goods (i.e., T&C). Still, its participation in these agreements is always perceived as a positive factor by investors targeting regional markets.

Given that natural gas and coal are the major energy resources of the country, there may be scope for investment in natural gas exploration, coal mine development, and coal power generation.

A wide gap persists between the demand for and supply of fabric and yarn, and although domestic investment in their production has been increasing recently, this is not sufficient to meet the demand of Bangladesh's clothing sector. There may be scope for investment in this area, especially from India and Pakistan, considering their strong textile industries.

With the growing population in urban areas and their relatively higher income levels, demand for passenger cars is increasing. Yet there seems to be no interest in investing in this industry, even if companies are currently exporting their products to Bangladesh. Without the availability of sufficient steel, it will be difficult for automobile manufacturers to set up plants in Bangladesh.

Investment in Bangladesh is constrained by the lack of infrastructure. The quality of existing infrastructure is too poor for the needs of businesses. In addition, businesses are also constrained by the lack of skilled workers, corruption, inefficient bureaucracy and long waiting time, policy instability, and limited access to financing. Thus even if the savings–investment gap has turned positive and is widening, the surplus that is available for investment remains idle. Policies that actively promote and encourage FDI are no match to the constraining effects of these inadequacies, thus FDI remains low.

The services sector, in particular telecommunications, and oil and gas exploration, receive the majority of FDI, which is sourced mostly from the United Kingdom (UK), Canada, Malaysia, Norway, and US. Only 3% of total FDI inflows come from South Asian countries.

The development potential of the country's physical infrastructure, especially that of the energy sector, is paramount. Its human resources should also be developed to increase productivity. For the T&C industry, Bangladesh should explore and work toward increasing its trade within the region to maximize its comparative advantages. Finally, the development of backward linkages in textiles is crucial if Bangladesh is to be competitive in the global market.

India Country Investment Study

India is now one of the fastest-growing economies in the world, with an average annual growth rate of 8% since FY2003. Manufacturing, construction, and communications are the major drivers. The savings and investment rates are also beginning to move toward levels seen in East and Southeast Asia, at roughly 30% of GDP.

T&C together form India's largest manufacturing industry, contributing 14% of industrial production. It is also a major employer and a leading exporter. The clothing sector employs an estimated 3 million people and accounts for nearly 16% of total exports. In addition, a large number of subsidiary industries are dependent on T&C, such as machineries, accessories, dyes, chemicals, and retail.

An encouraging trend in recent years has been the resurgence of industry. India is now established as an automobile manufacturing base, and its automobile components sector showed annual growth of 20% during FY2001 to FY2005, and an average export growth rate of 29% during FY2003 to FY2006. While the automobile industry is now a major player in the economy, accounting for 4% of GDP, the country's automobile policy is still implementing directives to attract more foreign investment, as it envisages a globally competitive Indian automobile industry. Automatic approval of foreign equity investments of up to 100% and reduction of excise duties on small vehicles and raw materials are examples of such moves.

From FY1991 to FY1999, India received a rather modest amount of FDI of $17 billion. Since then, FDI has increased substantially, reaching $15.7 billion in FY2006 and $25 billion in FY2007. Given the country's sustained GDP growth, stable policy environment, and a large and still growing domestic market, India is expected to attract FDI at an even faster pace with a target of $35 billion in FY2008.

However, the inadequate supply of power, poor condition of roads, low handling capacity at ports, and overall poor transport linkages and communication facilities somewhat limit the amount of FDI that is attracted to the Indian economy. Since improvements in infrastructure require massive infusions of funds and given the limited funds of the local private sector, FDI in infrastructure is of the highest priority.

With regard to outward FDI, Indian firms prefer to establish businesses in Western Europe and North America due to the ease of conducting business in those regions and with a view to enhancing their global profile. Outward FDI to South Asia is quite weak even in comparison with Indian investment in Southeast Asia and Africa. This relates to security concerns, political instability, and an inadequate policy, enabling, and facilitation framework to assist in intraregional trade.

India can also make significant investments in the automobile and automobile components sector in Sri Lanka and Pakistan, and hydropower in Nepal. With India's considerable advances in software development, its companies can be encouraged to invest in information technology (IT)-related industries in Bangladesh, Nepal, and Sri Lanka.

Nepal Country Investment Study

The implementation of the Industrial Policy and Enterprises Act in 1987 was Nepal's initial move to attract FDI. Succeeding policies in 1992 offered further incentives, such as a 10-year tax holiday, the easing of visa constraints, a one-window policy, and the opening of nearly all sectors to foreign investment.

While Nepal may be regarded as the most open and trade-dependent economy in the region, 62.2% of its trade in FY2007 was with India. And with the weakening of its clothing exports, the share of trade with other countries, including SAARC member countries, has been declining. The country is also quite vulnerable to shocks as its trade is dependent on a few export items like carpets, clothing, woolen and pashmina goods, and some agricultural products.

Nepal has advantages as an investment destination. First, it has access to the largest markets in the world—PRC, India, and EU—through various agreements. Second, it has rich natural resources and enormous hydropower potential. Third, it has investment-friendly policies and a low-cost workforce. Fourth, average import tariff rates are the lowest in South Asia, making it very attractive for investors with third-party inputs, such as clothing.

FDI performance has been constrained by internal conflicts, a limited domestic market with low per capita income, and infrastructural problems brought about by its topography and landlocked geography. The high cost of power and inadequate road and railroad network are taking a toll on productivity and trading costs. These are aggravated by government and policy instability, inefficient bureaucracy, corruption, tax regulations, and delays in customs and transshipment.

At present, most FDI comes from India, PRC, Japan, US, Republic of Korea, and UK. India accounts for 97.5% of investments from SAARC member countries. Exploring the possibility of increasing investments from other South Asian economies may bear much fruit.

The rising importance of services is evidenced by the growing share in GDP and total inward FDI. With such a role and potential, the sector should be incorporated into the SAFTA framework. Tourism is the main foreign exchange earner, and tourism, health and health education, and IT are the subsectors with the highest potential for FDI. With the increasing number of joint-venture banks and finance companies, the financial sector also holds much promise.

The T&C industry provides employment to roughly 35,000 people, and clothing remains the largest export. Nepal's hand-knotted woolen carpets are well-known in the EU, in the same way that pashmina

shawls are in the US and UK. And although financial investment in these subsectors is not allowed, there is scope for technical collaboration in quality control, marketing, and design. As pashmina is facing declining demand (mainly due to the inferior quality of exports), and as domestic fabrics cannot compete with imported fabrics, collaboration in quality control will be timely.

With the increasing number of vehicles, especially motorcycles, and the volume of imported spare parts in Nepal, current technology-transfer ventures from the PRC in motorbikes should be augmented. High taxes and duties imposed on the industry are still factors with which investors have to contend.

Nepal suffers from power cuts and high energy costs despite huge hydropower potential, estimated at 83,000 megawatts. At present, generation capacity of the country's hydropower resources is only 0.7%. Considering the huge potential supply and the unmet demand in Nepal and in India's border provinces, this sector offers great FDI potential. The Government could consider further efforts to attract FDI into hydropower.

Sri Lanka Country Investment Study

From the late 1950s, Sri Lanka implemented an import-substitution policy and a fairly liberal foreign investment regime. However, a fragile balance of payments prompted a dualistic FDI policy, which restricted import-substitution projects and favored export-oriented ventures. But with the overall bias against export-oriented activities, FDI played a limited role in the economy until liberalization in 1977–1978.

Liberalization changed the structure of the economy from one based on agriculture to one driven by industry and services. This happened as FDI flowed into manufacturing, particularly T&C, into other industry sectors, and into services. However, the political conflict that escalated into a violent insurgency in the late 1980s hindered the smooth inflow of FDI in the country and put economic development largely on hold.

However, the economy has proven to be resilient as it posted GDP growth of around 5% a year on average over the last two decades. Growth has been uneven across provinces and sectors, though, and poverty has remained endemic in parts of the country. Agriculture contributed 16.8% of GDP and services expanded to 56.2% of GDP in 2006 and 41.2% of employment. Industry is still dominated by the manufacturing of export-oriented clothing. The overall performance of FDI, however, has remained weak, even with political normalcy and renewed liberalization.

In 2006, services-related FDI accounted for over 61% of total inflows, with construction, energy, telecommunications, and port services the largest areas. In the same year, manufacturing accounted for 39% of total inflows. T&C contributed 36% of total manufacturing FDI during 2001–2006. Reflecting the trend of FDI, by 2006, manufacturing exports had become the mainstay of merchandise exports, with T&C exports accounting for 42% of total export earnings. Intraregional FDI, which is primarily Indian FDI, played a very small part in the economy, accounting for only 1.2% of cumulative investment during 1978–1995. This is, however, changing with the total share of Indian FDI rising to an average of 5.6% a year for 2004–2006.

Sri Lanka has a relatively more liberal FDI regime, more educated workforce, lower labor costs, and higher per capita income than its South Asian neighbors. Thus it is no surprise that Sri Lanka is the preferred FDI destination in the region, particularly among Indian investors. The potential for expanding intraregional links in the T&C industry stems from the rapid increase in demand for T&C production. Since India and Pakistan are both large producers of textiles, the growth of the clothing sector and its exports will provide avenues and opportunities for intraregional trade and investment in the textiles–clothing industry nexus.

There are developing opportunities for export-oriented investments other than T&C. A net exporter of rubber, Sri Lanka seeks access to the growing Indian market. With relatively cheap labor and raw materials, and high quality of natural rubber, Indian automobile manufacturers are setting up plants in Sri Lanka for intermediate automobile parts. There is also a growing potential in services, particularly in health care, education, IT, telecommunications, and banking.

In spite of the fiscal incentives offered under the liberal FDI regime, Sri Lanka has not been very

successful in attracting FDI. Aside from the country's internal conflict, major constraints include the highly unstable and uncertain macroeconomic environment, which includes trade policies; poor infrastructure, including unreliable electric supply and its high cost, and inadequate and poorly maintained transport and telecommunications infrastructure; and underdeveloped capital markets, with high borrowing costs and rigid labor regulations. Limited investment-related services, bureaucratic red tape, and high costs of compliance also present obstacles to investing in Sri Lanka.

Country and Regional Policy Recommendations

If regional cooperation and integration are to be advanced, trading, market access, and FDI within the region must be improved and facilitated. Specific mechanisms include

i. reduction of tariffs and NTBs;

ii. improvement of trade facilitation with the simplification and transparency of trade regulations and procedures;

iii. curtailment of long negative lists and the removal of important trading items in those lists;

iv. improvement and expansion of transportation and telecommunications; energy generation, transmission, and distribution; and other infrastructure to support industry and commerce; and

v. removal of restraints and sector caps on investments among SAARC countries and simplification of investment regulations.

As the share of NTBs in total trading costs is increasing, efforts toward improved trade facilitation are paramount. Intergovernment cooperation is needed, as cross-border procedures and requirements have to be harmonized. Measures include transparency and professionalism in border clearance procedures and a collective action in upgrading ports.

Immense potential lies in services and manufacturing. Specific to intraregional investment would be the T&C and automobile industries, as well as the medical, education, financial, and telecommunications services sectors. Given the demonstrated comparative advantage of each South Asian country in T&C, it can be developed as the core export of the region.

Creation and modernization of more efficient marketing and distribution networks, especially in the T&C and automobile industries, as well as quick and cost-effective transport of locally made fabric, accessories, and components, must be assured.

An efficient and integrated transport system for the whole of South Asia is essential for the effective implementation of SAFTA. More land routes should be opened between SAARC countries, with effective infrastructure support at border points. Regional cooperation in energy is also important.

To broaden the scope of SAFTA to encompass investment and services, a transparent investment protocol for South Asia is needed.

CHAPTER 1

Introduction

East Asia has given the world valuable economic lessons on the benefits of trade liberalization, where market forces lead economies toward improved efficiencies and increased productivity. The high economic growth rates of Hong Kong, China; Republic of Korea; Singapore; and Taipei,China were driven by export-led strategies. This paved the way for them to become the newly industrialized economies of the region. When the People's Republic of China launched its reforms in 1978 and opened its doors to foreign trade and investment, it started an increasing momentum of growth, as the nation attracted huge sums of foreign direct investment (FDI). The world watched and learned.

Since then, most developing countries have come out of their protectionist stance and have started opening up their economies. Liberalization subsequently encompassed the spheres of finance and investment, leading to accelerated growth and improved living standards and human development for most of these countries.

South Asia is no different. From a long history of import substitution, protectionism, and inward-looking policies, South Asian countries are slowly changing both their outlook and policies. Led by India, the countries of the region have opened up their economies and encouraged trade and investment, bringing about accelerated growth rates and greater trade volumes. South Asia's 7.8% average annual growth for the period 2003–2008 was the second highest in the world—with East Asia the highest. Moreover, South Asia joins both East and Southeast Asia as having the greatest reductions in poverty in the past 25 years.

Still, much work needs to be done. Today, South Asia is home to 40% of the world's poor, with 29.5% of its population living on less than $1 a day. South Asia accounts for only 3% of global gross domestic product (GDP), even though almost a quarter of the world's population lives in the region (UNCTAD 2008a). In 2007, its share of total world exports was only 1.9%. East Asia's and Southeast Asia's shares of total world exports were 15.8% and 6.3%, respectively. In the area of investment, FDI inflows to South Asia in 2007 amounted to $29.6 billion—a paltry 2.1% of the region's GDP and a mere 1.6% of world FDI. South Asia's FDI share is not even an eighth of East Asia's $214.2 billion (UNCTAD 2008a). These numbers show how much more untapped opportunity, in terms of foreign markets and investments, exists for South Asia.

Intraregional data on South Asia show the same story of untapped economic opportunity and a very disproportionate bias toward extraregional trade and investment. In 2007, South Asia had a total trade value of $517.5 billion and of this only 4% was intraregional trade (IMF 2008). This is low compared to East Asia's regional trade in 2006, which constituted 32% of its total trade. Even Southeast Asia, with its less contiguous geography, is also much more integrated given that 25% of its trade was intraregional (UNCTAD 2008a). Even with the advantages of proximity in trade, South Asian countries still choose to trade with the more distant economies of the United States and European Union. In the same manner, most of the region's FDI also comes from outside the region. Given the similarity in the level of technology and cultures, plus the more labor-intensive production structures among South Asian nations, a different set of benefits, possibly more pronounced, would accrue from intraregional trade and investment, relative to extraregional trade and investment.

As with globalization, regional economic cooperation and integration are seen as a route toward economic prosperity, as they pave the way for expanding markets and trade opportunities. Some even perceive regional cooperation as a coping mechanism for smaller economies in a globally competitive world. In contrast to globalization, regional cooperation

engages countries in trade and investment agreements with others of the same economic structure, and of the same level of productivity and technological capacity. This limits the disadvantages of North–South agreements and their reciprocal commitments. Thus regional trade agreements are more viable because economies are on a level playing field and are more likely to have economic complementarity. To top this, countries in the same geographic region will have the advantages of proximity, familiarity, and lower transport costs. It is therefore not surprising that the past two decades have seen the rapid expansion of intraregional trade in all developing regions.

South Asian economies share these advantages of contiguity, proximity, and familiarity that make regional economic cooperation and integration less troublesome. However, South Asia has not taken full advantage of these features and their accompanying opportunities. Past conflicts and present-day tensions continue to hinder regional cooperation, such that the immense potential for regional integration—and its subsequent trade, investment, and growth opportunities—remains untapped.

While regional cooperation was discussed as early as 1947, it did not take root until 1980 with Bangladesh President Zia-ur Rahman's sharing of his working paper on regional cooperation in South Asia with other South Asian heads of state. After slow and incremental steps, the South Asian Association for Regional Cooperation (SAARC) was established in 1985 to promote welfare through active collaboration and cooperation toward economic growth, social progress, and cultural development. Recognizing the singular role of trade in stimulating investment and employment, SAARC member countries established the SAARC Preferential Trading Arrangement (SAPTA), which took effect in 1995. Subsequently, the South Asian Free Trade Area (SAFTA) was adopted in 2006 to foster deeper integration and economic cooperation through higher levels of trade. But in spite of all these positive developments and sincere attempts toward regional cooperation and integration, unshackling the burdens of history is difficult.

Full liberalization and economic integration could not take off and high levels of protection persist. South Asia still suffers from prohibitive tariffs and the distinction of having the highest interstate barriers to trade. SAFTA's annexed negative lists remain substantial. Moreover, the exclusion of services and investment in SAFTA renders the agreement quite limited. Interstate mobility is hampered by visa rules. The poor condition of infrastructure, especially in transport and trade facilitation, and protracted bureaucratic procedures do not help either. Intraregional trade and investment within the region remain meager.

During the past two decades, South Asia has been subject to this continuing seesaw between regional cooperation and skepticism. This study seeks to tilt the balance in favor of regional cooperation and integration. It will showcase the gains from intraregional trade and investment, and highlight recommendations that will help South Asia realize its full potential in the area of regional cooperation and integration. It will address constraints and identify reforms to promote particular areas of potential.

The Asian Development Bank (ADB) recognizes the critical role of regional cooperation and integration in South Asia in achieving the Millennium Development Goals by 2015, in that they can help in unlocking the region's vast economic potential, in achieving sustained and rapid growth, and in reducing poverty. Recently, ADB launched Strategy 2020, which includes regional integration as one of three development agendas (the others are inclusive economic growth and environmentally sustainable growth). This reshapes and refocuses ADB's course toward poverty reduction as it emphasizes the need for "neighboring economies to work within larger and freer markets to achieve shared interests through cooperation" (ADB 2008). In the longer term, regional cooperation and integration will enable South Asia to play a more effective role in wider Asian integration. And while they may be blocked by myriad political conflicts, it is hoped that they will pave the way for a more harmonious and peaceful South Asia, and begin the virtuous circle of economic progress.

This volume is structured as follows. South Asia is known to have problems in the area of trade facilitation and high nontariff barriers (NTBs). Chapter 2 represents a first step in answering SAARC's call (made in the Dhaka Declaration of 2005) for expeditious action to address the issues in this area and to facilitate intraregional trade. Studies have shown how poor trade facilitation logistics and NTBs can limit trade and investment. The experience

of SAFTA and SAPTA makes it clear that increasing trade takes more than signed agreements. It is imperative that actual trade logistics also be analyzed. Deeper integration in trade and investment requires governments to reduce not only restrictive tariffs and duties, but also to minimize import restraints, protracted customs requirements, and complicated and often redundant documentation, which hampers the flow of goods. Studies have also shown that poor trade facilitation, poor connectivity, and high trading and transport costs restrict trade. A study by Wilson et al. (2005) determined that enhancing trade facilitation would generate a global increase in trade volumes. Hummels (2001) focused on the importance of timeliness and showed how delays reduced trade volumes. In South Asia the isolated and landlocked regions and countries are particularly vulnerable to the effects of poor connectivity.

To bring the policy reform process to a manageable level, Chapter 3 focuses on exploring the potential of the region's major industry—textiles and clothing (T&C)—where more immediate and specific interventions can be implemented. Such focused reforms have higher chances of success and can be used to demonstrate the economic benefits of trade and investment liberalization to South Asian countries. T&C involve multiple production stages requiring varying degrees of skill and labor intensity—characteristics of industries with high potential for intra-industry intraregional trade. T&C also have strong backward and forward linkages that may be developed across countries. Given South Asia's comparative advantage in T&C and a large pool of skilled and cheap labor, FDI potential in this sector is investigated.

The dynamics of increased trade and an expanding market will likely restructure production to adhere to the efficiencies of resource allocation, diversification, specialization, economies of scale, and agglomeration. This restructuring can only be possible with an influx of new investment, which will bring about a new cycle of growth with increased productivity and technology development. With the low savings level of South Asia and its persistently negative domestic savings–investment gap, attracting FDI is crucial. It is therefore essential that SAFTA's free trade be complemented by investment liberalization together with other key elements, such as improved infrastructure, nonrestrictive labor policies, and an agreeable political environment. To address the concerns of foreign direct investors, particularly in terms of intraregional FDI in each of the South Asian economies, four selected parallel country investment studies were conducted for Bangladesh, India, Nepal, and Sri Lanka (Chapters 5–8).

Each of these four country studies brings into focus three relevant sectors: T&C, automobiles, and services. As with T&C, automobiles have a high potential for intra-industry and intraregional trade and integration. As for services, all South Asian countries single out this sector as the largest in their economies. Except for Nepal, whose services sector accounts for 41.5% of its GDP, services account for more than half of total output in South Asia's major economies (ADB 2007). In fact, the average growth rate of the service exports of South Asia at 28.6% for 2000–2006, is the highest in the world. India is already one of the world's top exporters of services in computers and information, communications, financial and insurance services, and construction (UNCTAD 2008b). A strong comparative advantage for South Asia is also increasingly evident in tourism, health, and education. The services sector also complements the expansion of trade and investment in goods, as well as the dynamic global supply chain. Issues and complications of cross-border mobility of services however abound and the need to explore this area is paramount given its relevance and potential.

Chapter 9 summarizes country-level policy recommendations from the T&C study and the four country investment studies. Organized by country and by sector/issue, the correspondence between country, sector/issue, and policy is clearly brought out. Efforts toward regional cooperation that have to be undertaken at the regional level are also presented.

The six component studies were written in 2007 and 2008, and were updated where possible with data available as of September 2008. A policy workshop was held on 4–5 December 2008 in Kathmandu, Nepal to present and discuss the draft final reports among South Asian government officials and researchers. (Another study conducted under this project was the *Potential for Trade in Services under SAFTA Agreement.* Its abstract is available at www.ris.org.in/res_proj_rud_08_6.htm.) And while the current global financial turmoil will surely have an impact on South Asian economies, this is beyond the scope of this study and is not addressed.

It is hoped that the underlying project, *Study on Intraregional Trade and Investment in South Asia*, will contribute to the regional policy debate on intraregional trade and investment in South Asia, as well as enhance the understanding of SAARC policy makers and relevant South Asia Subregional Economic Cooperation working groups of viable policies on trade and investment in the region to take regional cooperation and integration forward. The goal of the project is to bring about an expansion of trade and investment within South Asia, as key policy recommendations are adopted and implemented by SAARC members. With high growth rates being posted and with incomes increasing in the region, the potential to achieve this expansion may be at its zenith—the time is right to move toward regional cooperation and trade expansion.

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CHAPTER 2

The Role of Trade Facilitation in South Asian Economic Integration

Thomas W. Hertel and Tasneem Mirza

Motivation

Where the degree of integration is measured by intraregional trade in goods, capital, and ideas, South Asia is the least integrated region in the world (World Bank 2006). The past decade, though, has seen notable initiatives for greater integration, including implementation of preferential trade agreements by member countries of the South Asian Association for Regional Cooperation (SAARC) and the decision by the Secretariat of the South Asian Free Trade Agreement (SAFTA) to phase out customs duties on nearly all goods traded between countries in the region. Despite liberalization efforts and initiatives for greater integration, little has been achieved to date in terms of political and economic cooperation.

The eight countries within the region of South Asia—Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka—are still characterized by unusually low volumes of intraregional trade in goods and services. The total of such trade is less than 2% of gross domestic product (GDP), compared to East Asia's 20% (World Bank 2006). Nonetheless, South Asia's economy has grown by an annual average of 6% during the last 10 years. The high growth rate was primarily attributed to global integration, macroeconomic stabilization, and economic deregulation (Ahmed 2006), and to South Asia's success in capturing large shares of the markets for textiles and clothing (T&C) in the United States (US) and European Union (EU). The region likewise was a leader in providing highly skilled labor services, particularly the information technology (IT) sector in India.

Greater economic integration can further benefit the region by increasing trade in inputs and energy, facilitating the process of addressing political conflicts, promoting peace and stability, and enhancing the attractiveness of the region to foreign investors. Furthermore, greater cooperation may also help address inter- and intracountry inequalities and assist in attaining the higher growth rates seen in East Asia.

Nonetheless, while the potential benefits for greater regional integration are significant, factors such as political conflicts, similar endowments, and competition in the global export market impede trade within South Asia. In addition, the significance of nontariff barriers (NTBs), which are currently increasing their shares in total trade costs in the region, has recently drawn attention in the arena of policy making.

Consequently, this chapter focuses on trade facilitation as an avenue for overcoming NTBs related to customs procedures, on trade and transport costs, and on communications barriers—all of which have served to restrict trade in South Asia. The next section defines trade facilitation and discusses recent literature on the effects of trade facilitation on trade volumes. The third section develops the analytical framework of the econometric model for estimating the effect of NTBs on trade flows. The fourth describes data quality and sources, and the fifth, econometric results. Taking estimates from the econometric model, the sixth section investigates the impacts of simulating trade reforms in South Asia using the Global Trade Analysis Project (GTAP)-based computable general equilibrium (CGE) framework (a model developed by the Center for Global Trade Analysis). Conclusions and policy recommendations follow. (A closer look at the impacts of reforms in Bangladesh on employment, income distribution, and poverty is included in Appendix 2.1.)

Background

Trade Facilitation in SAFTA

SAARC, the first formal agreement on regional cooperation, was designed to reduce conflict, engender cooperation, and promote social progress and peace among South Asian countries. SAARC summits brought political actors together to discuss issues of common interest. SAARC allowed member countries to collaborate on regional concerns regarding education, poverty, technological progress, and foreign affairs with the rest of the world. The SAARC Preferential Trading Arrangement (SAPTA), in contrast, focused exclusively on trade in goods, and on reducing tariffs, paratariffs, and NTBs. Thus liberalizing trade through SAPTA was the first step toward creating an economic union. It also promoted fair trade by imposing antidumping laws and providing additional preferences to least developed nations.

Since the formation of SAARC, South Asia has made considerable progress in reducing conflicts and in collaborating on region-based interests and projects. The implementation of SAPTA has also been successful in lowering tariff barriers during the last decade, while more recently, SAFTA has accelerated liberalization. While issues associated with tariffs have been addressed to some extent, many NTBs did not receive adequate attention. SAFTA's agenda now includes emphasis on these NTBs, including improvements in trade facilitation by enhancing border logistics and negotiating transit rights for the landlocked countries of Afghanistan, Bhutan, and Nepal. Nevertheless, much needs to be done in terms of strategic planning and actual implementation of appropriate policies that can mitigate these trade-reducing effects in South Asia.

Trade Facilitation Defined

Trade facilitation is defined as "improving efficiency in administration and procedure, along with improving logistics at ports and customs" (Wilson et al. 2003). It also includes "streamlining regulatory environments, deepening harmonization of standards, conforming to international regulations" (Woo and Wilson 2000), and enhancing timeliness in trade (Hummels 2001). Poor trade facilitation in developing countries increases trading costs and deters the efficient movement of goods across borders, stemming from inefficient infrastructure, elaborate customs procedures, excessive paperwork, and bureaucracy among public officials.

Trade Facilitation in South Asia

Trade facilitation has become the leading NTB that reduces intraregional trade in South Asia. For example, airports and maritime ports in South Asia are less advanced than those in the People's Republic of China (PRC) and other countries in East Asia (World Bank 2006). While it takes just a few hours to clear a vessel in Singapore or Thailand, it takes two to three days for ports in Bangladesh to do the same. Studies further indicate that a longer time at port is strongly correlated with higher trading costs. Clark et al. (2004) find that improving port efficiency from the 25th to 75th percentiles lowers shipping costs by more than 12%. Hence, improving port facilities will reap high returns in terms of faster delivery and lower costs in South Asia.

Weak land networks across national borders also pose a formidable barrier to intraregional trade in South Asia, particularly for the landlocked countries. Furthermore, poor roads lengthen transportation time and reduce the longevity of vehicles, imposing higher per unit costs for cargo.

South Asia is also characterized by inefficient customs procedures, which increase clearance time. Excessive paperwork requirements, the lack of standardized documents, and the lack of transparency in inspection and documentation requirements complicate administrative procedures and increase border waiting time.

Existing Literature

There is an abundance of recent studies that estimate the impact of trade facilitation on trade flows. Using a global gravity model, Wilson et al. (2005), for example, determined that enhancing facilitation—represented by indexes for port efficiency, customs environment, regulatory environment, and e-business facilities—generated a global increase of $377 billion in trade volumes, equivalent to 9.7% of total world trade. The research further showed that all countries can benefit from rising exports and imports.

Soloaga et al. (2006) used a negative binomial model to study the effects of improving trade facilitation on industry sectors in Mexico. Their results suggest that domestic trade reforms can increase trade by up to 22.4% of total Mexican exports. Furthermore, by simulating the effect of improving trade facilitation for below-average countries to half that of the world average, their study showed that trade for these countries with the rest of the world can increase by nearly 7.4%.

Francois and Manchin (2007) employed a selection model with maximum likelihood estimation techniques to study the participation of various countries in international trade. Using data from the period 1988–2002, they discovered that infrastructure and institutional quality are significant determinants of export levels and strongly influence the propensity to participate in trade. Accordingly, they concluded that trade facilitation and institutional quality were larger determinants of North–South trade than tariffs and other market-access issues.

Several papers have investigated how delays at the border serve as an NTB in reducing trade volumes. Hummels (2001) modeled the importance of timeliness by comparing the affinity to pay for more expensive air cargo versus less expensive ocean shipping services. Using data for US imports of manufactured goods from the rest of the world, he ascertained that each additional day spent on transportation corresponded to an ad valorem tariff equivalent of 0.8% on manufactured goods and reduced the probability that the US would import from a country by 1%–1.5%.

Djankov et al. (2006) studied how delays affect trade volumes, using a modified gravity equation derived from the heterogeneous firm model of Helpman et al. (2006). On the basis of data from the World Bank's *Doing Business Report*, they established that each additional day lost in moving goods from the production site to the ship reduced trade by more than 1%.

Persson (2007) also looked into the effect of delays using data on the six regional groupings of the African, Caribbean, and Pacific countries with the EU. She learned that a 1-day time delay reduced exports by 1% and imports by 0.5%. She also found that the marginal effects of delays are larger for traded goods that already suffer from long delays.

Finally, several papers have employed CGE modeling to estimate the effect of trade facilitation on welfare. Walkenhorst (2004), for example, decomposed the costs of border barriers into direct and indirect costs, where direct costs measured the logistic barriers of moving goods across borders and indirect costs measured the cost to firms of delays in freight movement and border waiting times. These papers' findings suggest that estimated world income grows significantly in the wake of trade facilitation.

Analytical Framework

This chapter aims to evaluate the effect of trade facilitation on global trade flows using a cross-sectional gravity model with data on 95 countries (Appendix 2.2) for 2001. The analysis is conducted at a cross-sector level, where five sectors of interest are considered: agriculture, extraction and mining, T&C, automobiles and parts, and other manufacturing. The objective is to identify the relative size of trade barriers posed by trade facilitation for intraregional and interregional trade in South Asia. Estimates of the impact of trade facilitation on trade flows are then used to calibrate a GTAP-based CGE model, which is used to analyze the impacts on trade flows, employment, wages, and welfare. The analysis is then extended to a GTAP-based poverty module to explore poverty impacts of improved trade facilitation in Bangladesh—the only country in South Asia for which household data are available.

Most papers in the literature use an ordinary least squares (OLS) model to estimate the effect of trade facilitation on trade flows, by simply extending the gravity model that was developed for estimating the effects of size, income, distance, tariffs, and other country-specific and bilateral characteristics. However, it is argued that estimating the effect of trade facilitation on trade using this simple extension may lead to biased estimates due to the existence of bidirectional causality. The reverse direction of causality suggests that countries invest in their borders depending on the extent of trade. When countries have large trade, fixed costs are spread over more goods, and so returns from facilitation are greater. This suggests that the degree of trade determines how much a government is inclined to invest in border facilitation. In order to account for this, appropriate instrumental variables (IVs) were identified and a two-stage least squares procedure was used to estimate

the model. The independent variables of this model are: bilateral preferential tariff rate; distance between importing and exporting countries; common language; landlocked state; common border; trade facilitation indicators for importing and exporting countries; road density; congestion; proportion of paved roads; relative size of government expenditure; and the Corruption Perceptions Index. Appendix 2.3 details the development of the model, the choice of independent variables, and their operational definition.

Data Quality and Sources

Measuring Trade Facilitation using the Logistics Performance Index

Developing indexes to capture the degree of trade facilitation on an international level is not an easy task; previous researchers were restricted by limited data availability. Wilson et al. (2005) used data from three sources, namely, the *Global Competitiveness Index 2001–02*, *IMD World* Competitiveness Yearbook 2002, and Kaufmann et al. (2002). These indexes are not directly associated with the logistics and costs of cross-border trade.

To obtain a more accurate depiction of the border logistics in individual countries, the study employed the Logistics Performance Index (LPI), launched by the World Bank International Trade and Transport Department in 2006. The LPI[1] was constructed to meet the lack of data in trade and transport facilitation and to develop a cross-country comparable set of indicators to capture these data. Up to the present time, it is the only known dataset that is sufficiently robust and comprehensive in coverage (with a total of 150 countries), and that appropriately characterizes the various aspects of trade facilitation across many countries. Complementary datasets are not available because data are not observable and the notion of trade facilitation is not easy to estimate.

Trade, Tariffs, and Other Variables

In addition to the trade facilitation data, improved data for tariffs and trade flows were used in the econometric analysis. Bilateral tariff data for 2001 were obtained from the Market Access Maps (MacMap) contributed by the Centre d'études prospectives et d'informations internationales and improved by GTAP. The MacMap Data Base was compiled from UNCTAD TRAINS (Trade Analysis and Information System) data, from country notifications to the World Trade Organization, from the Agricultural Market Access Database, and from national customs information. The data used were the trade-weighted preferential rates, ad valorem tariffs (including tariff rate quotas), and the ad valorem equivalents of specific tariffs. Tariff preferences from recent trade agreements were incorporated. Tariff data were obtained at the sector level and were aggregated to the regional level using the GTAP trade data. Import data were more sophisticated in terms of their sourcing and coverage, nature and quality, and data processing.

The trade data were obtained from Comtrade as reflected in GTAP V6. This dataset incorporated reconciled bilateral merchandise trade data for 2001. The import value (price times quantity) used in this study was based on cost, insurance, freight (CIF) prices. The trade and tariff data from GTAP V6 were at the 57 GTAP sector level of aggregation. As mentioned earlier, this chapter focuses on five aggregated commodities (agriculture, extraction and mining, T&C, automobiles and parts, and other manufacturing goods). This simple aggregation helps keep the focus on the two industries of greatest interest: T&C, and automobiles and parts. The T&C industry is large for most countries in South Asia and determines significant volumes of trade, while the automobiles and parts industry exhibits immense potential in promoting economic growth in India. The rest was aggregated into the categories of agriculture, extraction and mining, and other manufacturing to observe how these broad sectors are affected from improvements in trade facilitation. Appendix 2.4 discusses how tariff data for each aggregated sector were obtained.

It is important to mention here that there is a large informal trade market in South Asia, which was not captured in the trade data used in this study. Although there is literature on the informal trade sector that obtains its information through interviews of customs officials or by visits to markets that sell these goods, estimates vary considerably.

[1] The LPI ranges on a scale from 1 to 5, where higher values denote better trade facilitation.

Data for the remaining variables were easily available from standard sources for almost all countries. Data on real GDP, population, and instrumental variables[2] were obtained from the Penn World Tables, the World Bank's *World Development Indicators*, and the *International Financial Statistics* of the International Monetary Fund (IMF). Data on distance, products of land areas, common border, and common language, and whether landlocked were obtained from the Central Intelligence Agency's *World Factbook* (2007). Common border and common language are dummy variables that take a value of 0 or 1; the landlocked dummy variable takes a value of 0, 1, or 2 for none, either, or both countries being landlocked, respectively. Data on corruption come from the Corruption Perceptions Index constructed by Transparency International.

The correlation matrix for all explanatory variables is shown in Table 2.1. Based on the results, trade is highly correlated with the product of partner GDPs (0.81) and the trade facilitation levels of the exporting countries (0.62) and importing countries (0.42), whereas an exporter's trade facilitation is correlated with other exporting country-specific instrumental variables—road density (0.54), proportion of paved roads (0.50), congestion (0.74), size of government expenditure (0.44), and corruption (0.83).

Similarly, an importer's trade facilitation is correlated with other importing-country-specific instrumental variables. These variables have some correlation with trade, but this does not necessarily imply causation. In other words, there is no reason to believe that improving the interior infrastructure of a country will affect trade flows. Hence these instrumental variables are appropriate to use in the model.

Econometric results

Benchmark Model Regression Results

In this section, results are presented for the econometric model that is estimated using the two-stage procedure. Overall results indicate that trade facilitation plays an important role in determining global trade flows of agricultural and manufactured goods. The relative impact of improving the exporter's border logistics is larger than developing the importer's logistics. Results also indicate that trade facilitation has a larger effect on trade flows than tariffs. These findings are consistent with the existing literature. The coefficient estimates and standard errors of the second-stage regression are displayed in data columns one and two of Table 2.2.

For robustness, data on actual time of trading to proxy for trade facilitation were used and compared with the LPI (survey-based) estimates. Simulation results confirmed that the effects of improving trade facilitation on trade were very similar across the two datasets of measuring trade facilitation. This is presented in the last two data columns.

Finally, comparing instrumental variable estimates with OLS results, the study shows that OLS estimates were biased downward. This result has proven consistent across a multitude of econometric tests. This suggests that the impacts of trade facilitation on trade are even larger than those suggested in the literature. A more detailed investigation of the downward bias in the OLS estimates is documented in Mirza (2008). (That paper also takes a step further by designing a theoretical model of monopolistic competition that incorporates endogenous investments in trade facilitation that justifies the need for a simultaneous approach to estimate the effects of trade facilitation on trade.)

The second stage had an impressive R-squared value of 0.78. This implies that 78% of the variations in trade were explained by the exogenous variables in the model. The first stage of the regression also had a high R-squared value of 0.81, which suggested that the instrumental and other exogenous variables explain a large part of the variation in trade facilitation. The coefficient estimates for all variables were statistically significant at the 1% level. Overall, the model was successful in explaining a large portion of cross-country variations in trade flows.

Based on the results, the coefficient estimate for enhancing the level of an exporter's trade facilitation is 5.53—it is expected that increasing an exporter's trade facilitation by 1% would boost trade by 5.53%. The equivalent coefficient estimate for improving an importer's trade facilitation is 4.53. This implies that

[2] Instrumental variables are used for they are appropriate in estimating the expected cross-country trade facilitation levels but they are uncorrelated with trade flows. Refer to Appendix 2.3 for a detailed explanation.

Table 2.1: Correlation Matrix for Explanatory Variables

Explanatory Variable	Trade	Exp TF	Imp TF	Tariff	GDP	GDPpc	Dist	Lang	Land-lock	Border	Exp Road	Exp Paved	Exp Conges	Exp Gov	Exp CPI	Imp Road	Imp Paved	Imp Conges	Imp Gov	Imp CPI
Trade	1.00																			
Exp TF	0.62	1.00																		
Imp TF	0.42	0.14	1.00																	
Tariff	(0.28)	(0.18)	(0.29)	1.00																
GDP	0.81	0.64	0.41	(0.12)	1.00															
GDPpc	0.60	0.75	0.47	(0.27)	0.63	1.00														
Dist	(0.32)	(0.10)	(0.10)	0.20	(0.03)	(0.11)	1.00													
Lang	0.09	(0.04)	(0.09)	0.00	(0.06)	(0.04)	(0.13)	1.00												
Landlock	(0.32)	(0.26)	(0.18)	(0.03)	(0.31)	(0.28)	(0.08)	(0.05)	1.00											
Border	0.21	(0.02)	0.07	(0.07)	0.07	0.00	(0.38)	0.10	0.04	1.00										
Exp Road	0.42	0.54	0.12	(0.10)	0.38	0.46	(0.20)	0.00	(0.15)	(0.01)	1.00									
Exp Paved	0.40	0.50	0.11	(0.13)	0.32	0.48	(0.25)	0.01	(0.12)	0.01	0.42	1.00								
Exp Conges	0.53	0.74	0.15	(0.15)	0.50	0.76	(0.09)	(0.02)	(0.28)	0.01	0.45	0.55	1.00							
Exp Gov	0.31	0.44	0.11	(0.14)	0.27	0.51	(0.21)	0.00	(0.10)	0.03	0.45	0.35	0.60	1.00						
Exp CPI	0.49	0.83	0.14	(0.17)	0.48	0.76	(0.11)	0.00	(0.24)	(0.04)	0.51	0.53	0.77	0.61	1.00					
Imp Road	0.09	0.00	0.38	(0.28)	0.00	0.16	(0.18)	(0.11)	0.05	(0.01)	0.01	0.05	0.02	0.02	0.01	1.00				
Imp Paved	0.24	0.03	0.37	(0.09)	0.17	0.24	(0.17)	(0.12)	0.00	0.02	0.04	0.06	0.05	0.03	0.04	0.28	1.00			
Imp Veh	0.29	0.19	0.53	(0.32)	0.20	0.53	(0.22)	(0.14)	(0.11)	0.03	0.15	0.16	0.19	0.16	0.19	0.46	0.51	1.00		
Imp Gov	0.02	0.06	0.11	(0.13)	(0.04)	0.20	(0.22)	(0.10)	0.05	(0.01)	0.06	0.08	0.05	0.06	0.06	0.42	0.18	0.54	1.00	
Imp CPI	0.27	0.17	0.67	(0.29)	0.18	0.54	(0.13)	(0.03)	(0.18)	0.02	0.14	0.13	0.16	0.13	0.17	0.45	0.37	0.63	0.38	1.00

() = negative, Border = common border, Conges = congestion, CPI = Corruption Perceptions Index, Dist = distance, Exp = exporter, GDP = gross domestic product, GDPpc = gross domestic product per capita, Gov = relative size of government expenditure, Imp = importer, Landlock = landlocked, Lang = common language, Paved = proportion of paved roads, Road = road density, TF = trade facilitation.

Source: Authors' calculations.

Table 2.2: Benchmark Regression Results

Explanatory Variables	IV Model using LPI		OLS Model		IV Model using Time	
	Coefficient	Std. Error	Coefficient	Std. Error	Coefficient	Std. Error
Log of Exporters' Trade Facilitation	5.53	0.45	3.36	0.26	(1.44)	0.14
Log of Importers' Trade Facilitation	4.53	0.41	2.14	0.23	(0.95)	0.10
Log of Tariff	(3.65)	0.48	(4.44)	0.48	(4.22)	0.47
Log Product of Real GDPs	0.86	0.02	0.94	0.02	1.06	0.02
Log Product of Per Capita Real GDPs	(0.31)	0.04	(0.13)	0.03	(0.28)	0.04
Log Distance	(0.96)	0.04	(1.00)	0.04	(0.98)	0.04
Dummy for Common Language	1.13	0.08	1.05	0.08	1.03	0.09
Dummy for Landlocked	(0.59)	0.07	(0.65)	0.07	(0.26)	0.08
Dummy for Common Border	1.40	0.22	1.33	0.20	1.43	0.22
Constant	(37.66)	0.81	(39.33)	0.75	(30.09)	1.33
R-squared	0.78		0.79		0.76	
F(9, no. of observations); Prob>F	1,362.61: 0.00		1,460.90: 0.00		1,287.60: 0.00	
Number of Observations	3,614		3,614		3,601	

( ) = negative, IV = instrumental variable, LPI = Logistics Performance Index, OLS = ordinary least squares.

Results are statistically significant at the 1% level for all variables.

Source: Authors' calculations.

countries will have a larger effect on increasing exports from own-country reforms rather than from importing-country reforms. The larger effect of enhancing exporters' rather than importers' trade facilitation is also partly due to the fact that the pattern of trade displayed is from South to North and from South to South. Since exporters in the sample are representative of low-income countries with low-quality border infrastructure, improving their trade facilitation is predicted to have a larger effect on bilateral trade. This also suggests that the marginal benefits of improving trade facilitation would be larger for less developed countries than more developed economies.

The coefficient estimates for the other variables in the model were consistent with expectations and closely resembled findings from the empirical literature. The elasticity of trade with respect to tariffs was -3.65—a 1% reduction in tariffs would increase trade by 3.65%. Similar to other gravity model results, this suggests that larger countries trade more. The coefficient estimate for distance was 0.96—an increase in the great-circle distance[3] by 1% would reduce trade values by 0.96%; Wilson et al. (2005) claimed a coefficient estimate of -1.26 for distance while Rose (2003) put forward an estimate of -1.12. Countries that have the same language are expected to trade 1.13% more than countries with different languages. Countries that are landlocked trade 0.59% less than others. If two countries share a common border, their expected trade would increase by 1.4%. Thus the sign and magnitude of the coefficient estimates were as expected and all estimates were statistically significant at the 1% level. The only deviation from expectation was that the sign for the per capita real GDP was negative. This perhaps can be explained by the high correlation of per capita real GDP with LPI and real GDP, which extract the variations in log of per capita real GDP with trade. Excluding either LPI or real GDP from the regression equation resolved this issue of multi-collinearity and changed the sign of per capita real GDP back to positive. However, the variable of per capita real GDP is used in addition to real GDP in the model, so as to control for income in addition to the size of the trading countries.

[3] Standard unit for measuring distance between different regions of the world.

It is possible to estimate the relative effects of trade facilitation versus tariffs on trade using the econometric model. A comparison of standardized coefficients of tariffs and trade facilitation showed that the relative magnitudes of the impact of trade facilitation of an exporter (0.315) and of an importer (0.208) on bilateral trade were larger than that of tariffs (-0.088) and all other explanatory variables. This suggests that at the turn of the twenty-first century trade facilitation posed a more significant barrier to trade than tariffs. Massive trade liberalization around the globe for a decade reduced the relevance of tariffs as trade barriers and increased the importance of other barriers to trade. Given that the trade data reflect global trade for 2001, it incorporated many of the changes undertaken under the Uruguay Round negotiations as well as numerous bilateral trade agreements. Since the 1990s, more than 250 regional trade agreements have been reported to the World Trade Organization and about 70 others are known to be operational. These significant liberalization efforts have continued to reduce the importance of tariffs as trade barriers while other trade costs such as trade facilitation are taking much larger shares in total trade costs.

It is also important to compare the findings obtained in this study across alternative model specifications and data. Data columns three and four of Table 2.2 show results from the simple OLS regression model, which assumed trade facilitation to be exogenous. Based on the results, an increase in an exporter's and importer's trade facilitation by 1% would increase trade volumes by 3.36% and 2.14%, respectively. The model predicted the effect of trade facilitation to be smaller compared to the two-stage least squares model. Hence, restricting the model by assuming exogeneity underestimates the effect of improving trade facilitation on trade flows. Since in this model the effect of trade facilitation on trade was smaller, the effect of tariffs on trade was biased upward (-4.44). The coefficient estimates for all other variables were almost the same and only changed marginally.

Measuring Trade Facilitation Using Data on Timeliness

Model results can also be compared to those in papers that model trade facilitation using data on timeliness. Similar to Persson (2007) and Djankov et al. (2006), the study used the World Bank's *Doing Business* database to study the effect of reducing time on trade flows using the same structure as the benchmark model. This was done by replacing the trade facilitation variable with data on delays for exporting and importing. The exporting time was the time taken for goods to physically move from the production site onto ships in the port. It also included the time required for the completion of customs, administrative, and port procedural requirements as well as other paperwork associated with trading. Since this incorporated all the time taken for local transportation, customs clearance, and other waiting times at the border, it provided a useful measure for the degree of efficiency in trading. Using this alternative dataset, the results revealed the coefficient estimates for exporting and importing times to be equal to -1.44 and -0.95, respectively. These values are very similar to those estimated in the literature. Persson (2007) assessed exporters' and importers' trade facilitation at -1.5 and -1.3 for the trade of African, Caribbean, and Pacific countries with the EU. In order to compare the coefficient estimates to the LPI-based estimates, these values have to be translated into a common metric.

Table 2.3 compares the effect of enhancing trade facilitation using the survey-based LPI measures of trade facilitation and time measures of trade facilitation. It was hoped that the effect of trade facilitation on trade would be more or less the same, irrespective of the measure of trade facilitation that was used. Since results may be sensitive to the levels of country-specific trade facilitation measures, simulations based on broader sets of countries were considered. Specifically, the model simulated the effect of improving trade facilitation up to half the average level of middle-income countries for two sets of countries: low-income countries and South Asian countries. Results of the model showed that the expected changes in trade were strikingly similar whether trade facilitation was modeled using the LPI or the number of days delayed measure.

The LPI for low-income exporting countries was increased from 2.40 to 2.56, which was half of the average level of middle-income countries. Implementing a similar shock to enhance the trade facilitation level to half the average of middle-income countries entailed reducing exporting time from 42 to 33 days. Accordingly, trade increased by 36.5% using the LPI-based simulation compared to 38.1% using

Table 2.3: Robustness Check for Simulations using LPI-based versus Time-based Data

Type of Simulation	Initial Level	Final Level	Effect of Exporting Country Reforms on Trade (%)	Effect of Importing Country Reforms on Trade (%)
Low-income Countries				
LPI-based	2.40	2.56	36.5	29.0
Exporter's Time-based	42	33	38.1	n.a.
Importer's Time-based	52	42	n.a.	23.1

Type of Simulation	Initial Level	Final Level	Effect of Exporting Country Reforms on Trade (%)	Effect of Importing Country Reforms on Trade (%)
South Asian Countries				
LPI-based	2.54	2.61	16.2	13.1
Exporter's Time-based	31	28	16.1	n.a.
Importer's Time-based	36	34	n.a.	6.2

LPI = Logistics Performance Index, n.a. = not applicable.

Source: Authors' calculations.

time-based simulation. A similar shock was conducted by increasing the LPI levels of low-income importing countries and reducing the number of importing days from 52 to 42 days. This time, trade went up by 29% using LPI-based simulation and by 23.1% using the time-based simulation.

A similar exercise was conducted for South Asian economies. Here, enhancing exporters' trade facilitation bolstered trade by 16.2% with LPI-based simulations and by 16.1% with time-based simulations. The consistency of the effect of trade facilitation on trade shows the close resemblance between survey-based evaluations and timeliness data. Thus there is more confidence in the ability of the model to have captured well the nature of cross-sectional differences in trade facilitation with LPI-based simulations as well as time-based data. Of course, the advantage of the LPI measure is that it is multidimensional—capturing not only timeliness of trade but also other aspects.

Effects on Trade across Components of the Logistics Performance Index

This section describes the results of the study's investigation into the relative size of trade impacts across various components of the LPI. The LPI was constructed using the principal components analysis method. This was used instead of simply averaging the component parts of the index in order to reduce the noise in the data. Treated as independent variables, the components of the LPI of particular interest, and therefore included in the analysis, are: efficiency of customs and other border procedures, quality of transport and IT infrastructure, and timeliness. Needless to say, the costs associated with improving customs procedures are likely to be much lower than those for improving the quality of infrastructure. Improving customs and border-related procedures usually entails improving efficiency by reducing paperwork requirements; simplifying lengthy, complex clearance procedures; enhancing transparency; and reducing corruption and bureaucracy among public officials. While these may be difficult to achieve, they are not inherently costly measures. Improving infrastructure however, such as building highways and ports, entails substantial outlays.

Table 2.4 shows the impacts of changes in customs, infrastructure, and timeliness—the disaggregated LPI components—on trade flows. Using trade flows as the dependent variable for each of the above variables, the model predicted that improving customs and border-related procedures has a relatively smaller

Table 2.4: Analyzing the Trade Impact across Different Aspects of Trade Facilitation

	Customs		Infrastructure		Timeliness	
Explanatory Variables	**Coefficient**	**Std. Error**	**Coefficient**	**Std. Error**	**Coefficient**	**Std. Error**
Log of Exporters' Trade Facilitation	4.02	0.36	5.02	0.39	5.20	0.66
Log of Importers' Trade Facilitation	3.43	0.36	4.00	0.35	4.22	0.61
Log of Tariff	(3.88)	0.48	(3.82)	0.48	(3.95)	0.51
Log Product of Real GDPs	0.94	0.02	0.85	0.02	0.92	0.02
Log Product of Per Capita Real GDP	(0.25)	0.03	(0.39)	0.04	(0.22)	0.04
Log Distance	(0.97)	0.04	(0.94)	0.04	(0.98)	0.04
Dummy for Common Language	1.07	0.09	1.18	0.08	1.18	0.09
Dummy for Landlocked	(0.63)	0.07	(0.56)	0.07	(0.72)	0.07
Dummy for Common Border	1.44	0.22	1.43	0.22	1.27	0.22
Constant	(39.29)	0.77	(34.55)	0.93	(42.43)	0.77
R-squared	0.78		0.79		0.76	
F(9, no. of observations); Prob>F	1,337.15: 0.00		1,399.36: 0.00		1,296.89: 0.00	
Number of Observations	3,614		3,614		3,614	

() = negative.

Results are statistically significant at the 1% level for all variables.

Source: Authors' calculations.

impact on trade flows than improving the physical and electronic infrastructure. The elasticity of an exporter's (importer's) customs procedures with respect to trade was placed at 4.02 (3.43) and that of infrastructure at 5.02 (4.00). These were expected since improving infrastructure is likely to reduce transportation costs and therefore, has a more direct impact on per unit costs of tradable commodities. The impact of enhancing timeliness (5.20 for exporters and 4.22 for importers) was similar to that of using the composite LPI, since timeliness captures a broader set of border-related aspects.

Effect of Trade Facilitation across Sectors

Inefficiency in trading created by various border frictions affects trade volumes of some goods more than others. Lengthy waiting time at the border and delays in transportation affect goods that are more time-sensitive. For instance, perishable goods, such as flowers, newspapers, and magazines as well as goods that are in fashion, such as clothing and jewelry, are expected to show large decreases in value as trading time rises. Likewise, demand for intermediate inputs of manufacturing products is particularly sensitive to uncertainty in delivery, since these goods may halt the supply chain. In these cases, if two countries are the same in all respects except that one can ensure more efficient and timely delivery of time-sensitive goods, that country is likely to obtain a greater share of the global market for that product in a competitive environment.

In this section, results of a cross-sector analysis of the effect of trade facilitation on trade are discussed. The impact of border costs can be expected to vary across sectors depending on the characteristics of the traded good. Regressions were carried out for each aggregated sector as shown in Table 2.5. Results indicate that the impact of trade facilitation varies largely across sectors. The coefficient estimate of exporter specific trade facilitation was quite large for automobiles and parts (7.27), other manufacturing (7.08), and T&C (4.86). These suggest that own-country trade facilitation reforms can have large impacts on boosting exports for these sectors. The relative impact of exporters' trade facilitation was even larger than the effects of tariffs for these sectors. This result is expected since demand for T&C may be time-sensitive due to changes in tastes and fashion.

Table 2.5: Effect of Trade Facilitation on Trade Varies Across Sectors

	Agriculture		Extraction and Mining		Other Manufacturing		Textiles and Clothing		Automobiles and Parts	
Explanatory Variables	Coef-ficient	Std. Error	Coef-ficient	Std. Error	Coef-ficient	Std. Error	Coef-ficient	Std. Error	Coef-ficient	Std. Error
Log of Exporters' Trade Facilitation	0.19	0.60	2.10	0.69	7.08	0.46	4.86	0.49	7.27	0.56
Log of Importers' Trade Facilitation	6.46	0.51	7.22	0.58	3.48	0.42	5.26	0.45	0.83	0.48
Log of Tariff	(1.74)	0.36	(5.67)	0.65	(4.16)	0.54	(0.94)	0.25	(1.23)	0.37
Log Product of Real GDP	0.97	0.03	0.94	0.03	0.84	0.02	0.83	0.02	0.92	0.03
Log Product of Per Capita Real GDPs	(0.34)	0.05	(0.43)	0.06	(0.26)	0.04	(0.39)	0.04	0.11	0.05
Log Distance	(1.05)	0.05	(1.13)	0.06	(0.96)	0.04	(1.13)	0.04	(1.02)	0.05
Dummy for Common Language	0.61	0.12	0.69	0.13	1.36	0.09	0.93	0.11	0.76	0.12
Dummy for Landlocked	(0.55)	0.09	(0.87)	0.09	(0.67)	0.07	(0.66)	0.07	(0.51)	0.09
Dummy for Common Border	1.24	0.26	2.39	0.35	1.59	0.23	1.07	0.26	2.14	0.31
Constant	(41.55)	1.07	(42.81)	1.15	(38.82)	0.85	(37.01)	0.87	(50.29)	1.03
R-squared	0.59		0.62		0.80		0.70		0.75	
F(9, no. of observations); Prob>F	732.89: 0.00		931.13: 0.00		1,576.32: 0.00		1,106.95: 0.00		1,411.38: 0.00	
Number of Observations	3,614		3,614		3,601		3,614		3,567	

() = negative.

Results are statistically significant at the 1% level for all variables.

Source: Authors' calculations.

Demand for automobiles and parts and for other manufacturing goods, which includes intermediate inputs, is also particularly sensitive because they may halt the production chain in the industries of the importing countries. This implies that own-country trade facilitation reforms will enable exporters to obtain larger shares in global markets for these products. The role of exporters' trade facilitation on trade in agricultural and extraction goods appears to be much smaller and statistically insignificant.

The role of importers' trade facilitation was also sizable and statistically significant for most sectors, suggesting that reforms in importing countries will affect bilateral trade volumes. The coefficient estimate of importers' trade facilitation in T&C was slightly larger than that of exporters' trade facilitation. This implies that own-country reforms will have large effects on both imports and exports of T&C, because countries exporting products in this sector also obtain large quantities of raw materials for these exports. The results suggest that the poorer the amenities at the borders of these countries, the larger the costs of importing and exporting, and hence the fewer the benefits from trade. Improving own-country trade facilitation will enable these countries to obtain intermediate textile inputs at lower cost and thereby boost production of T&C for domestic and export sales.

While own-country trade facilitation has a large impact on the export of automobiles and parts, it does not have a significant impact on imports of this category. As discussed before, exports of automobiles and parts are contracted to countries that have

efficient trading systems at the border, to ensure smooth delivery. The absence of a significant impact of trade facilitation on imports is likely because imports of automobiles and parts depend primarily on other factors, such as whether the countries have automobile assembly industries, per capita income level, and consumer demand for automobiles.

Turning to the other variables in the model, the effects of tariffs were higher for extraction and mining and other manufacturing than for the other sectors. This implies that tariffs play a larger role in determining global trade flows for these commodities. Trade in extraction and mining and in automobiles and parts was much larger for countries sharing a common border. This is plausible because these goods are relatively more expensive to transport, and hence traded more with neighboring countries. Results were also statistically significant for all variables, except for exporters' trade facilitation in agriculture and in extraction and mining, and importers' trade facilitation and product of per capita GDPs in automobiles and parts.

Policy Scenarios and Expected Impacts on Trade

Policy Scenarios

In order to quantify the effects of trade facilitation on regional and global trade, the econometric model results were used to simulate the partial equilibrium effect of improving trade facilitation in South Asia. As noted previously, LPI captures a wide variety of trade facilitation, including infrastructure, efficiency of customs procedures, relative sizes of trading costs at the border, and timeliness. Thus a positive shock to this index corresponds to increases in the various aspects of border logistics, entailing significant improvements in overall efficiency, including customs; infrastructure; timeliness; rates of transporting cargo using rail, ships, and other media; and rental rates of warehouses.

Since these investments are costly and budgets are inherently limited, particularly for developing countries, the effect of improving the trade facilitation level of South Asian countries by reasonable amounts was simulated on the basis of what may be realistically attainable. This corresponds to roughly the change in trade facilitation required to move the South Asian region to half the average of all middle-income countries. Improvements in trade facilitation were assumed to be uniform across Bangladesh, Pakistan, and Sri Lanka, as well as an aggregated region called "Rest of South Asia," which comprises Afghanistan, Bhutan, Maldives, and Nepal. According to the LPI data, the level of trade facilitation is highest in India, taking a value of 3.07.[4] Indeed, it was even higher than the average of middle-income countries (which have an LPI of 2.69). Thus, further reforms in India are predicted to be more expensive and difficult to attain.

Simulations were then made on the effect of enhancing India's trade facilitation by only half the level of improvement in each of the countries in South Asia. Specifically, the LPI was increased by 0.15 for each country in South Asia (and by 0.075 in India); based on the analysis presented above, a 0.15 increase in the LPI would correspond to a reduction in exporting or importing time of about 10 days.

Partial Equilibrium Analysis Using the Econometric Model

The coefficient estimates of trade facilitation for each of the five sectors shown in Table 2.5 were used to simulate the effect of enhancing trade facilitation in South Asia. Tables 2.6 and 2.7 show the estimated impacts on exports and imports across sectors. Based on the results, there were large increases in exports of T&C, automobiles and parts, and other manufacturing goods. Imports of agriculture and of

[4] Although India ranks much higher in LPI among all South Asian countries, the quality of trade facilitation as measured by other indexes, such as the World Bank's *Doing Business*, suggests poorer trade facilitation in India in certain aspects. India's performance relative to others varies according to what is being measured, such as documentation preparation, assembly, and customs. Given that trade facilitation measures various qualitative aspects and uses various techniques to capture the essence, it is difficult to compare such disaggregated data. Also, the World Bank's dataset measures time of trading using data for a very limited set of products, particularly tea, spices, and a few other goods. This partly explains why the rankings of South Asian countries do not match precisely across the two datasets. Nevertheless, the important point is that results on trade impacts remain robust across these two different measures of trade facilitation.

Table 2.6: Impact of Trade Facilitation Reforms on Changes in Exports in South Asia (%)

Sector	Bangladesh	India	Pakistan	Sri Lanka	Rest of South Asia
Agriculture	0	0	0	0	0
Extraction and Mining	0	0	0	0	0
Textiles and Clothing	33	12	31	34	39
Automobiles and Parts	54	19	50	55	64
Other Manufacturing	52	19	48	54	62

Source: Authors' calculations.

Table 2.7: Impact of Trade Facilitation Reforms on Changes in Imports in South Asia (%)

Sector	Bangladesh	India	Pakistan	Sri Lanka	Rest of South Asia
Agriculture	46	17	43	48	55
Extraction and Mining	53	19	49	55	63
Textiles and Clothing	36	14	34	38	43
Automobiles and Parts	5	2	5	5	6
Other Manufacturing	23	9	21	23	27

Source: Authors' calculations.

extraction and mining were also significantly large. The estimated impacts on exports of agricultural and of extraction and mining goods were 0 because the coefficient estimates of improving an exporter's trade facilitation were statistically insignificant for these commodities. The impacts on trade were similar for Bangladesh, Pakistan, and Sri Lanka; smaller for India; and larger for the Rest of South Asia. Changes in India were smaller due to the smaller shock while those in the Rest of South Asia were larger because they are starting from a very low level of trade facilitation; therefore, the common increment to the LPI represented a larger percentage increase in this trade facilitation index.

Of course, this partial equilibrium analysis disregarded competition for labor and capital across diverse sectors of the economy. Not all sectors can expand simultaneously due to limited endowments. Neither did this partial equilibrium analysis consider intersector linkages. For example, consider the exports of textile products from Bangladesh to Europe. These exports may increase because of improved export facilitation but they may also benefit from improved import facilitation. Since Bangladesh can now import intermediate inputs of yarn and cotton from India at lower cost—owing to import trade facilitation reforms in Bangladesh and export reforms in India—Bangladeshi exports to Europe will receive a boost. Given that these indirect effects were not observable from the econometric model, they were analyzed using the general equilibrium model.

Perhaps most important, the partial equilibrium analysis did not impose any overall balance-of-payments equilibrium condition on these economies. Given current levels of savings and investment, any increase in imports must be offset by an increase in exports. Furthermore, it was expected that improved efficiency in trading will make South Asia more attractive for investors. If investment increases (more than any rise in savings), the trade balance can deteriorate to equate the sources and uses of national expenditure. These macroeconomic closures that link various aspects of the economy are modeled in a general equilibrium setting. Thus, in a general equilibrium model, all these additional impacts of trade facilitation on South Asia's economies can be captured.

General Equilibrium Analysis Using a CGE Model

In order to estimate both the direct and indirect impacts of enhancing trade facilitation on trade in South Asia as well as with the rest of the world, a CGE model developed by the Center for Global Trade Analysis was employed. Estimates of the direct impacts obtained from the above simulations were used to calibrate trade facilitation variables in the CGE model. This was done by simulating the effect of changing trade flows and asking how much of an improvement in trade facilitation would be required to elicit this change in trade flows. Technically, this calibration was achieved by internalizing the (normally externally determined) trade facilitation variable for a given sector or region and introducing shocks to that country's trade volume by the amount predicted from the econometric model. These trade facilitation variables were specific to exports and imports since the magnitude of impacts were predicted to be different by the econometric model. Having performed this calibration exercise for all sectors and countries in the region, the simulation of their combined impact was then carried out. This was done by returning to the standard general equilibrium closure in which the trade facilitation variables were exogenous and shocks were imposed on all of them simultaneously, as would be the case with a comprehensive set of regional reforms in the trade facilitation arena. The results of this process are discussed below.

Macroeconomic Impacts Using a CGE Model

This section discusses the macroeconomic effects of trade facilitation reforms obtained from the simulations in the CGE model. Results show that trade facilitation has large impacts on trade flows, export prices, real exchange rates, and wages. Demand for South Asian T&C would strongly expand in the wake of trade facilitation. Greater demand would push up export prices and lead to real currency appreciation. Changes in trade flows would alter the production structure and employment. Increases in production and exports would positively affect the real wages of skilled and unskilled labor and returns to capital. Regional income and per capita consumption would rise in South Asia and would improve welfare.

Intraregional trade was estimated to increase significantly within South Asia; the proportionate rise in intraregional trade is larger than in interregional trade. Table 2.8 presents sector changes in intraregional and interregional trade[5] for all countries in South Asia, and Table 2.9 decomposes these changes by country and sector. Intraregional trade in all tradable goods is expected to rise by $5.8 billion from $7.8 billion to $13.6 billion, corresponding to 75% growth. At the same time, South Asia's total trade with the rest of the world would climb from $140 billion to $170.7 billion, registering an increase of $30.8 billion or 22%. Table 2.8 indicates that proportionate increases in intraregional trade would

Table 2.8: Impact on South Asia's Trade Volumes, Intraregional versus Interregional ($ million)

	Intraregional Trade			Interregional Trade		
Sector	Initial Volume	Change (in levels)	% Change	Initial Volume	Change (in levels)	% Change
Agriculture	1,211	767	63	8,042	1,597	20
Extraction and Mining	730	(7)	(1)	16,812	(104)	(1)
Textiles and Clothing	1,411	1,365	97	36,296	12,596	35
Automobiles and Parts	151	48	31	2,050	367	18
Other Manufacturing	4,267	3,689	86	76,694	16,387	21
All Sectors	**7,770**	**5,862**	**75**	**139,894**	**30,843**	**22**

() = negative.

Source: Authors' calculations.

[5] Total intraregional trade measures total exports and imports between South Asian countries, while interregional trade measures total exports from South Asia to the rest of the world and total imports of South Asia from the rest of the world.

be larger than in interregional trade for all sectors, partly due to the trade facilitation improvements carried out in South Asian countries. Hence, when both trading partners push through with trade facilitation reforms, the impact on bilateral trade is expected to be significantly larger.

Table 2.9 illustrates that for most goods, proportionate increases in intraregional trade would be much larger than in interregional trade. For instance, intraregional trade growth in T&C is predicted to be substantial for Pakistan (151%) and the Rest of South Asia (117%). Similarly for other manufacturing goods, growth in intraregional trade would be more than three times larger than growth in interregional trade for most countries; growth in intraregional versus interregional trade for India is approximated at 93% and 21%, respectively; while the figures for Pakistan are 108% and 25%, respectively. Agricultural trade would expand relatively more within the region for some countries—India (66% versus 5%) and Sri Lanka (7% versus -27%)—and grow more with the rest of the world for others—Pakistan (32% versus 57%). The last two data columns of Table 2.9 show that total intraregional trade growth would be larger for all countries. Thus overall intraregional trade growth for all economies is predicted to be stronger.

To further illustrate the driving forces behind large increases in intraregional trade, Tables 2.10 and 2.11 decompose total intraregional trade into exports and imports with respect to region and sector. Some of the dynamics in trade flows across countries highlight the following: total intraregional trade would expand by a sizable 75%. Most of this increase would be accounted for by larger exports of other manufacturing goods ($1,774 million), T&C ($664 million), and agriculture ($354 million). Total exports from India ($1.9 billion) would make up nearly two thirds of total increases in intraregional exports ($2.8 billion) from South Asia. There would also be substantial increases in exports from Pakistan ($284 million) and the Rest of South Asia ($500 million); these would consist largely of T&C and other manufacturing goods exports. Total exports from Bangladesh and Sri Lanka to other South Asian countries, however, would be much smaller.

As regards imports, as shown in Table 2.11 there would be large increases in intraregional imports of Bangladesh ($1.5 billion) and these would form nearly half the increases in total intraregional imports ($3.1 billion). Most of that country's imports would be in the form of other manufacturing goods ($700 million), T&C ($443 million) from India and Pakistan, and agricultural goods ($313 million). The increase in agricultural imports would be the result of specialization away from agricultural production to T&C production, and of the larger income and consumption levels following trade facilitation reforms. Intraregional imports would also increase for all other countries but by smaller degrees, although imports of other manufacturing goods would rise significantly.

Table 2.9: Changes in Intraregional versus Interregional Trade in South Asia, by Country and Sector (%)

	Agriculture		Extraction and Mining		Textiles and Clothing		Automobiles and Parts		Other Manufacturing		All Commodities	
Country	**Intra.**	**Inter.**	**Intra.**	**Inter.**	**Intra.**	**Inter.**	**Intra.**	**Inter.**	**Intra.**	**Inter.**	**Intra.**	**Inter.**
Bangladesh	109	112	29	20	128	82	39	25	94	32	103	62
India	66	5	(1)	0	75	1	30	10	93	21	75	14
Pakistan	32	57	(10)	(5)	151	49	107	41	108	25	97	33
Sri Lanka	7	(27)	(23)	(16)	53	44	48	35	40	4	38	17
Rest of South Asia	50	49	(4)	(1)	117	65	13	6	78	38	60	39
All South Asian Countries	**63**	**20**	**(1)**	**(1)**	**97**	**35**	**31**	**18**	**86**	**21**	**75**	**22**

() = negative.

Source: Authors' calculations.

Table 2.10: Changes in Intraregional Exports in South Asia, by Country and Sector ($ million)

Sector	Bangladesh	India	Pakistan	Sri Lanka	Rest of South Asia	All South Asian Countries
Agriculture	31	311	(17)	(2)	32	354
Extraction and Mining	(2)	7	0	(2)	(9)	(5)
Textiles and Clothing	14	268	207	85	91	664
Automobiles and Parts	0	22	1	0	0	23
Other Manufacturing	(11)	1,316	93	(11)	386	1,774
All Commodities	**32**	**1,925**	**284**	**70**	**500**	**2,811**

() = negative.

Source: Authors' calculations.

Table 2.11: Changes in Intraregional Imports in South Asia, by Country and Sector ($ million)

Sector	Bangladesh	India	Pakistan	Sri Lanka	Rest of South Asia	All South Asian Countries
Agriculture	313	(15)	78	12	24	412
Extraction and Mining	16	(11)	(1)	(1)	(4)	(2)
Textiles and Clothing	443	89	12	61	97	702
Automobiles and Parts	7	0	0	13	4	24
Other Manufacturing	700	375	442	201	197	1,915
All Commodities	**1,480**	**437**	**531**	**285**	**318**	**3,051**

() = negative.

Source: Authors' calculations.

Among all sectors, intraregional trade in T&C and in other manufacturing goods stands out. There would be large increases in exports of other manufacturing goods ($1.3 billion) from India. This shows that India would gain regional competitiveness in producing manufacturing goods following trade reforms. Similarly, India and Pakistan would export more T&C. Most of the imports from India and Pakistan would consist of raw materials and intermediate inputs of textiles that are used in the production of exportable textiles from Bangladesh, Sri Lanka, and the Rest of South Asia. Consequently, any measures that increase the timeliness and reliability of trade in these goods are likely to have a large impact on imports of intermediate inputs.

Changes in Trade Flows

This section looks at the impacts on aggregate exports and imports to all regions. Tables 2.12 and 2.13 show the changes in total exports and imports from South Asia. Total exports and imports are predicted to go up by $17.5 billion and $19.2 billion, respectively. Hence, South Asia's trade volume would increase by $36.7 billion. Since imports are expected to expand more than exports, the trade balance is foreseen to deteriorate by $1.8 billion. Overall, however, trade volumes are forecast to grow significantly as a result of trade facilitation reforms in South Asia.

Table 2.12 shows a decline in the exports of other sectors, particularly agriculture. This stems from several factors. First, the econometric model showed that lower border costs had different effects depending on the type of industry: trade facilitation reforms had larger effects on T&C, automobiles and parts, and other manufacturing exports, but had negligible effects on agriculture and extraction and mining. Second, as exports of manufacturing goods rise, resources are reallocated to these industries.

Table 2.12: Impact on Total Export Values in South Asia, by Sector ($ million)

Sector	Bangladesh	India	Pakistan	Sri Lanka	Rest of South Asia	All South Asian Countries
Agriculture	17	8	(226)	(372)	35	(538)
Extraction and Mining	(6)	(78)	(17)	(24)	(15)	(140)
Textiles and Clothing	4,639	42	3,320	1,924	480	10,405
Automobiles and Parts	(2)	60	4	(2)	1	62
Other Manufacturing	(357)	8,155	(92)	(517)	489	7,678
All Commodities	**4,291**	**8,187**	**2,990**	**1,008**	**991**	**17,467**

() = negative.

Source: Authors' calculations.

The crowding-out effect of resources causes factor prices to rise in all sectors. This reduces the relative competitiveness of agricultural goods in the global market and leads to declines in exports.

There would be large increases in South Asia's imports as shown in Table 2.13. Total T&C imports are expected to climb by $3.6 billion, with particularly large increases from Bangladesh and Pakistan. Currently, more than half total textile imports are in cotton, fiber, yarn, and other textile materials that are used as intermediate inputs in these countries. Most countries in South Asia import a wide variety of linen and cotton from India. At the same time, there is a large volume of intra-industry trade in textiles and readymade clothing. The US and EU outsource production of textiles to countries in South Asia where labor is less expensive but provide their own-country raw materials to maintain product quality. This explains why a large portion of imports consists of intermediate inputs and why imports are likely to rise along with the expansion of T&C exports.

Agricultural imports would also record large increases, particularly in Bangladesh and Pakistan. Much import demand would be spurred by higher income and consumption levels in these countries. Also, as domestic agricultural goods become relatively more expensive, a larger share of demand would be met by foreign imports. Agricultural imports are also expected to expand due to declines in import prices of agricultural goods in the wake of trade facilitation, coupled with high elasticity of substitution for agricultural goods that are homogeneous, such as rice and wheat. Import demand for manufacturing goods would also go up substantially because of higher income and consumption. Moreover, a large fraction of the imports of manufacturing goods are used as intermediate inputs in producing manufacturing goods in India. This leads to larger intra-industry trade due to outsourcing.

The rise in competitiveness of South Asian goods following trade facilitation boosts demand for the region's products throughout the world. This increased demand gives rise to real exchange rate appreciation, which, in turn, will be reflected in higher wages and returns to other factors of production in the region. In the CGE model results, for instance, wages of unskilled labor are expected to increase by 24% in Pakistan, 16% in Bangladesh, 14% in Sri Lanka, and 2% in India. Wages of skilled labor should go up by 30% in Pakistan, 23% in Bangladesh, 12% in Sri Lanka, and 2% in India. The model likewise predicts that returns to capital will rise by 29% in Bangladesh, 16% in Pakistan and Sri Lanka, and 1% in India.

Female employment is also expected to climb in South Asia. This is because of the expansion of the T&C industry that employs a disproportionately large share of female workers. Women account for more than two thirds of the global labor force in the industry and the share is even higher in many parts of South Asia. Since real wages of unskilled labor in the industry will rise, the gender wage gap is expected to decrease in the region. Thus increases in trade, particularly larger exports of T&C, can contribute toward women's empowerment in the region.

Higher incomes are likely to boost domestic consumption and imports. Real consumption increases

Table 2.13: Impact on Total Import Values in South Asia, by Sector ($ million)

Sector	Bangladesh	India	Pakistan	Sri Lanka	Rest of South Asia	All South Asian Countries
Agriculture	1,246	507	1,008	72	69	2,902
Extraction and Mining	135	92	(107)	(88)	(4)	29
Textiles and Clothing	2,108	465	615	146	223	3,557
Automobiles and Parts	54	92	146	53	7	353
Other Manufacturing	2,743	5,835	2,532	858	430	12,398
All Commodities	**6,286**	**6,991**	**4,195**	**1,041**	**724**	**19,238**

() = negative.

Source: Authors' calculations.

for all countries in South Asia, as predicted by the CGE model, for example, come to 60% in Bangladesh, 41% in Pakistan, 31% in Sri Lanka, 5% in India, and 6% in the Rest of South Asia, indicating that standards of living will improve there.

As factor returns rise, so too do free on board (FOB) prices of exports. At the same time, the cost, insurance, freight (CIF) cost of imports from within the region falls, as trade facilitation lowers trade costs on intraregional trade. Therefore, it is no surprise that the model predicts an improvement in the terms of trade for South Asian economies by 18% in Pakistan, 14% in Bangladesh, 11% in Sri Lanka, 2% in India, and 1% in the Rest of South Asia. Coupled with the efficiency gains realized by trade facilitation, as well as the creation of additional trade, all these gains contribute to increased welfare, as measured by the equivalent variation of each country (based on net national expenditure). The aggregate welfare gain in South Asia is about $32 billion, although this does not account for the cost of attaining these improvements in trade facilitation.

The CGE model forecasts that of the percentage increases in welfare (equivalent variation as a percentage of initial expenditure) for all countries, proportionate welfare increases are largest in Pakistan (22%) and Bangladesh (20%)—corresponding to welfare gains of $12 billion and $8.8 billion, respectively—and smallest in India. This is largely because the degree of reforms in India is half that of each of the other countries in the region. In a side experiment, equal reforms for all countries in South Asia led to somewhat larger increases in welfare for India.[6]

Comparison with Tariffs

Additional experiments were conducted to compare the relative impacts of trade facilitation reforms and the removal of tariffs in South Asia. The experiment was designed to remove tariffs on all commodities for trade between South Asian countries. Results indicate that the relative impacts are smaller for the removal of tariffs than for improvements in trade facilitation. This is understandable since trade facilitation is consistent with open regionalism. For example, in addition to increases in intraregional trade, improvements in trade facilitation would lead to substantial increases in South Asia's trade with the rest of the world. In particular, exports from Bangladesh are predicted to rise by about $3.1 billion because of trade facilitation reforms and by $1.3 billion because of tariff removal; Indian exports would increase by $7.2 billion with trade facilitation reforms and by less than half that amount ($3.3 billion) with tariff removal. For all countries, increases in total exports and imports are expected to be larger from trade facilitation reforms than from tariff removal.

[6] Results indicate that India's welfare increases by $18.42 billion, equivalent to 4%, with equal reforms for all countries. There are no significant changes in welfare for other South Asian countries.

Conclusions and Policy Recommendations

This study has investigated the role of trade facilitation in achieving greater regional integration in South Asia. It began by constructing a gravity model to econometrically estimate the effect of trade facilitation on global trade flows of agricultural and manufacturing goods using data on 95 countries for 2001. Estimates from the gravity model show that trade facilitation plays an important role in determining patterns of global trade flows. The relative effect on bilateral trade of improving an exporter's border logistics is larger than that of improving an importer's trade facilitation. Using standardized coefficients, it was also found that the magnitude of the elasticity of trade was smaller with respect to tariffs than to trade facilitation. For robustness, the analysis was extended using alternative sets of data to measure trade facilitation (survey-based LPI versus data on trading time). Comparable coefficient estimates were determined from these data.

The analysis was likewise extended to a GTAP-based CGE model where the effect of enhancing trade facilitation in South Asia by incorporating estimates from the econometric model was simulated. Results indicate that trade facilitation reforms have large impacts on South Asian countries' trade among themselves and with the rest of the world and that such reforms are fundamentally consistent with open regionalism. In addition, the results show proportionate increases in intraregional trade to be relatively larger than increases in trade with the rest of the world. This implies that in the wake of trade facilitation reforms, South Asia would be somewhat more regionally integrated. In the study, intraregional trade increased by $5.8 billion or 75%, while interregional trade rose by $30.8 billion or 22%. Sector-level analysis reveals that proportionate increases in intraregional trade are larger in all countries for T&C, automobiles and parts, and other manufacturing goods.

The T&C industry represents an important engine of growth in South Asian trade. As depicted in the general equilibrium model, intraregional trade in T&C more than doubles for Bangladesh, Pakistan, and the Rest of South Asia with enhancements in trade facilitation to levels midway to the averages of middle-income countries. Imports of T&C from India and Pakistan are used as raw materials (e.g., knitting thread for the manufacture of textile products) and intermediate inputs (e.g., yarn and cotton for clothing production) in the textile industry in Bangladesh, Sri Lanka, and the Rest of South Asia. Availability of lower-cost inputs further increases competitiveness of the South Asian T&C-exporting sectors relative to the PRC and other competing exporters.

While most South Asian countries specialize in the T&C industry following trade facilitation reforms, resources in India are directed toward the automobiles and parts and other manufacturing industries. India obtains a larger share of the market for these goods both within South Asia and the rest of the world. This implies that lowering border costs causes larger outsourcing of manufacturing goods to India, where they can be produced with low-skill capital. Thus a shift of specialization from more agriculture-based production to manufacturing goods is expected as trade facilitation in India improves.

The CGE model predicts large macroeconomic impacts on the economies of South Asia. It predicts that increased competitiveness of South Asian goods in the global market will likely lead to real exchange rate appreciation. Indeed, under the trade facilitation scenario, real exchange rates strengthen in Bangladesh by 60%, Pakistan by 39%, and Sri Lanka by 35%. The model also sees higher real returns to labor and capital: real wages of unskilled labor increase by 24% in Pakistan, 16% in Bangladesh, and 14% in Sri Lanka. Increased employment in T&C raises women's employment in South Asia. Higher income lifts domestic consumption and therefore improves the standard of living. Further analysis reveals that positive terms-of-trade effects and efficiency gains lead to welfare increases of $32 billion in the region. Proportionate increases in welfare are largest in Bangladesh and Pakistan. One must bear in mind, however, that the increases in welfare do not account for costs associated with undertaking trade facilitation reforms. Additional research on the costs of various reforms will give a clearer picture of the net welfare gains of such reforms.

The study has also investigated the relative impacts across various components of trade facilitation. Results indicate that the quality of customs and

infrastructure has high and statistically significant impacts on trade flows. Since customs procedures, components, and physical infrastructure make South Asian LPI low, these would be excellent priority areas to address. Reducing bureaucracy and enhancing transparency should be among the first steps toward improving the customs environment. Developing infrastructure by increasing the number of cross-national highways, and by enhancing the quality and density of roads, will significantly contribute to reductions in unit trade costs.

The least developed countries in South Asia have the poorest trade facilitation. Since the general equilibrium model shows that under uniform trade facilitation reforms, returns to investments are larger for countries that have poorer facilitation, countries with lower levels of trade facilitation should obtain priority for reforms. Afghanistan, Bangladesh, and Nepal, for example, have much lower levels of trade facilitation than India. Longer waiting times and higher costs at the border significantly reduce the marketability of their products in the world market. Moreover, countries that are landlocked, such as Afghanistan, Bhutan, and Nepal, have to depend on transit permits. The lack of roads and highways across international borders poses formidable barriers to globalization for these countries. Thus, development of international roads, availability of land permits, and enhanced efficiency in cross-border trade will enable the less developed countries both to strengthen their comparative advantage in producing low-skill-intensive goods, such as T&C, and to perform better in the global market vis-à-vis competitors, such as the PRC, and high-income Asian countries that enjoy higher levels of trade facilitation. Increases in trade will also have a positive impact on employment of low-income workers and help in reducing poverty for these countries.

To summarize, trade facilitation reforms significantly contribute to greater regional integration in South Asia in terms of intraregional trade. Greater intraregional trade helps countries obtain lower-priced imports of intermediate inputs that are used in the production of exportable commodities. This increases the marketability of South Asian products to other regions in the world. Following trade facilitation reforms, all countries in South Asia produce and export more T&C; and India gains a larger share of the global market both for automobiles and parts and for other manufacturing goods. Such specialization toward manufacturing can potentially enable South Asia to attain higher economic growth rates similar to those in East Asia. Export growth increases employment, particularly women's employment in T&C. Increases in export prices further lead to increases in real wages, which can lift large numbers of low-income households out of poverty. Therefore, trade facilitation should become an integral part of the agenda for regional economic integration and development in South Asia.

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Appendix 2.1: Simulating the Poverty Impacts of Trade Facilitation Reforms in Bangladesh—The GTAP Poverty Module

To elicit the impacts on factor returns to low-income earners, the study used the framework published by Hertel et al. (2007). This modified version of the standard Center for Global Trade Analysis Project (GTAP) model (Hertel 1997) used a poverty module (Hertel et al. 2004) that incorporated household data from 15 focus countries designed to assess impacts of trade reforms on households in the neighborhood of the poverty line. Several characteristics of the poverty model make it appealing for this study. First, it incorporates detailed treatment of agriculture, and many of the poor in South Asia live in rural areas. Second, the model assists in poverty analysis by investigating short-run impacts across low-income households differentiated by their primary source of income. Finally, the model includes a specialized demand system to more accurately estimate the consumption behavior of low-income earners.

Quantitative analysis of poverty receives much attention in the deliberations of multilateral trade liberalization, and the poverty module facilitates such analysis. Most researchers exploit the expenditure side of household surveys to make inferences on poverty, due to greater reliability on spending data. While this is partially useful in measuring poverty impacts, the analysis remains incomplete if the income side is not explained, particularly in the analysis of trade reforms and the impacts on poverty through various channels. To further illustrate this point, changes in trade flows affect factor returns, which in turn determine the impacts on poverty. Thus the income side of the story is equally important.

A further contribution of this poverty module is that it unveils short-run impacts across low-income households with different sources of income. While most researchers focus on per capita income to measure poverty, this study conducted deeper analysis by presenting the dynamics within subgroups of low-income earners. If, for example, changes in trade reforms negatively affect agricultural prices and labor is immobile in the short run, labor employed in agriculture is likely to be affected more than that employed in urban manufacturing. To study the impacts across groups of low-income earners, Hertel et al. (2004) stratified households by their primary sources of income: agricultural self-employment, nonagricultural self-employment, rural wage labor, urban wage labor, or transfer payments. The remaining households were grouped into rural and urban diversified strata, leading to a total of seven strata.

An additional useful feature of this particular model is that it incorporates a specialized demand system, which captures greater detail in the consumption patterns of low-income households. Instead of employing the constant difference elasticity functional form as used in the standard GTAP, it uses the implicit, directly additive demand system (AIDADS) of Rimmer and Powell (1992a, 1992b, 1996) to represent household preferences (Cranfield et al. 2000). The parameters in this demand system have been specially estimated for use in the present study. The uniqueness of the AIDADS demand system lies in its emphasis on capturing consumption behavior at very low levels of income. Thus the estimated budget share for food drops sharply as one moves from low to high household income levels. Because this study has investigated the impact on low-income groups and poverty, the use of AIDADS has enhanced the depth of the analysis, particularly with regard to changes in the cost of living at the poverty line.

The model was used to assess impacts on factor returns in Bangladesh—the only country in South Asia where household data are available. The same trade facilitation shocks were run as previously, only now with the poverty-augmented model to infer impacts on low-income earners in Bangladesh. The model predicts impacts on real wages of low-income workers deflated by the consumer price index, which estimates the cost of living near the poverty line. Farm

income would decrease by 28% in Bangladesh in the aftermath of trade facilitation reforms. (Farm income refers to the income of self-employed agricultural workers, who would be affected by decreases in agricultural production.) The reduction in farm income would be a result of the expected decrease in factor returns—land prices are predicted to fall by 33% and real wage returns of own-employment would decline by 16% for unskilled labor and 11% for skilled labor. These are likely to have adverse impacts on agricultural employment and poverty. Against this, off-farm income is predicted to expand by 31%.

Differences in impacts across household groups stem from the dynamics in the trade patterns following trade facilitation reforms. Trade facilitation reduces trade costs, and increases exports of T&C, automobiles and parts, and other manufacturing. Export growth in these sectors raises demand for labor and capital, thereby pushing up wages and squeezing the farm sector. As the prices of agricultural products rise, they become less competitive against foreign imports. And as import costs decline with trade facilitation reforms, imports grow even faster. As agricultural exports decline and imports increase, trade balances deteriorate. Consequently, agriculture suffers a loss of competitiveness relative to manufacturing following the reforms: factor employment decreases and real wages of agricultural workers fall.

To mitigate these adverse effects, additional initiatives could be undertaken to maintain agriculture's relative competitiveness. One important measure would be to improve rural infrastructure—since the poor quality of many rural roads connecting to the cities and ports imposes high costs on those seeking to market their agricultural produce. Accordingly, from a distributional point of view, there is a good argument for investing in both domestic and international infrastructure at the same time. In the absence of these domestic investments, the rural population, particularly those involved in agriculture, may well be left behind.

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Appendix 2.2: List of 95 Exporting and Importing Countries in the Econometric Model

Albania	Estonia	Lesotho	Russian Federation
Algeria	Ethiopia	Lithuania	Rwanda
Argentina	Finland	Madagascar	Senegal
Austria	France	Malaysia	Singapore
Azerbaijan	Germany	Mauritius	Slovenia
Bangladesh	Ghana	Mexico	South Africa
Belarus	Greece	Moldova	Spain
Belgium	Guatemala	Mongolia	Sri Lanka
Bolivia	Hungary	Morocco	Sudan
Brazil	India	Namibia	Sweden
Bulgaria	Indonesia	Nepal	Thailand
Cambodia	Iran, Islamic Republic of	Netherlands	Tunisia
Cameroon	Ireland	New Zealand	Turkey
Chile	Israel	Nicaragua	Uganda
China, People's Republic of	Italy	Norway	Ukraine
Colombia	Jamaica	Oman	United Arab Emirates
Costa Rica	Jordan	Pakistan	United Kingdom
Croatia	Kazakhstan	Panama	United States
Czech Republic	Kenya	Papua New Guinea	Uruguay
Denmark	Republic of Korea	Paraguay	Venezuela
Dominican Republic	Kuwait	Peru	Yemen, Republic of
Ecuador	Kyrgyz Republic	Philippines	Zambia
Egypt	Latvia	Poland	Zimbabwe
El Salvador	Lebanon	Portugal	

Appendix 2.3: Model Specification

Quantifying the Effect of Trade Facilitation on Trade Flows

The first step taken was to construct an econometric model to quantify the effect of trade facilitation on global trade flows. The specification of the ordinary least squares (OLS) model is:

$$M_{ijk} = e^{\beta}(Y_i Y_j)^{\beta_Y}(YPC_i YPC_j)^{\beta_{YPC}} T_{ijk}^{\beta_T} B_{ij}^{\beta_m} I_i^{\beta_n} X_j^{\beta_o} e^{\varepsilon_{ijk}} \quad (1)$$

where

i = exporting country

j = importing country

k = commodity

In the model, M_{ijk} is the value of imports at cost, insurance, freight (CIF) prices. On the right hand side of the model, $Y_i Y_i$ is the product of the gross domestic products (GDPs), and $YPC_i YPC_i$ is the product of GDP per capita of the trading countries. T_{ijk} is the bilateral preferential tariff rate by commodity. In addition to tariffs, a set of bilateral variables B_{ij} is included in the model, which may affect trade, namely: distance, dummies for common border, and language. I_i and X_j are the importing and exporting country-specific variables in the model, which include a dummy variable for landlocked countries and the trade facilitation variables. Since several empirical papers (such as Wilson et al. 2005; Persson 2007) have determined that the effect of trade facilitation on trade flows varies across importing and exporting countries, the model is relaxed by allowing the coefficient estimates to vary. As motivated by Anderson and van Wincoop (2003), it is appealing to include dummies to capture country fixed effects to eliminate country-specific omitted variable bias. However, similar to all research in the literature of trade facilitation, these dummy variables are not included in order to avoid problems with multi-collinearity that stem from trade facilitation variables, which are also exporter and importer specific.

Accounting for Potential Biases in Estimates

This section focuses on issues with the specification of the regression model and econometrics. Most of the literature on trade facilitation using gravity modeling overlooked potential caveats that could lead to biased coefficient estimates. In this study, each factor that might lead to biased estimates was identified and accounted for in the model. More specifically, the following aspects were considered: reverse causality between trade facilitation and trade flows; spurious correlation between trade facilitation and other country characteristics, which may lead to misinterpretation of coefficient estimates; the differing impacts of trade facilitation on trade flows across sectors; and the use of improved data on trade facilitation. The modified econometric model was further strengthened through elaboration on each of these issues.

The intuition of reverse causality between trade facilitation and trade flows is quite simple. Although building efficient infrastructure at the border may ensure faster movement of goods, one can argue the reverse direction of causation—countries that trade more have greater incentives for building a more efficient electronic and physical infrastructural network since cost savings are distributed over a larger quantity of goods. Thus it is not clear whether improvements in border infrastructure enhance trade or whether more trade entails larger investment incentives on border logistics. This issue of endogeneity was addressed in the study through the use of the instrumental variable/two-stage least squares procedure. If appropriate instruments can be identified, the error terms will no longer be correlated with trade facilitation and this will essentially fix the endogeneity.

The difficulty with this approach is in identifying the appropriate instruments for estimating the expected cross-country trade facilitation levels, such that

these instruments are uncorrelated with trade flows. Countries that have improved trade facilitation at the border tend to have high trade volumes; hence factors that affect trade facilitation also affect trade flows. To overcome this issue, the study considered the fact that countries that have good infrastructural amenities at the border generally have a good infrastructure network in the interior. Given this expected correlation between "border" and "interior" infrastructure, instruments that affect "interior" infrastructure (which are less likely to be correlated with trade flows), rather than "border" infrastructure, can be used.

Provision of efficient road and highway networks connecting the interior of the country characterizes higher-quality infrastructure. To estimate the quality of the infrastructure, data on road density and the quality of roads were used. Data on total road networks were obtained from the *World Development Indicators* database, which included all motorways, highways, main or national roads, secondary or regional roads, and all other roads in the country. To compute for road density, this indicator was divided by the total land area of the country. As a measure of road quality, data on the proportion of paved roads were used. A range of other factors also affect the transportation network. For example, heavy traffic increases the time and costs of transportation. To estimate congestion levels, data on the number of motor vehicles per kilometer of road were used. Motor vehicles are all four-wheeled vehicles, such as cars, buses, and freight vehicles; a greater number of motor vehicles on the road is indicative of higher congestion levels.

Another possible variable may be a governance indicator that estimates institutional structure. Countries that have poor institutional structure and high levels of corruption tend to have inadequate infrastructure. Therefore, countries with bureaucratic institutions tend to have poorer provision of public services. It is also expected that countries with larger government sectors have better provision of a variety of public amenities. Total government expenditure as a share of GDP was then used to capture the relative size of the public sector. Altogether, these instrumental variables are intuitively appropriate based on the fact that they are appropriate to estimate the interior infrastructure of the country. Likewise, it is not apparent how they may directly influence trade.

Trade facilitation is likely to be highly correlated with other country characteristics. Industrial countries tend to have high levels of trade facilitation and high levels of GDP, liberal trade policies, etc.—all of which boost trade. Hence, it may be that the coefficient of trade facilitation is capturing the effect of these variables rather than the direct effect. The direct effect can be filtered by controlling for these variables through including them in the model. Real GDP, real GDP per capita, and tariffs were included, all of which are likely to be highly correlated with trade facilitation. A potential problem of including "too many" of these variables, however, is that it may result in multi-collinearity, which may lead to statistically insignificant coefficients for the correlated explanatory variables.

To account for endogeneity, the two-stage least squares procedure was adopted with the following instrumental variables: road density, proportion of paved roads, congestion, relative size of government expenditure, and corruption. Taking logarithms on both sides, the more familiar log-linear form of the model is:

$$\ln M_{ijk} = \beta + \beta_Y \ln(Y_i Y_j) + \beta_{YPC} \ln(YPC_i YPC_j) + \beta_T \ln Tariff_{ijkD} + \beta_D \ln D_{ij} + \beta_{LA} Lang_{ij} + \beta_{LL} LanLock_{ij} + \beta_B Border_{ij} + \beta_M \ln\hat{TF}_i + \beta_x \ln\hat{TF}_j + \varepsilon_{ijk}$$

$$\ln TF = \alpha + \alpha_Y \ln(Y_i Y_j) + \alpha_{YPC} \ln(YPC_i YPC_j) + \alpha_T \ln Tariff_{ijk} + \alpha_D \ln D_{ij} + \alpha_{LA} Lang_{ij} + \alpha_{LL} LanLock_{ij} + \alpha_B Border_{ij} + \alpha_R \ln Road + \alpha_P \ln Paved + \alpha_C \ln Cong + \alpha_G \ln Gov + \alpha_{CPI} \ln CPI + \mu_{ijk} \quad (2)$$

where

i : Exporting country

j : Importing country

k : Commodity

M_{ijk} : Value of imports at CIF prices from i to j of k

Y_iY_i : Product of GDPs of i and j

YPC_iYPC_j : Product of per capita GDPs of i and j

$Tariff_{ijk}$: Bilateral preferential tariff rate on k

D_{ij} : Great-circle distance between i and j

$Lang_{ij}$: Dummy variable for common language of i and j

$LanLock_{ij}$: Dummy variable that takes a value of 0, 1 and 2 if none, either, or both countries are landlocked

$Border_{ij}$: Dummy variable for common border for *i* and *j*

F_i : Trade facilitation indicator of *i*

F_j : Trade facilitation indicator of *j*

Road : Road density

Paved : Proportion of paved roads

Cong : Congestion

Gov : Relative size of government expenditure

CPI : Corruption Perceptions Index

Note: In the second equation, trade facilitation is estimated for *i* and *j* separately to be plugged in for $\hat{TF}_i$ and $\hat{TF}_j$ in the first equation.

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Appendix 2.4: Tariff Data Computation

Tariff data for each aggregated sector were obtained by taking the sum of trade-weighted shares of tariffs. For example,

$$\left[\sum_m Tariff_m * \left(\frac{Trade_m}{\sum_m Trade_m}\right), m \in Extraction \,\&\, Mining \equiv \{\text{Forestry, Fishing, Coal, Oil, Gas, Minerals nec}\}\right],$$

where

$$\left(\frac{Trade_m}{\sum_m Trade_m}\right),$$

In other words, the tariff level for each disaggregated sector, such as forestry and fishing, was determined, multiplied by its corresponding weighted share in the total trade of the aggregated sector, and then products were summed to obtain the tariff level for the aggregated sector of extraction and mining.

CHAPTER 3

The Textiles and Clothing Industry

Meenu Tewari

Purpose of the Study and Methodology

Drawing on the "inventory approach"[1] developed by the Asian Development Bank (ADB), this industry study has used fieldwork, the secondary literature, and an examination of industry trends to understand the existing structure and themes of intraregional trade and investment in the South Asian[2] textiles and clothing (T&C) industry. The goals are to identify both the areas in the T&C supply chain that could provide the greatest potential for intraregional trade and investment to grow and for regional production networks to take root, and the bottlenecks that impede the process of regional integration.

These goals are approached in two ways. First, an analysis of trade data at the Harmonized System (HS) two- and six-digit levels looks at what, where, how, and how much is being traded in the T&C sector; where the demand lies; the varied and complementary strengths of Bangladesh, India, Pakistan, and Sri Lanka across the T&C supply chain; and the product segments where they compete. Second, an institutional approach is employed to analyze current processes empirically, complemented by an ethnographic understanding of the processes of exchange that are taking place in the region. To comprehend these processes more fully, the author conducted 44 interviews in Colombo, Sri Lanka; Dhaka, Bangladesh; and New Delhi, Gurgaon, Bangalore, and Chennai, India, in July and August 2007. She also conducted 16 interviews with global buyers in India in late 2006 and early 2007 as well as with local suppliers. For reasons of time, she did not carry out fieldwork in Pakistan.

This chapter, through a field-based approach to institutional understanding of the priority areas of the sector for stakeholders, describes what can be done to mitigate the barriers to greater intraregional trade and investment in the members of the South Asian Association for Regional Cooperation (SAARC).

Structure of the Textiles and Clothing Industry in South Asia

The T&C sector is South Asia's largest manufacturing industry, a major employer, and a leading export earner. In 2006,[3] South Asia exported over $43.1 billion and imported $8.4 billion of T&C. The sector also collectively employed over 55 million people directly and nearly 90 million indirectly in 2005, including an estimated 38 million in India, 15 million in Pakistan, 10 million in Bangladesh, and 2 million in Sri Lanka.[4]

Tables 3.1 and 3.2 show a clear division of labor in terms of the region's sector composition and specialization. In Bangladesh and Sri Lanka, exports are dominated by clothing; in Pakistan, textiles; India has a rough parity between the two. In other words, clothing exports are the engine of growth for Bangladesh and

[1] Developed by William James (ADB), the inventory approach aims to develop, through stakeholder and firm-level interviews, a matrix of actual (or perceived) hurdles faced by firms in expanding exports or interregional trade.

[2] "South Asia" and "region" in this chapter refer to Bangladesh, India, Pakistan, and Sri Lanka, unless stated otherwise.

[3] Unless stated otherwise, data in this chapter relate to calendar years.

[4] Sources: Centre for Policy Dialogue (1999), World Bank (2006), Joint Apparel Association Forum (2007), and Ministry of Textiles (2007).

Table 3.1: Exports of Textiles and Clothing from South Asia, 2006 ($ million)

Exporting Country	Textiles	Clothing	Total	Share of Clothing (%)	Share of Textiles (%)
Bangladesh[a]	1,645.7	8,252.0	9,897.7	83.4	16.6
India	10,533.8	8,885.7	19,419.5	45.8	54.2
Pakistan	7,619.4	3,250.3	10,869.7	29.9	70.1
Sri Lanka	182.8	2,745.8	2,928.6	93. 8	6.2
Total	**19,981.7**	**23,133.8**	**43,115.5**		

[a] 2005.

Source: United Nations Statistical Division (2009).

Table 3.2: Imports of Textiles and Clothing into South Asia, 2006 ($ million)

Importing Country	Textiles	Clothing	Total	Share of Clothing (%)	Share of Textiles (%)
Bangladesh[a]	2,512.0	161.4	2,673.4	6	94
India	2,680.4	73.7	2,754.1	3	97
Pakistan	1,322.2	25.0	1,347.2	2	98
Sri Lanka	1,571.6	83.9	1,655.5	5	95
Total	**8,086.2**	**344.0**	**8,430.2**	**4**	**96**

[a] 2005.

Source: United Nations Statistical Division (2009).

Sri Lanka, while textiles form an important part of the T&C export sector in India and Pakistan.

The second pattern shows that South Asia exports more than it imports, and thus its sector exports have low import intensities.[5] The import intensity stands at 19.5%, indicating that much of the textile value chain is localized in the region and the bulk of imports are of specialized fabric, yarn, and accessories, with very little clothing imported or traded. India and Pakistan have the lowest import intensities while Bangladesh and Sri Lanka have larger shares. Between Bangladesh and Sri Lanka, the latter has higher import intensities, pointing to the fact that Bangladesh has more extensive backward linkages. Interviews indicated that Bangladesh manufactures 80% of its knitwear fabric locally and meets about 20% of its woven fabric needs.

Table 3.3 shows the trade balance in South Asia's T&C industry in 2006 (2 years after the removal of quotas). These data reinforce the point regarding the apparent "division of labor" noted earlier. They show that all four countries have a strong comparative advantage in clothing (i.e., they are net exporters of clothing and import very little clothing).

On the face of it, India and Pakistan could more than meet the textile needs of Bangladesh and Sri Lanka. As noted earlier, Bangladesh has slightly deeper

[5] Import intensities are calculated by dividing total T&C imports into a country by total T&C exports from that country (i.e., imports as a percentage of exports).

Table 3.3: Trade Balance in Textiles and Clothing, South Asia, 2006 ($ million)

Country	Textiles	Clothing
Bangladesh[a]	(866.3)	8,090.6
India	7,853.4	8,812.0
Pakistan	6,297.2	3,225.3
Sri Lanka	(1,433.6)	2,747.8
Total	**11,850.7**	**22,875.7**

() = negative.

[a] 2005.

Source: United Nations Statistical Division (2009).

backward linkages than Sri Lanka, as demonstrated by a smaller trade deficit, despite having larger clothing exports than the latter. At the regional level, the four countries together show a trade surplus for T&C.

Bangladesh

Bangladesh's T&C industry began to grow in the mid-1970s and has surged in the past 20 years. Its total exports have grown rapidly post the Multi-Fiber Arrangement (MFA) and contrary to widespread predictions that quota elimination would harm its clothing exports. By some accounts, Bangladesh's T&C exports nearly doubled from $6.2 billion in 2004 to an estimated $12 billion in 2007 (Centre for Policy Dialogue, information received by author, 2007). As noted, readymade clothing dominates the structure of output in the T&C industry of Bangladesh. Clothing accounts for some 80% of the country's exports and 17% of total imports (World Bank 2005, James 2007).

Bangladesh's main export markets for clothing are the European Union (EU) and the United States (US), and tariff-free access to the EU and Canadian markets has been an important driver of growth. Indeed, Bangladesh has been successful in fostering backward linkages in spinning and weaving. The sector used to have an 80:20 split between woven exports and knitwear but the latter has grown rapidly in the last few years, and now stands at nearly 50:50, with expectations of knitwear overtaking woven clothing soon. This has important implications for local linkages and for multiplier effects from the sector's growth since knitwear is much more deeply integrated in the domestic textile value chain and the growth of this subsector will also ensure much better value retention under the EU's Generalized System of Preferences (GSP). Cotton dominates the region's fiber base, but imported inputs ensure a mix of blends, impregnated, coated, and other man-made fibers.

Five product categories dominate Bangladesh's exports: knit T-shirts; men's and boys' cotton shirts, both knit and nonknit; men's and boys' trousers; and pullovers of wool and man-made fiber.

India

India has rapidly integrated in the global market during the 15 years following extensive deregulation that began in the mid-1980s. In FY2005, India exported about $18 billion worth of T&C or 15% of exports (Ministry of Textiles 2006). Historically, textiles dominated India's exports, but clothing has now overtaken and accounts for more than half the industry's export share. The EU accounts for 45% of India's clothing exports and 35% of its textile exports, while the US accounts for 33% of clothing and 26% of textile exports (Directorate General of Foreign Trade 2007). India's T&C imports have also grown in recent years, rising from a historical low of 1.2% of total exports in 2000 to 14% in 2006. These imports totaled $2.7 billion in 2006 (Ministry of Textiles 2006, Tewari 2006, UN Statistical Division 2009). Fabric and accessories account for the bulk of T&C imports, driven in part by the rapid rise and shifting mix of India's exports after the elimination of quotas in 2005. India remains one of the largest cotton yarn producers in the world with a 13% share in worldwide production of all fibers (Ministry of Textiles 2006).

The following seven products constitute 51% of India's clothing exports: knit T-shirts and vests, woven women's shirts and blouses, nonknit men's/boys' shirts of cotton, nonknit women's and girls' skirts, men's/boys' knit shirts, men's/boys' cotton woven trousers and bottoms, and women's/girls' knit blouses.

Pakistan

Pakistan's T&C industry is dominated by textiles. In 2006, Pakistan exported $7.6 billion in textiles and $3.2 billion in clothing (UN Statistical Division 2009). It imports little fabric and has a relatively comprehensive

cotton-based T&C value chain. Total T& C imports were only $1 billion in 2006 (UN Statistical Division 2009). Its main markets are the US, which accounts for more than half its exports, followed by the EU. The top exports are dominated by textiles and made-ups: bed linen, toilet and kitchen linen, cotton yarn, men's/boys' cotton knitted shirts, woven fabrics of cotton, nonknit men's and boys' cotton trousers, and plain weave cotton fabrics. T&C exports are an important source of foreign exchange, accounting for about two thirds of total export earnings.

Sri Lanka

Sri Lanka is distinct from its South Asian neighbors in that its T&C industry is not dominated by a cotton fiber base but by sophisticated blends and man-made fibers. It has carved a niche for itself in the production of lingerie and swimwear, and is also known for its leadership in corporate social responsibility in T&C production. This is in part demonstrated by the fact that Sri Lanka has the highest sector wages in South Asia, by branding itself as the source of "garments without guilt" and by using "ethical sourcing" strategies. Clothing exports dominate Sri Lanka's T&C industry, constituting 95% of the sector's exports and accounting for $3 billion in exports to the EU and the US in 2006. Exports of T&C make up 45% of total exports.

Clothing exports rely heavily on textile imports, which in 2005 constituted 94% of the country's total T&C imports, giving clothing exports an import intensity of 55% (UN Statistical Division 2007). During the first quarter of 2006, the US market for Sri Lanka's T&C exports grew by 9% while the EU market grew by 21% (Joint Apparel Association Forum 2007). Within the EU, France, Germany, Italy, and United Kingdom are its largest buyers. This is reflected not only in its export statistics, but also in its textile imports of lingerie, swimwear, and formal clothing, which are imported by these Western markets. A good share of the base fabric that Sri Lankan exporters use is supplied by its main EU and US buyers.

Top exports include lingerie, nonknit men's/boys' cotton trousers, knit T-shirts, nonknit women's and girls' trousers of cotton and of other materials, nonknit men's/boys' cotton shirts, and cotton pullovers.

Intraregional Exports

Intraregional trade in T&C is low, but has been growing strongly in recent years (Tables 3.4 and 3.5). India and Pakistan dominate the region's textile exports, with India dominating the other countries in absolute terms. Smaller countries, such as Bangladesh and Sri Lanka, increased the volume of their T&C exports to the rest of South Asia much faster than the larger countries. For example, India's textile exports to Bangladesh doubled from 2001 and 2005, but Bangladesh increased its textile exports to India 83 times and doubled its textile exports to Sri Lanka. Similarly, it increased its clothing exports to India 10-fold, doubled its clothing exports to Pakistan, and increased its clothing exports to Sri Lanka by 66%. Similarly, Sri Lanka significantly increased its clothing exports to Bangladesh and Pakistan.

Tables 3.4 and 3.5 highlight the following issues. First, despite regional problems, intra-SAARC trade

Table 3.4: Evolution of Intraregional Exports of Clothing, 2001–2005 ($'000)

Exporting Country	Bangladesh		India		Pakistan		Sri Lanka		World	
	2001	2005	2001	2005	2001	2005	2001	2005	2001	2005
Bangladesh[a]			341	3,344	86	189	145	241	4,443,695	6,295,714
India	1,957	19,844			475	1,081	17,192	37,115	5,062,358	9,228,100
Pakistan[b]	958	1,870	470	1,073			1,583	3,695	2,445,702	3,633,952
Sri Lanka	12	247	216	510	0	40			2,336,351	2,876,598

[a] 2003 and 2004.

[b] 2003 and 2005.

Source: Calculated from United Nations Statistical Division (2007).

Table 3.5: Evolution of Intraregional Exports of Textiles, 2001–2005 ($'000)

Exporting Country	Bangladesh		India		Pakistan		Sri Lanka		World	
	2001	2005	2001	2005	2001	2005	2001	2005	2001	2005
Bangladesh[a]			346	28,627	23,150	27,069	1,469	2,236	527,695	596,477
India	186,692	364,792			1,368	77,578	100,109	182,990	5,404,314	9,259,948
Pakistan[b]	152,399	194,078	12,343	46,385			58,471	99,061	6,180,405	7,274,242
Sri Lanka	1,614	5,264	4,388	9,227	836	1,004			231,936	182,812

[a] 2003 and 2004.

[b] 2003 and 2005.

Source: Calculated from data from United Nations Statistical Division (2007).

in T&C has grown much faster than the region's T&C exports to the rest of the world, suggesting that market access is beginning to open up within South Asia. India dominates the net increases in intra-SAARC T&C trade and reinforces the importance of opening India's market to its South Asian neighbors. Bulk of the increase in trade comes from textiles, not clothing. Indeed, less than 0.5% of the $22 billion of clothing that South Asia exported in 2005 was sold to South Asia. In contrast, at least 6.25% of the region's textile exports were traded within SAARC countries. Textiles are likely to be the driver for intraregional integration in the industry while clothing will serve the same role extraregionally. Consequently, market access and intraregional investment are likely to bear the greatest results in terms of regional integration if they are first initiated in textiles.

Second, while India and Pakistan dominate the region in textile exports in absolute terms, the smaller countries, such as Bangladesh and Sri Lanka, which are better known for clothing exports, have increased their intraregional share of textile exports at a rapid pace during the last few years. Bangladesh's textile exports to India rose by over 1,100% from 2001 to 2006, and its share of textile exports to SAARC rose sharply from 5% in 2003 to 10% in 2004. Sri Lanka has also increased its intraregional textile exports noticeably. These data are evidence that backward linkages are indeed taking root in Bangladesh and Sri Lanka.

South Asia's Clothing Export Performance in the EU and US Markets

As noted earlier, the EU and the US are the main markets for all of South Asia's major clothing-exporting countries. The EU and the US together account for 78%, 94%, and 95% of clothing exports from India, Bangladesh, and Sri Lanka, respectively (Table 3.6). The EU is a more important destination for South Asia's clothing exports than the US.

Table 3.7 summarizes the "safeguard opportunity" of the People's Republic of China (PRC) (James 2007), which presented itself after the US imposed restraining quotas and duties on the PRC in 2005.

Table 3.6: Share of the US and EU in South Asia's Clothing Exports, 2005 (%)

Exporting Country	EU	US	EU and US
Bangladesh[a]	64	30	94
India	45	33	78
Pakistan	—	—	—
Sri Lanka	56	39	95

— = data not available.

[a] 2004.

Source: United Nations Statistical Division (2007).

The PRC's shipments to the US of items that were restricted in 2005 totaled 18% of the world's shipments of these categories. From 2004 and 2006, shipments by SAARC members in these categories rose by 20% and 19% in value and volume, respectively. Overall, the volume share of the restricted categories in the US rose from 9% to 12% and from 10% to 14% in value terms. SAARC members have clearly made gains in the US market in volume and especially in value, which indicates an upgrading in product quality.

Table 3.7: South Asia's Performance in Categories Restricted by the US from the PRC under Safeguards, 2004 and 2006 (market share, %)

	2004		2006	
	Volume	Value	Volume	Value
SAARC	9	10	12	14
Bangladesh	5	3	6	4
India	**4**	**3**	**5**	**4**
Clothing	3	3	4	4
Cotton Clothing			5	6
Yarn	<1		5	
Fabric	2	2	4	3
Pakistan	**6**		**7**	
Clothing			3	2
Cotton Clothing	4	<3	5	>3
Made-ups	10	8	12	10
Sri Lanka	**>1**		**1**	**<2**

Source: Adapted from James (2007).

In terms of exports of clothing to the EU, SAARC members expanded their market share and improved on their unit values. Bangladesh led South Asian exports to the EU-15[6] and its exports grew to more than double India's in 2005 (Table 3.8). India exported the fourth-highest quantity to the EU-15 during 1995–2005 while Pakistan had the lowest export value during the same period. Sri Lanka had the lowest export quantity among all South Asian countries. In terms of value, India and Bangladesh outperformed other SAARC members in the EU market; India's export quantity and value to the EU-15 grew by 19% from 1995 to 2000 and increased by 44% from 2000 to 2005 (Eurostat 2007).

Table 3.9 makes an important point about the differences in export quality and strategy among SAARC member countries to the EU. India and Sri Lanka's unit values were almost double those of Bangladesh and Pakistan in 2005. The first two countries appear to be following an export strategy of shipping smaller volumes and shorter runs of relatively higher value products, and the last two seem to be following a PRC-like strategy of exporting large volumes of relatively low-value products.

Table 3.8: Top Five Exporters of Clothing to the EU-15, by Quantity, 1995, 2000, and 2005 (100 kgs)

Rank	Exporting Country	1995	Exporting Country	2000	Exporting Country	2005
1	PRC	2,480,275	PRC	3,803,580	PRC	14,909,505
2	Turkey	1,676,373	Turkey	2,949,167	Bangladesh	4,501,302
3	India	1,080,687	Bangladesh	2,399,114	Turkey	4,164,579
4	Morocco	948,992	Morocco	1,363,559	India	2,083,488
5	Tunisia	930,588	Tunisia	1,297,714	Romania	1,540,151

Source: Calculated from data from Eurostat (2007).

[6] Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Table 3.9: Unit Values of Clothing Exports to the EU from South Asia and other Selected Countries, 2005 (€/100 kgs)

Exporting Country	2005 Unit Values
Sri Lanka	1,545.7
India	1,536.2
Bangladesh	779.6
Pakistan	753.4
Turkey	1,886.7
Mexico	1,839.3
Viet Nam	1,338.5
Cambodia	1,338.3
PRC	1,101.3

Source: Calculated from data from Eurostat (2007).

This has implications on the kinds of products in which the different SAARC countries specialize. In the previous section, it was shown that one of the top exports of all four countries are knit T-shirts. T-shirts are a product category in which all SAARC countries compete with each other, but there might actually be qualitative differences in those shipped by each country. For example, India and Sri Lanka are likely to export higher-value or more design-intensive varieties than Bangladesh and Pakistan, Sri Lanka is likely to specialize in man-made fiber and blended products, and India is likely to specialize in cotton. In short, there may be more complementarities among the products exported by SAARC members than suggested by the data.

There are important differences in the structure of the clothing exports of each country to the EU and US. For example, India and Pakistan are exporters of textiles as well as clothing, while Bangladesh and Sri Lanka export primarily clothing. In contrast, Pakistan's success has been in cotton made-ups, such as bed linen, yarn, and fabrics. Finally, it is striking that there is very little penetration of Japan or Oceania by South Asian exporters. Collectively, they export less than 2% of their T&C output to Japan, compared with just under 40% by the PRC (UN Statistical Division 2007).

Regional Value Chain Analysis: What Do Subsector Specializations Tell Us About Regional Complementarities?

Intraregional versus Extraregional Trade in Textiles and Clothing

Table 3.10 summarizes the level of intraregional trade in T&C, its evolution over time, and its share of the region's global T&C trade. The table illustrates three important points. First, South Asia's T&C trade within the region is dwarfed by its trade with the rest of the world. In 2005, the intraregional share of T&C trade was only 3% of the region's global share. By 2006, this had risen to only 3.3.%. Second, trade in clothing is minuscule within South Asia, accounting for only 0.21% of SAARC's trade in clothing in 2006. Each of the four SAARC countries examined exports a significant volume of clothing outside the region; but the ties that exist in the T&C industry in the region are currently limited to intraregional trade in textiles. However, as Table 3.10 shows, there is a slow improvement in intraregional trade in T&C in the region. Intraregional trade in T&C as a share of South Asia's global T&C exports rose from 1.9% in 2001 to 3.3% in 2006 (calculated from UN Statistical Division 2007).

On the supply side, there are some important differences in how buyers perceive each country's comparative advantage or niche. This quasi-specialization suggests that each country may have distinct pathways to competitiveness and that competition among them need not be cut-throat. In 2005 (and 2004 for Bangladesh and Sri Lanka), only 4 out of 14 distinct products at the six-digit level were common between each country's top five clothing exports to the US, and these were all basic items. While India and Pakistan had four overlaps, India's unit values are higher, which may signify different levels of quality and value addition, and may suggest little direct competition. The same difference is also apparent in textiles, where India and Pakistan's top five textile and fabric exports have barely any overlap. This distinctiveness in export baskets is significant because it means that a number of South Asia's textile exports do not compete against each other in key overseas markets (Tables 3.11 and 3.12).

Table 3.10: Intraregional Exports of Textiles and Clothing as a Share of South Asia's Global Exports, 2001–2006 ($'000)

HS Classif.	Pattern	2001[a]	2002[a]	2003	2004	2005	2006[c]	% Change (2001–2006)	% Change (2005–2006)
Textiles									
50–60, 63	Intraregional[b]	314,333,489	334,005,392	670,112,910	725,388,336	1,098,001,016	1,297,248,445	312.70	18.15
50–60, 63	World	6,150,807,445	6,842,313,691	13,753,351,379	14,433,948,684	17,555,588,385	19,798,820,730	221.89	12.78
	Intraregional as % of World	**5.11**	**4.88**	**4.87**	**5.03**	**6.25**	**6.55**		
Clothing									
61–62	Intraregional[b]	20,364,856	34,849,175	50,511,791	48,142,047	67,187,902	41,844,530	51.33	(37.72)
61–62	World	11,437,898,742	12,013,440,422	15,958,605,231	17,637,291,459	21,235,908,446	20,388,272,079	43.90	(3.99)
	Intraregional as % of World	**0.18**	**0.29**	**0.32**	**0.27**	**0.32**	**0.21**		
Textiles and Clothing									
	Intraregional[b]	334,698,345	368,854,567	720,624,701	773,530,383	1,165,188,918	1,339,092,975	300.09	14.92
	World	17,588,706,187	18,855,754,113	29,711,956,610	32,071,240,143	38,791,496,831	40,187,092,809	128.48	3.60
	Intraregional as % of World	**1.90**	**1.96**	**2.43**	**2.41**	**3.00**	**3.33**		

[a] Excluding Pakistan.

[b] Bangladesh, India, Pakistan, and Sri Lanka only.

[c] Excluding Bangladesh.

Source: Authors' calculations from data from United Nations Statistical Division (2009).

Table 3.11: Pakistan's Top Five Textile Exports to the US, 2003–2004 ($'000)

	2003				2004		
HS	Product Description	Value	Share (%)	HS	Product Description	Value	Share (%)
620231	Bed Linen, of Cotton, n.e.s.	279,983	18	620231	Bed Linen, of Cotton, n.e.s.	501,266	24
630260	Toilet and Kitchen Linen, of Cotton	222,783	14	630260	Toilet and Kitchen Linen, of Cotton	294,421	14
630710	Floor-cloths, Dish-cloths, etc.	118,170	8	630710	Floor-cloths, Dish-cloths, etc.	158,040	8
520819	Woven Fabrics of Cotton	106,240	7	630232	Bed Linen, of Man-made Fibers	134,391	5
570110	Carpets of Wool or Fine Animal Hair	97,748	6	630210	Bed Linen, of Knitted Textile	122,437	6
	Total	**824,924**	**53**		**Total**	**1,210,555**	**58**

n.e.s. = not elsewhere specified.

Source: Authors' calculations from data from United Nations Statistical Division (2007).

Table 3.12: India's Top Five Textile Exports to the US, 2003–2004 ($'000)

	2003				2004		
HS	Product Description	Value	Share (%)	HS	Product Description	Value	Share (%)
630492	Furnishing Articles	235,630	7	630492	Furnishing Articles	368,206	8
630790	Dress Patterns, Made-up Articles, etc.	193,311	6	630790	Dress Patterns, Made-up Articles, etc.	195,456	4
500720	Woven Fabrics of Silk/ Silk Waste	88,206	3	570110	Carpets of Wool or Fine Animal Hair	148,752	3
570110	Carpets of Wool or Fine Animal Hair	87,978	3	630419	Bedspreads of Textile Materials	113,099	2
630260	Toilet and Kitchen Linen	82,303	3	500720	Woven Fabrics of Silk/ Silk Waste	95,633	2
	Total	**677,428**	**22**		**Total**	**921,146**	**19**

n.e.s. = not elsewhere specified.

Source: Authors' calculations from data from United Nations Statistical Division (2007).

In other words, the structure of exports and product level specialization within SAARC has subtle but important variations, and these can be used to nurture regional production networks and support niche investments in ways that do not pit countries against each another.

Product-Level Variation and Value Chain Analysis

Tables 3.13, 3.14, and 3.15 summarize the value-added chain, distribution of costs, and final price of cotton shirts in three countries. The first point to note

Table 3.13: Distribution of Value Added for Cotton Shirts, India

Men's Cotton Shirts/Unit	Global Retail	Manufacture	Weaving	Spinning	Fiber
Value($)	11.38	4.93	2.35	1.03	0.05
Value Added (%)	57	23	12	5	4
Men's Khaki Casual Trousers/Unit	**Global Retail**	**Manufacture**	**Weaving**	**Spinning**	**Fiber**
Value	18.75	7.25	3.75	1.13	0.05
Value Added (%)	61	19	14	3	3

Cost Ranges	%
Raw Material Cost	45
Energy Costs	7–10
Labor Costs	7–10
Transportation Costs	4–6
Administrative Costs	7
Design and Prototypes	5
Logistics	2
Profit	10–15

Note: All costs except retail are based on input and manufacturing costs in India.

Source: Calculated from KSA Technopak's analysis of value added at each stage of processing in India of men's cotton shirts and khaki trousers (Singhal et al. 2004).

Table 3.14: Distribution of Value Added for Cotton Shirts, Bangladesh

	Free On Board (%)
Production Costs (100%)	
Material	78
Cutting and Layering	1
Sewing/Assembly	5
Finishing	2
Packaging/Loading	3
Administrative	12
Energy Costs	**20**
Labor Costs	67
Maintenance	14
Import Costs (100%)	
Cotton Fabric	93
Import Costs	4
Accessories	3
Export Costs (100%)	
Export Charges	27
Interest	21
Overhead	12
Profit	41

Source: World Bank (2005).

is that input costs are a higher proportion of total costs in countries where raw materials are imported than in countries where fabric is produced locally. In Bangladesh and Sri Lanka, input costs account for as much as 78% and 65% of total production costs, respectively. In contrast, input costs are 45% of total production costs in India. In countries where raw materials are not available locally, import costs become an important component of total costs. Also, sourcing inputs overseas can easily add an additional 6–8 weeks to the procurement process, therefore, expansion of textile production capacities within South Asia can significantly lower overall production costs and enhance the region's competitiveness.

Second, different amounts of value added may be realized at different nodes in the clothing chain. In India, about a quarter of a garment's value is added in the spinning, weaving, and textile segments of the value chain with another quarter in manufacturing; about half the value of the product is added through design and branding. Thus in Sri Lanka and India, design is emerging as a new source of competitive advantage. This ongoing upgrading should be supported since it will enable the region as well as its firms to retain more of the value of the products.

The amount of value that is extracted at each node depends on the structure of the value chain. Table 3.15 illustrates cut, make, and trim (CMT) assembly

Table 3.15: Distribution of Value Added for Cotton Shirts, Sri Lanka

Costs	Cut, Make, and Trim ($)	%	Free On Board ($)	%
Cost of Fabric	0	0	4.8	60
Cost of Accessories	0.2	10	0.4	5
Labor Costs	1.2	60	1.6	20
Overhead	0.4	20	0.8	10
Profit Margin	0.2	10	0.4	5
Total	**2.0**	**100**	**8.0**	**100**

Source: Fonseka and Fonseka (2004).

production, and the "full package" or free on board (FOB) production model. As these two Sri Lankan examples show, CMT production is an example of a buyer-driven chain where global retailers control design, distribution, sourcing, and product specification, and the supplier merely assembles precut or pre-sourced inputs. Labor costs are the main component of total production costs and can reach as high as 60% in CMT chains, while input costs can be as low as zero if the buyer provides the supplier with inputs. By contrast, input and material costs dominate production in the FOB production model, where suppliers have discretion over the sourcing of materials and the responsibility to ensure timely delivery. As the Sri Lankan case in Table 3.15 shows, input costs can be as high as two thirds of product costs in the FOB model.

The CMT model dominates much of South Asia's clothing production but is vulnerable to transitory capital. Because labor costs are the largest expense in this model, wages drive sourcing decisions and buyers constantly scour the globe for cheaper sites. There are also no incentives in this model for upgrading through product development, design, research, or investment unless outside actors broker these shifts. Energy and transportation costs are also important variables over which policy has control. Indeed, better roads as well as cheap and consistent power supply can lower production and inventory costs.

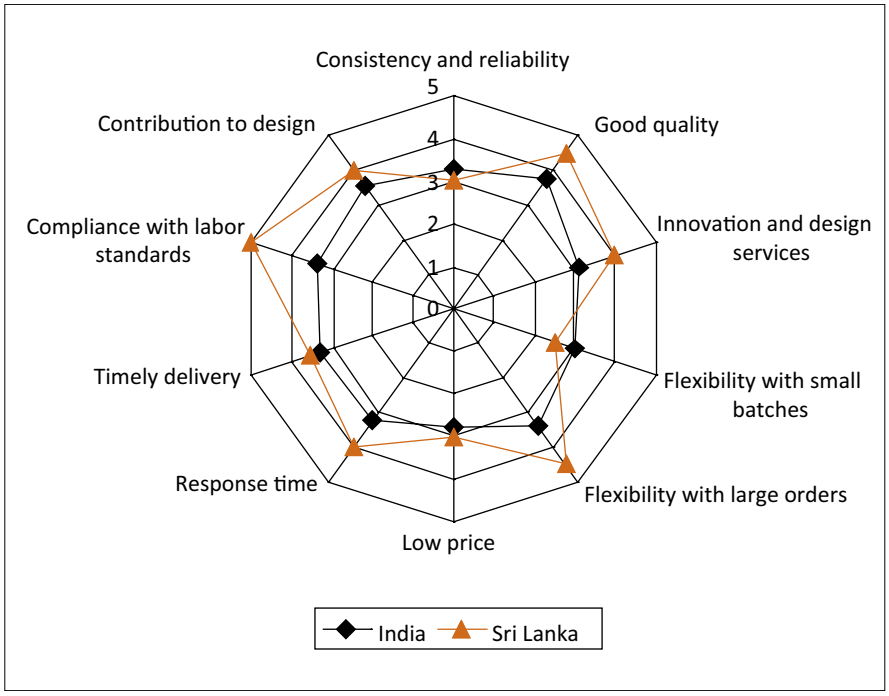
Complementarities: A Ground-Up View of Regional Competitiveness from Global Buyers

This section draws on a detailed buyer survey that the author conducted between late 2006 and early 2007 with the Indian Council for Research International Economic Relations (ICRIER). Sixteen major buyers who source T&C from South Asia and other parts of Asia were interviewed with the goal of understanding how buyers rate their suppliers and how they make their sourcing decisions. Interviewed buyers included representatives of giant discount chains, department stores, branded merchandisers, and buying houses and intermediaries.

Buyers were asked to compare their suppliers in Bangladesh, India, Pakistan, PRC, Sri Lanka, and other developing countries along 10 key dimensions of competitiveness based on current market conditions, namely, consistency and reliability of supply, good quality, innovation and design services, low prices, flexibility with small orders, flexibility with large orders, response time, timely delivery, compliance with labor standards, and contribution to design.[7]

[7] The buyer survey and some of the parameters were inspired by Schmitz and Knorringa (2000).

Figure 3.1: Buyer Comparisons of Sri Lanka and India



Source: Tewari/ICRIER Survey.

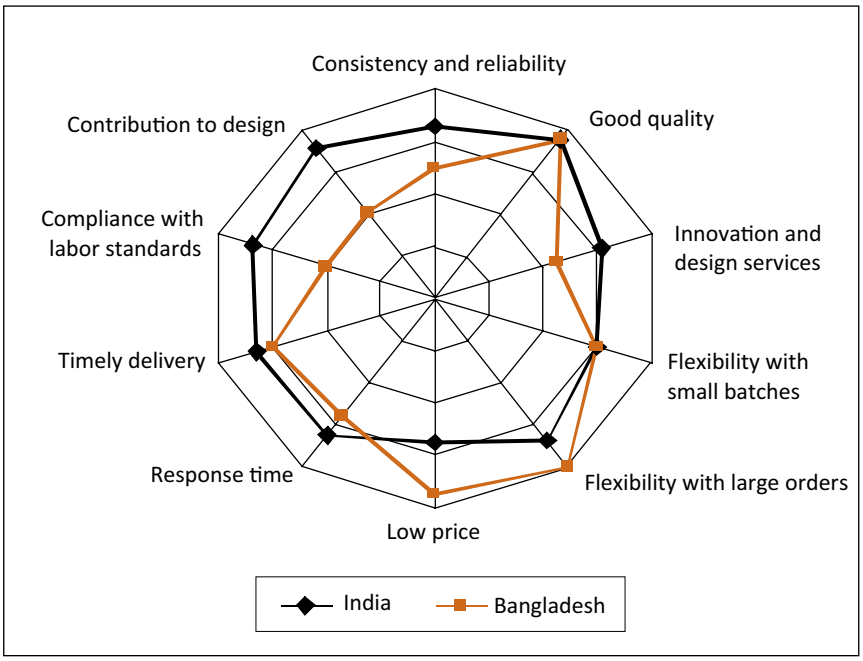
Sri Lanka and India

Within South Asia, Sri Lanka leads in terms of quality and beats India in flexibility with large orders, innovation and design services, good quality, response time, and most importantly, compliance with labor standards and contribution to design. These are displayed in 10-dimensional radar graphs, on a scale of 0 (worst) to 5 (best) (Figure 3.1). India was found to be no better than Sri Lanka on almost all of the 10 measures, except for flexibility with small batches, but even in this regard, Sri Lanka is not far behind. The interviews also revealed that in terms of a regional strategy, Sri Lanka's trajectory is a movement toward progressively higher value-added and specialized clothing, a move that complies with increasingly stringent labor and environmental laws. The results also suggest that these two countries can emerge as South Asia's design hubs, especially with their design training and educational institutions, as well as past investments by the state and industry.

Bangladesh and India

The success of post-MFA Bangladesh comes from its production efficiencies that combine low prices and mass production with good quality and timely delivery. It was seen that Bangladesh beats India in terms of flexibility with large orders and low price, and is on a par with India in terms of quality and flexibility with small batches, which is a good niche for India. India outperforms Bangladesh in terms of innovation and design services, compliance with labor standards, contribution to design, consistency and reliability, and to some extent, response time and timely delivery (Figure 3.2). Although Bangladesh has been a steady performer post MFA, the narrow basis of its advantage is evident (i.e., it excels in the production of basic menswear in knits and woven fabrics). Its consistent performance and outstripping of India in several areas should give pause for thought to India in terms of areas that need to be strengthened and upgraded.

Figure 3.2: Buyer Comparisons of Bangladesh and India



Source: Tewari/ICRIER Survey.

Pakistan and India

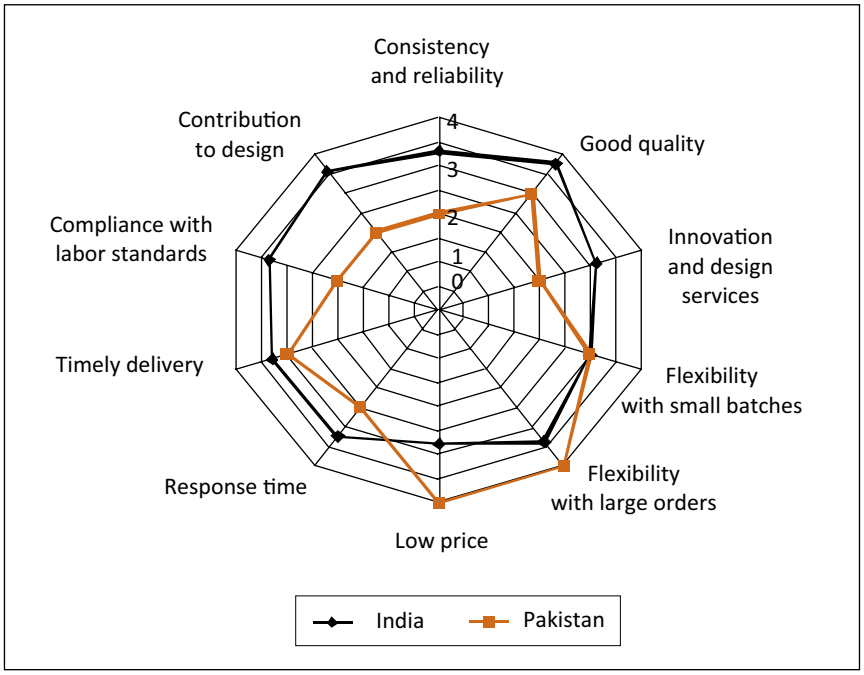
In many ways, Pakistan is similar to India in that both countries have strong exports of textiles, fabrics, and clothing. However, the survey shows that scale and price are significant advantages that Pakistan has over its rivals, especially India. However, it lags behind other countries like India and Sri Lanka in contribution to design, innovation and design services, quality, and consistency and reliability (Figure 3.3).

Nearly half the 16 buyers responded to questions comparing India and Pakistan's fabric, yarn, and textile exports. For these buyers, Pakistan is the preferred source of bed linen and home furnishings. Pakistan's advantage lies in its large volumes, high-quality fabric, and broad gauge of its widths. Indian fabric is produced in smaller volumes than what buyers felt was viable and India's superiority lies in the mid-range and finer counts than in the standard weave. Printing technologies in Pakistan were also judged to be better than India's and Pakistan did better than India in man-made fiber fabrics, in flannel, and in fleece.

Bangladesh and Pakistan

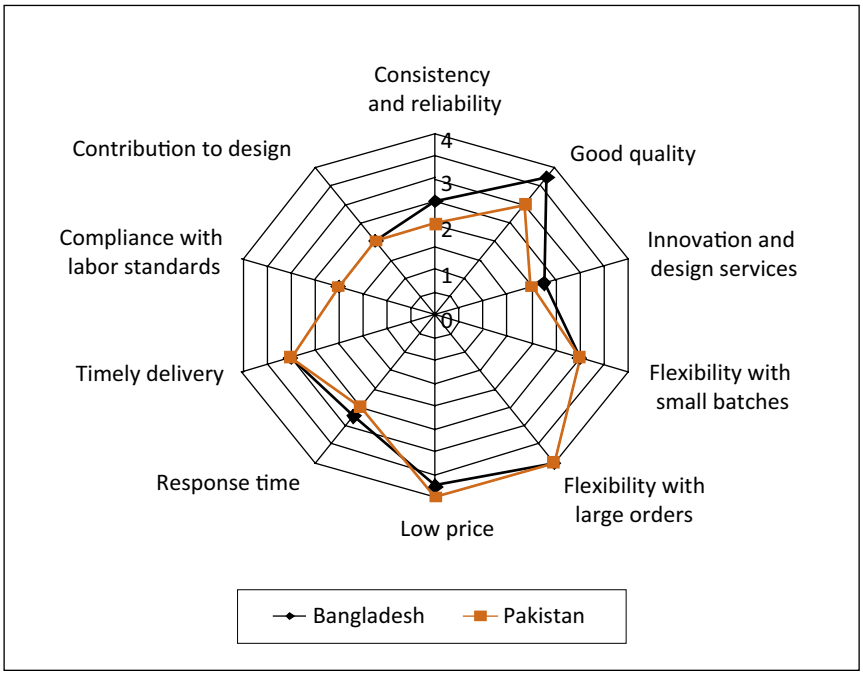
It is arresting how similarly buyers rated Bangladesh and Pakistan in terms of contribution to design, innovation and design services, price, ability to execute large orders, compliance with labor standards, and timely delivery. However, Bangladesh edges out Pakistan in the areas of quality, consistency and reliability, response time, and innovation and design services (Figure 3.4).

Figure 3.3: Buyer Comparisons of Pakistan and India



Source: Tewari/ICRIER Survey.

Figure 3.4: Buyer Comparisons of Bangladesh and Pakistan



Source: Tewari/ICRIER Survey.

Sri Lanka and Pakistan, and Sri Lanka and Bangladesh

Pakistan lags behind Sri Lanka in virtually all categories except price, ability to execute large orders, and small volume production (Figure 3.5). A subset of buyers who source fabric from Pakistan considered the local availability of fabric a major advantage. The same results have also been reported for Sri Lanka and Bangladesh (Figure 3.6).

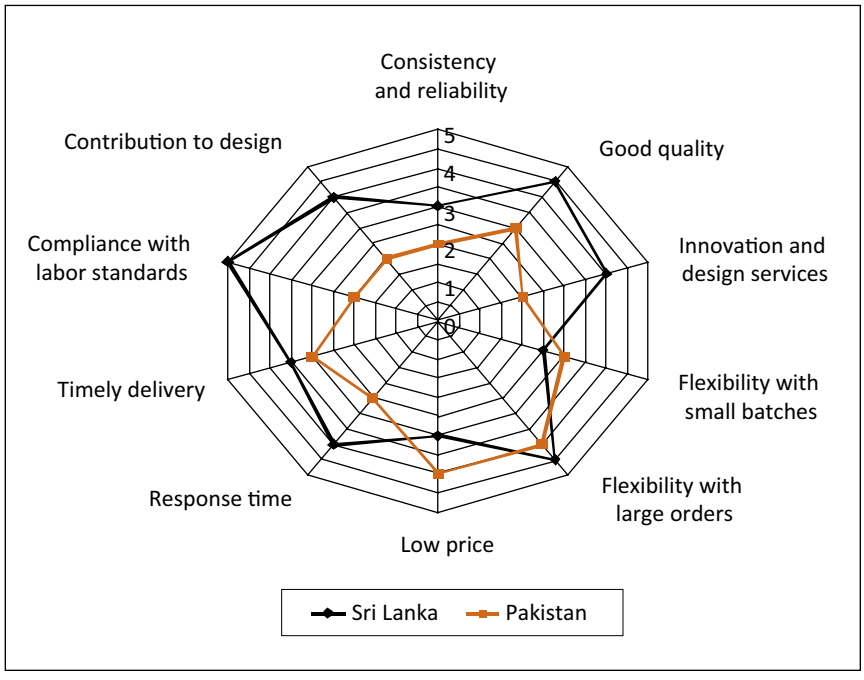
Sri Lanka clearly leads all other South Asian countries in the capabilities that buyers increasingly value from their full-package suppliers. However, it is striking that the country has achieved these quality- and design-intensive standards without fully internalizing the establishment of backward linkages in textiles. The Sri Lankan case, therefore, illustrates that it is possible to move away from CMT vulnerabilities by deepening "soft" skills while still following an import-intensive production strategy.

South Asia and the PRC

The survey showed that PRC outperforms South Asia in 6 of the 10 dimensions measured in the survey and only Sri Lanka and India ranked better than the PRC in any of the 10 categories (Figure 3.7). The PRC is superior to India in terms of flexibility with large orders, timely delivery, consistency and reliability, response time, good quality, and prices. The only dimension where India clearly beats the PRC is in contribution to design. Similarly, Sri Lanka outperforms the PRC in compliance with labor standards, innovation and design services, and contribution to design.

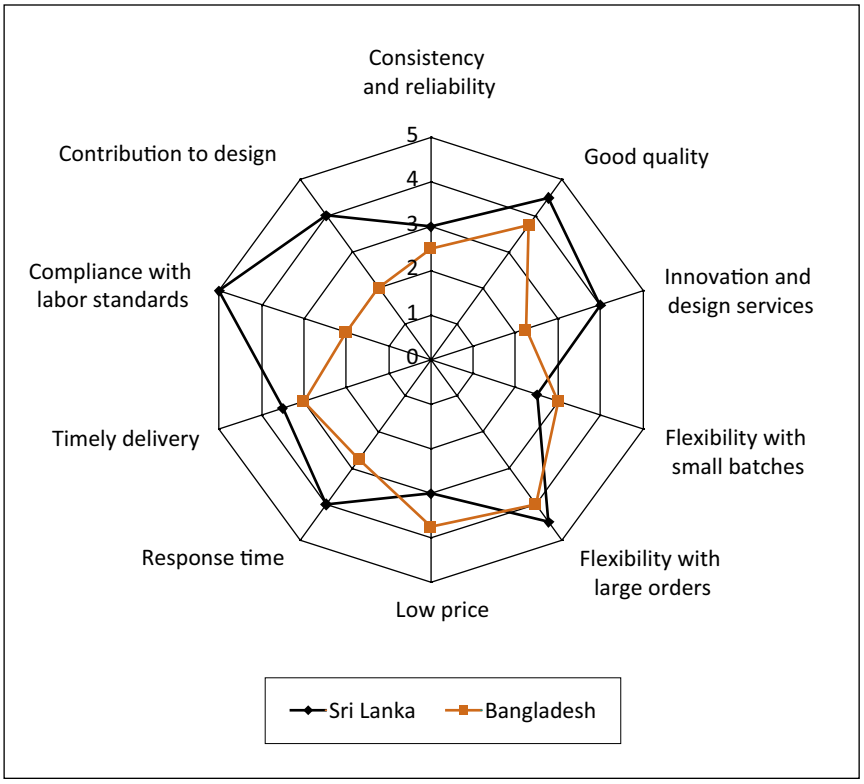
It is also surprising that the quality of the PRC's products is perceived to be better than that of India. The PRC garnered a perfect score on flexibility with large orders, and is no worse than India in terms of flexibility with small batch production, and innovation and design services. In contrast to perceptions that

Figure 3.5. Buyer Comparisons of Sri Lanka and Pakistan



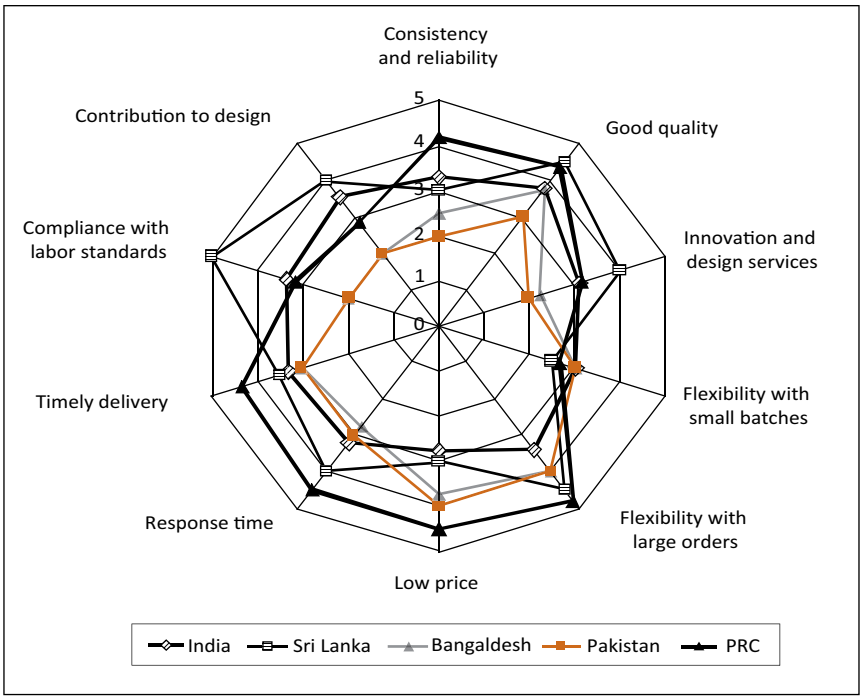
Source: Tewari/ICRIER Survey.

Figure 3.6: Buyer Comparisons of Sri Lanka and Bangladesh



Source: Tewari/ICRIER Survey.

Figure 3.7: Buyer Comparisons of South Asia and the PRC



Source: Tewari/ICRIER Survey.

labor standards are slack and poorly upheld in the PRC, India is no better than the PRC in compliance, while Bangladesh and Pakistan are perceived by buyers as lagging far behind the PRC and other South Asian countries. Sri Lanka alone outcompetes the rest of South Asia and the PRC in this important area of competitiveness.

Implications for Policy

The existing areas of strength in South Asia are fragmented relative to competitors like the PRC. Indeed, Bangladesh, Sri Lanka, and Pakistan come close to the PRC in terms of their ability to supply large orders and offer economies of scale; Sri Lanka and India can compete with the PRC in terms of flexibility with small batch sizes and in their contribution to design. However, the PRC remains a much more efficient executor of T&C products and services. It provides buyers with much greater levels of consistency and reliability, better prices, lower response time, timely delivery, and scale economies. South Asia's textile firms need to do much more to improve their performance in these key areas. Design services should be promoted in the region while Bangladesh, India, and Pakistan have to improve their product quality and response time.

It was seen that Sri Lanka leads in the capabilities that buyers value. It is all the more impressive that Sri Lanka has achieved this in spite of political disturbance and its reliance on imported inputs. It has increased its unit value realization and upgraded its design and quality standards, as well as its labor conditions. The entire industry and the Government has collaborated to change the image and substance of its labor strategy, and therefore, illustrates the possibility of moving away from the vulnerabilities associated with buyer-driven global value chains by improving "soft" skills and labor relations.

SAARC Sourcing Patterns in Textiles and Clothing: The Growing "Substitution" Problem

In spite of the clear division of labor between clothing exporters and textile producers in South Asia, there is very little intraregional trade in T&C. Indeed, Bangladesh sourced only 17% of its textile needs from South Asia in 2004 while its textile purchases from the PRC stood at 37% that year. Similarly, Sri Lanka's textile procurement from Hong Kong, China and the PRC, taken together, rose from 29% in 1990 to 41% in 2005, far outpacing the increase in its intra-SAARC textile sourcing, which stood at 13% in 2005 (UN Statistical Division 2007).

The domination of East Asia as the source of textile imports for Bangladesh and Sri Lanka stems from the MFA-induced quota-hopping investments from Hong Kong, China and Taipei,China starting in the early 1970s. Investors and buyers sought sites with underutilized quotas and fueled Sri Lanka's clothing export industry from 1974. Similarly, investors and buyers from the Republic of Korea promoted clothing assembly and exports in Bangladesh, which gained strength throughout the 1980s and 1990s. Given the strong early role of these producers and buyers, East Asia became the major supplier of raw materials, fabric, and other textile inputs to clothing exporters in these two countries.

The most striking change in this pattern occurred after the PRC's accession to the World Trade Organization (WTO). From 2001, the PRC emerged as the single largest supplier of textiles and fabric to Bangladesh with a 37% share in 2004, up from just 3% in 1990 (Table 3.16). In 2004, Bangladesh sourced about 17% of its textiles from South Asia compared to 50% from the PRC and Hong Kong, China together; and another 23% from, together, Asia, not elsewhere specified; Republic of Korea; Indonesia; and Thailand. This pattern was repeated in 2005 in the case of Sri Lanka, where East and Southeast Asia accounted for 68% of its textile imports and South Asia only 13% (Table 3.17).

The major point that this pattern suggests is while South Asia's share in Bangladesh and Sri Lanka's textile imports has increased, there is a clear substitution of supply going on from outside the region. Bangladesh and Sri Lanka rely far more heavily on textile imports from the PRC and elsewhere in East Asia than from South Asia, despite the latter's proximity and shared geography. The following are likely explanations.

Table 3.16: Share of Leading Suppliers in Bangladesh's Textile Imports (HS 50–60, 63), 1990, 1995, 2000, and 2004 (%)

Year/ Economy	Hong Kong, China	PRC	Asia, n.e.s.	Republic of Korea	Thailand	Indonesia	Singapore	India	Pakistan	Sri Lanka
1990	27	3	20	26	3	1	1	13	4	0.30
1995	34	13	—	17	1	2	2	10	9	0.00
2000	18	24	24	10	2	4	2	6	2	0.10
2004	13	37	11	6	3	3	0	12	5	0.10

— = data not available, n.e.s. = not elsewhere specified.

Source: Calculated from data from United Nations Statistical Division (2007).

Table 3.17: Share of Leading Suppliers in Sri Lanka's Textile Imports (HS 50–60, 63), 1990, 1999, 2001, and 2005 (%)

Year/ Economy	Hong Kong, China	PRC	Asia, n.e.s.	Republic of Korea	Japan	Southeast Asia	India	Pakistan	Sri Lanka	The West (US, UK, Italy)
1990	22	7	26	15	7	8	3	3	—	6
1999	25	4	19	16	3	10	6	1	—	10
2001	26	6	17	15	2	10	7	2	—	12
2005	26	15	11	6	2	8	9	4	—	13

— = data not available, n.e.s. = not elsewhere specified.

Source: Calculated from data from United Nations Statistical Division (2007).

Initial Conditions, Institutional Inertia, and Transactions Costs

Both Bangladesh and Sri Lanka have more years of experience working with suppliers from East Asia—especially those in Hong Kong, China; Republic of Korea; and Taipei,China—relative to India and Pakistan, which were relatively closed to trade in the late 1970s and 1980s. As respondents in Colombo explained, Sri Lanka's readymade clothing industry began to expand in 1977 after the country's liberalization and when East Asian industrialists began to establish their clothing firms post MFA. Thus Sri Lankan firms have built ties of familiarity with East Asian buyers, intermediaries, and sourcing networks over the last 30 years and in a quasi path-dependent fashion. It is, therefore, easier and cheaper to do business with existing partners.

Sri Lanka, like Bangladesh, began its clothing exports as a CMT assembler and an assembly platform, and its assemblers have little say in terms of which suppliers to patronize with regard to procurement of inputs. Because East Asian industrialists drove the growth of Sri Lanka's clothing industry, most of the inputs, such as fabric, accessories, buttons, zippers, and machines, all came from East Asian economies. They did not have that many links with South Asia in the readymade clothing industry at the start (Kelegama 2007). Given this long history of business ties with East Asian input suppliers, institutional inertia has discouraged T&C firms from shifting to suppliers elsewhere.

Designated Suppliers and Networks of Commissions

The status of Bangladesh and Sri Lanka's clothing industries as CMT assemblers has constrained their ability to diversify their input supply base. Many of these designated suppliers of Western buyers are in Hong Kong, China;[8] Indonesia; Singapore; Taipei,China; and Thailand, where US and European buyers have a long history of immersion. As a Sri Lankan respondent explained, shifting to new input suppliers (in India or Pakistan, for example) is a cumbersome process. Moreover, if the assembler recommends a new supplier, he or she needs to ensure quality, timely delivery, and price, otherwise lead time may be affected. As a result, larger clothing exporters have sought locally based joint ventures with suppliers designated by their buyers instead of branching out into new relationships.

In addition, money, in the form of commissions, flows between buyers, fabric suppliers, and assemblers. This generates extra economic benefits that interested parties want to keep intact, thereby perpetuating existing relationships and providing little incentive to disturb existing ties. However, with the rise of FOB production in South Asia, which gives manufacturers greater autonomy to make sourcing decisions, it is unsurprising to find that clothing producers have begun to source a greater share of fabric and accessories from within the region. An important implication of this shift is that South Asia's clothing industry should be upgraded toward FOB. Moreover, full package suppliers earn better returns and retain greater value than CMT assemblers.[9]

Product Variety and Range of Choice

It is well known that India and Pakistan dominate the region's yarn-spinning capacities. In spite of these vast capacities, which are second only to the PRC and in some cases the US, intraregional trade in textiles is very low. The lack of diversity in the region's fiber range and the virtual absence of a competitively priced variety of man-made fiber and materials limit the reach of South Asia's textile exporters. The absence of noncotton blends and versatile fabrics that are increasingly preferred by global buyers is also an important lacuna that puts South Asia at a distinct disadvantage vis-à-vis the PRC and elsewhere in East Asia. By focusing on a narrow product range, South Asia's textile producers have excluded themselves from the networks of supply and demand that are emerging in the region. Product diversification beyond cotton is an important priority, and industry associations and business intermediaries have an important role to play in this process. Anachronistic tax laws and excise duties on man-made fiber in India and Pakistan may also be rethought. Indeed, after at least three rounds of tax revisions in the textile sector, Indian laws still tax man-made fiber at twice the rate as cotton yarn (Ministry of Textiles 2006). Product diversification may be encouraged in part by restructuring incentives and tax structures.[10]

Bundling

The attractiveness of East Asia as a supplier of textile inputs to Bangladesh and Sri Lanka is deepened by the possibility of bundling a variety of inputs and manufacturing services. For many South Asian producers, this region is an important source of fabric, accessories, trims, and textile machinery. The relationship has gradually spread into other areas, such as advice as to what kinds of machines were best for particular fabrics. In the early and mid-1990s, the Republic of Korea and Taipei,China were the main producers of these relatively low-cost machines, but during the last half decade, the PRC has become the main source of machinery imports to South Asia, especially Bangladesh and Sri Lanka.

Thick channels of trade in one area (e.g., fabric and accessories) facilitated the transfer of knowledge and

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8 And now in the PRC.

9 In the case of Sri Lankan cotton shirts discussed in the section "Regional Value Chain Analysis: What Do Subsector Specializations Tell Us About Regional Complementarities?", the value of the final product increased from $2 to $6 per shirt when producers went from "labor-job" or "cut-sew" manufacturing to full package production.

10 Historically, the high duties and excise rates on man-made fiber and fabric were a defensive measure to protect the domestic hand and power loom industry from competition. However, several studies have documented the resilience of the local hand and power loom base against stiff competition. Thus, the industry has ample room to accommodate great product variety and diversity.

goods in other spheres as well (e.g., technology and know-how). Latecomers in the machinery market, such as India and Pakistan, will need to do more to catch up with their East Asian rivals to compete for intraregional business not only in fabrics but also in textile equipment. This thickening of ties is in part because interregional trade relationships have turned into foreign direct investment (FDI) relationships as the PRC and other East Asian economies increase their investment in production. About 40% of the overseas investment in the T&C industry in Sri Lanka is from East Asia. In contrast, South Asian investments amount to less than 2% of total FDI in T&C in the region (De Silva 2007).

Price

Two trends are evident in discussions with buyers. On the one hand, a subset of global buyers seems to be moving to consolidate regional sourcing to South Asia to match the patterns of local fabric availability. This is because costs and speed to market are increasingly important parameters of exports. For example, a respondent in the survey said that he was looking to move nearly 40% of his East and South Asian sourcing of casual bottoms and cotton shirts to India because of dramatic improvements in inputs. On the other hand, some buyers feel that prices dictate whether to buy or import local fabric, especially when small amounts of diversified material or specialized fabrics are involved. The overwhelming finding from numerous interviews in Bangladesh and Sri Lanka was that it was still cheaper to source from the PRC and elsewhere in East Asia than from India and Pakistan. The respondents pointed to at least five reasons for these price differences.

One was high energy costs relative to the PRC and elsewhere in East Asia. For example, power is 20%–25% dearer in India than in the PRC. Respondents also had concerns about the poor quality and inconsistency of power in South Asia. As a result, firms have their own captive power units, entailing capital outlays and adding to operating costs.

Another reason concerned low scales of production and productivity in South Asia. Indeed, some countries in the region, such as India, suffer from low yields of cotton per acre, especially when compared to the PRC and the US.

Specific duties and high tariffs and customs costs have also contributed to higher prices. For example, the import duty for polyviscose fabric in India can vary from 15% to 200%. This leads to tremendous misclassification by smaller operators and is exacerbated by complex customs rules. Others point out that on paper, India is considered cost competitive because of low labor costs, but Indian clothing exporters have to pay duties ranging from 18% to 34%. These duties, which are ad valorem, impose countervailing duties of up to 16.3% and thereby serve to raise product prices (Taneja and Sawhney 2007).

Another reason, cited repeatedly by clothing firms in Bangladesh and Sri Lanka that export to India, related to the nontariff barriers (NTBs) to market access imposed by India's complex testing protocols. For example, a firm exporting clothing from Dhaka via Petropole must send its samples and items to Chennai, more than 1,100 kilometers away for testing. In the interim, there are no bonded warehouses at the customs station for the importer to store products.

Finally, the varying levels of duty prevalent across the HS of product schedules in various SAARC member countries, as well as the time required for the verification of the detailed product category to which the item belongs, affect prices. While six-digit HS categories are globally standardized, eight- and 10-digit HS categories are country specific and an eight-digit category in India may mean very different final products in Bangladesh. This creates tremendous space for delays and erroneous implementation across each country's regulations and tax regimes. As a result, there is an upward creep of inventory risk and so prices go up as well.

Higher transportation costs caused by infrastructure-induced bottlenecks can also add to lead times and raise the cost of inventory. When passed on to consumers, they can raise prices to uncompetitive levels.

To meaningfully counter the trend of SAARC moving away from the region in terms of procurement and trade, at least in the textile industry, it will be crucial to make improved trade facilitation the center stage of South Asian Free Trade Area (SAFTA) implementation.

Improved trade facilitation in the region, as well as domestic upgrading efforts, would help member countries improve the efficiency of their textile industries and lower their product prices. The region should prioritize discussion of finding concrete ways to simplify tariffs, rationalize paratariffs, remove specific duties that countries like India impose on importers, lower energy costs, improve import and export intermediation procedures at ports and on land routes, and facilitate transportation and infrastructure reforms. One study suggests that trade facilitation reforms can increase intraregional trade in South Asia by nearly 64% (Mirza and Hertel 2007).

Summary

Other than prices and trade costs, this section has identified low scales of operation, low productivity, and lack of sufficient product and fiber diversification as problems that limit intraregional textile trade in South Asia. Textile line agencies and business associations need to mount a serious program of product diversification and upgrading in the region. An important initiative that can aid in product upgrading would be India's Textile Technology Upgrade Fund, which can be leveraged to promote product diversification. It is also important that textile firms access up-to-date information about market demand to be able to make informed investment and diversification decisions.

Economies of scale and scope should also be leveraged at the level of an industrial district or geographic cluster, as well as at the level of individual firms. Rather than viewing scale merely as a proxy for low value, standardized mass production, or a source of dangerous rigidity in volatile global markets, South Asian firms would do well to learn from Hong Kong, China's example, where large scales of operation did not always produce rigidity. Instead, firms used technology and work organization reforms as well as interfirm relationships strategically to produce multiple lines of products on a single factory floor (Berger and Lester 1997). Scale economies and productivity are, therefore, not only a reflection of technology and of the level of capitalization, but also of organizational attributes.

GSP, Backward Linkages, and the Rules of Origin Conundrum

One of the central issues that has emerged as a major hurdle to freer trade between SAARC member countries, at least in the T&C industry, related to compliance with rules of origin. As James (2007) notes, the costs of complying with rules of origin are an important determinant of how much intra-SAARC trade actually benefits from preferential trading regimes. Compliance with these rules comes at considerable cost, especially since fulfilling them clashes with each country's desire to develop backward linkages.

To take two cases, Bangladesh has lobbied against cumulative rules for SAARC and super-cumulative rules of origin. First, it argued that it would disrupt its growth, benefit Indian and Pakistani fabrics exporters, and undermine the development of backward linkages in Bangladesh. Second, sentiment was against these agreements because the rate of concession depended on which country had the highest value added. In Sri Lanka, in contrast, the clamor was for the expansion of the SAARC cumulation rule to include East Asia and the creation of super-cumulative rules of origin because Sri Lankan exporters felt that it was costlier for them to source fabric from South Asia than from the PRC and elsewhere in East Asia. The fabric range in South Asia was also inadequate, they felt. Consequently, Sri Lankan exporters argued that being forced to rely solely on South Asia's fabric base would make them globally uncompetitive. In view of the resistance of Bangladesh and Sri Lanka, the EU revised its GSP and cumulation rules, albeit marginally.

Four points may be gleaned from the above discussion. First, distributional consequences of regional integration, such as displacement and intensified import competition, can often seem orthogonal to the demands of local development (e.g., the development of backward and forward linkages). Integration can put pressure on nascent local producers, expose them to direct competition with experienced outside producers, and complicate the fostering of local linkages. This is primarily so because the goals of regional collaboration and

local development are often perceived as zero-sum tradeoffs that can be hard to reconcile. The challenge is to find ways to transform these supposed tradeoffs into more positive-sum outcomes, strategies, and sequences (Tendler 2007). This can be done by searching for and building on areas of common and overlapping interest that can generate wider linkages and spillovers across the region, rather than by focusing on differences.

Second, even if the goals of regional cooperation are laudable, high costs of regional trade and local production inefficiencies can make the dynamics of such cooperation unworkable. For it to work, local production networks must be individually strong and efficient. Thus regional integration cannot come at the expense of developing and deepening local capabilities. In the South Asian case, this means improving the competitiveness of the textile industry in individual countries such as India and Pakistan, lowering product prices, and reducing the costs of intraregional trade through trade facilitation reforms.

Third, smaller countries show immense wariness that they might be overwhelmed by India's market size, potential investments, control over resources, and local markets. They also have concerns about opening their borders to fuller trade and investment from India. If borders are opened, what will be left behind and what will be denuded? Thus, the onus is on India, the largest economic power in the region, to simplify its rules of origin, improve product prices, and diversify its product range in ways that are relevant for the region's clothing industry. Only when individual members see that their individual benefits are tied up with the growth of the region as a whole can regional integration be sustainable. In this regard, it would seem that the SAARC cumulation rules under the revised GSP would be good for promoting regional cooperation, but are not workable under the current conditions of high regional trade and production costs. In this view, South Asia's textile producers should improve their productivity and performance by lowering production costs, increasing efficiency, and inducing strategic technical and organizational modernization. Of course, the administrative costs of intraregional trade should also be lowered. For its part, the EU could consider modifying the rate at which value added is measured in beneficiary countries, to allow countries fuller tariff exemption on intermediates imported from within the SAARC region.

Finally, a larger point that this discussion illustrates is the power of agency and local politics in shaping the nature of regional integration. The discussion shows how contention and confrontation between actors at different nodes of the clothing value chain (e.g., clothing exporters of Bangladesh versus its textile lobby) influence and are influenced by the wider trajectories of trade and investment dynamics. The extent to which relatively small countries like Sri Lanka can induce much larger powers, such as the EU, to change the rules (even if marginally) through continued resistance is striking. Indeed, the EU came up with the SAARC cumulation rule under the revised GSP in response to regional pressures in 1995. It is once again considering simplifying its GSP and is said to be moving toward adopting value-added rules of origin. This illustrates how seemingly weak actors on the periphery can reshape apparently invincible trade rules put in place by powerful actors.

Investment: Is Cross-Border Investment an Answer to the Conundrum of Weak Intraregional Trade?

Only two South Asian firms (both from India) have invested in the T&C industry of Bangladesh and three have invested in Sri Lanka. Ironically, the largest intraregional investment is from a big Sri Lankan clothing exporter, Brandix, which is developing an integrated fabric and final goods clothing park in India's Andhra Pradesh state—Brandix Clothing City. This 1,000 acre park in Vishakhapatnam's export processing zone (EPZ) was initiated in 2005 with an investment of $750 million. The total investment in the park is expected to grow to $3 billion in 5 years (Kuruppu 2007). The rest of this section looks at reasons why firms in South Asia want greater intra-SAARC investment, investigates why there is so little

intraregional investment, and discusses ways to leverage new opportunities.

Firms' Interest in Greater Intra-SAARC Investment

In interviews, firms and policy makers offered numerous reasons why they want more South Asian investment in textiles and why there is general enthusiasm for sourcing intermediate inputs, such as fabric and accessories, from within South Asia. Firms see these benefits as contributing to the production of regional production networks of T&C that would make South Asian firms as a whole more globally competitive. The main reasons are as follows.

Leveraging Economies of Scale

In the example of Brandix, the firm was interested in setting up Brandix Clothing City in India to take advantage of the investment support that the Indian Government was giving in its desire to generate an agglomeration of related companies in the clothing park. In setting up its own yarn-and fabric-making plant for sophisticated, fashion-driven swimwear and lingerie, the company not only wanted to supply fabric to its own plants in Sri Lanka, but to use the large and growing size of the Indian market to achieve economies of scale (Kuruppu 2007).

Lead Time and Time Pressure of Customization

Policy makers and firms in Bangladesh and Sri Lanka spoke of the need for greater investment in textile and fabric production within their borders. This would not only create backward linkages within their clothing chain, but would also cut down on the cost and time of sourcing textile inputs from abroad. It can take a month or more to source fabric, and in an industry where delivery time is becoming shorter and shorter, this is a liability. For many firms, the largest advantages of greater intraregional investment in textiles are the cost and time that would be saved if the sourcing of fabric could be made closer. One respondent emphasized that nothing compares with local sourcing, and that local investment would allow greater interaction between suppliers and buyers. This would then lower the risk of losses of time and money through miscommunication of specification, quality, and design requirements. In addition, it would also allow for greater customization at lower cost.

Inventory Costs and Risks

In the clothing industry, a related reason for more proximate access to intermediate inputs is the need to reduce the cost of holding inventory in transit and storage. With growing consumer preference for greater variety and shorter fashion cycles, retailers have sought ways to reduce their risk of holding an inventory of items whose demand may diminish quickly. Although a majority of South Asia's clothing exporters operate on a 60-day production cycle, the trend is moving toward far shorter turnaround times, and so becoming stuck with obsolete inventory is a growing risk. Several leading exporters in Bangladesh, India, and Sri Lanka spoke of the pressure to vertically integrate backward into fabric making to deal with these pressures or to build relational ties with local fabric producers. Intraregional investment in textiles that would deepen the availability and choice of local fabric producers within South Asia is a high priority for many clothing exporters.

Streamlining

South's Asia's existing comparative advantage in basic (cotton) fabrics and made-ups could be played up more with better regional collaboration. This advantage cannot be leveraged fully unless production is expanded and streamlined. Streamlining production also means adopting harmonized and compatible standards across the region, and this is expected to induce modernization.

Modernization

Some firms are looking for South Asia-based lead firms to help modernize SAARC's T&C industry, upgrade its supply chain, and underwrite the risks of adopting new standards and technologies. This chapter has identified, other than prices and trade costs, low scales of operation, low productivity, and lack of sufficient product and fiber diversification as problems that limit intraregional textile trade in South Asia. Some firms feel that if one of the big clothing giants purchases enterprises in a South Asian country, it might then try to create links to suppliers in other South Asian countries and thus there will be better prospects of

growth (Kelegama 2007). The arrival of Brandix in India and Arvind Mills' forays into Bangladesh hold similar promises for supply chain upgrading. Modernization would also allow for the adoption of more up-to-date and effective technologies that could lower costs, cut turnaround times, and increase product diversity.

GSP Benefits

Finally, as noted earlier, the benefits of GSP do not reach the intended beneficiaries (i.e., only 50% of GSP benefits are used by least developed countries). This is because poorer countries are unable to adequately meet the requirements of a "stages of production" model needed to take advantage of GSP. Many firms feel that increased intraregional investment in textiles would be a way for clothing producers across South Asia's poorest countries to benefit much more from GSP.

Paucity of Intraregional Investment

The first reason for the small amount of intraregional investment, despite professed interest, is the long years of inward orientation in both India and Pakistan. India was preoccupied with meeting domestic demand for cheap cloth throughout the 1970s and 1980s, and forced a domestic focus on its textile sector through high export tariffs and domestic hank-yarn obligations, as well as by declaring it an essential commodities sector. As the country opened up in the 1990s, firms sought to build ties with Western markets and to meet domestic demand, which grew rapidly throughout the 1990s.

The second reason is the security situation in Pakistan and Sri Lanka, which created disincentives for South Asian investment in these countries and in Bangladesh.

Third, South Asian investments undergo much scrutiny and are also involved with long delays, lost files in the bureaucratic process, or are arbitrarily put on hold as "new evidence" is sought or motives are pondered over. These are factors related to the burden of history and the "X factor" that many say comes into play with regard to mutual dealings by some South Asian neighbors.

Finally, the problems of history are manifest throughout the region. Two Indian firms have been trying to invest in Bangladesh for three years, but nothing has moved and, for one reason or another, authorities in the country have stalled in making decisions.

Leveraging New Opportunities to Overcome the Burden of History

There is a strong sense among some clothing producers that the expiration of PRC safeguards imposed by the EU and US in 2008 represents an important turning point for the region. Suppliers and some policy analysts in Bangladesh pointed out that after the PRC entered WTO in 2001, exports of Bangladesh to the US began to decline by about $400 million (James 2007, Rehman 2007). Many analysts and industry actors believe that the market for T&C in South Asia is likely to undergo another structural change after 2008, which might put pressure on firms to forge cooperative ties, build joint ventures, and deepen intraregional investment to remain globally competitive. This demand for structural change can be leveraged and may create the conditions for greater cooperation between SAARC countries and enable them to take advantage of their shared geography and complementary competitive advantages.

This means that regional cooperation will have to be led by investments in textile and fabric production, and that it should move toward FOB production. It will be important to strategically use the distinctive strengths of SAARC members. In addition to upgrading production capabilities, the region will need to improve cross-border distribution and transportation networks, upgrade technologies, and induce greater inflows of capital into T&C. Institutional support to aid these processes will then have to be put in place, especially a regional investment protocol or agreement.

Also, one of the most striking findings from the fieldwork undertaken for this study was the emergence of young professionals who were senior managers of older family firms or new start-ups, who share professionalism, global linkages, education, and a forward-looking business ethic. This new generation has little hesitation in working with partners across borders so long as their partners are professional and globally oriented. This trend should be encouraged by national governments, especially by SAFTA's

leadership. New forums should be created to induce greater interaction among the region's younger entrepreneurs and government managers. Joint marketing trips, leadership development courses, and exposure to cutting-edge business practices and technologies as well as to design and value addition are examples of the kinds of forward-looking activities that could bind the region's emerging generation of professionals in the T&C industry.

The broad and growing diffusion of managerial and technical staff across each other's markets is also an excellent sign of the deepening integration in the region's T&C industry. This movement of personnel across borders is creating the conditions for the diffusion of ideas, best practices, and exchange of information. This in turn has the potential to create a common space and a shared language that may help overcome years of wariness by forging positive-sum alliances and mutual interdependence. However, easing and simplifying visa rules will be needed to keep such growing interpenetration going.

Market Access: First Best?

Market access is clearly important for textiles as well as clothing. The question is how to achieve greater market access within SAARC. At the very least, investment and market access may have to move in tandem or in recursive fashion to reinforce each other. Currently, market access issues center on tariff rates, long negative lists, and high customs and trade costs that act as NTBs in the region. At a more pragmatic level, market access issues in South Asia hinge on the degree of openness of India's large domestic market to its SAARC neighbors.

At present, market access in India is being negotiated bilaterally through the various free trade agreements that India has with Bangladesh and Sri Lanka, but the process is not going well. In January 2008, India's offer to allow Bangladesh and Sri Lanka to export 8 million pieces of clothing each to India duty free was a big issue. Exports did in fact proceed as scheduled, enabling Bangladesh and Sri Lanka to export 8 million pieces each duty free to India, with India eventually conceding to most of the demands made by these two countries. Both of them have three main issues: restricted ports of entry, prior notification of detailed export content, and rules of origin.

Initially, India wanted all tariff-free exports to enter the country only through four ports because not all of its customs points have the capacity to keep records and to ensure that the limit of 8 million pieces was not exceeded. However, Bangladesh and Sri Lanka saw this restriction as an NTB and both countries rejected this clause. Similarly, on India's request for prior notification on products that would be exported, exporters from Bangladesh and Sri Lanka argued that this would depend on demand (i.e., at the six-digit level), and that there was no way that they could forecast demand two seasons ahead and give prior notification. India's reasoning was that it was safeguarding its domestic producers from the potential flooding of its market with tariff-free exports of 8 million pieces of just one or two products. However, as instituted, it proved impractical and unworkable. But being the dominant regional economy, India may take the lead in opening the region's markets to SAARC members by shortening (and eventually eliminating) its negative lists, reducing its tariff rates, lowering in-state taxes, and improving trade facilitation.

Important opportunities are being squandered with regard to building up regional scale, expanding product variety, and learning from each others' specializations and successes. As shown by James (2007), even in the absence of the PRC's full participation in textile exports due to the EU and US post-MFA safeguards, South Asia has been unable to take as much advantage of displaced demand as it could have. SAARC's performance in the US market with regard to the market share of its T&C exports in value terms was only marginally better in 2006 (when the PRC was restricted) than it was in 2004. The primary reasons for South Asia's inability to take advantage of the temporary lull in competition from the PRC in the US market relate to five main factors:

i. South Asia's production networks are fragmented and small scale;

ii. Firms have inadequately invested in capacity expansion and new technologies, such as shuttleless looms or computer-controlled equipment, which could enhance productivity and quality;

iii. Not only are production costs high, but a long list of additional duties, specific taxes, and paratariffs adds significantly to production costs.

In addition, poor infrastructure and inadequate real services (e.g., warehousing, buyer-seller meetings, or trade fairs) further lead to heavy inventory costs and shipment delays that can push up the cost of doing business in much of South Asia;

iv. The tightness of labor markets for skilled workers puts a strain on the industry's production capacities; and

v. South Asia's poor insertion in global distribution networks has hindered its ability to make sufficient inroads into the global market.

For all these reasons, South Asia's T&C industry lags behind its competitors in the global market (with only a 5% share relative to a 27% share for the PRC) and has been unable to really exploit the opening created by the EU and US safeguards on the PRC.

Constraints

The chief problem in South Asia's T&C industry is that the region's major clothing exporters have substituted East Asia as the sourcing hub of fabric and accessories. The long-standing transactions of South Asian T&C firms with East Asian textile suppliers have made it difficult to alter existing relationships, and Western buyers who source clothing from South Asia have reinforced these ties. The origins of South Asia's clothing industries and the flow of commissions have also perpetuated the status quo, leaving little room for developing and deepening intraregional ties within South Asia. Another contributing factor is related to the tradeoffs and contradictory incentives embedded in various GSP and preferential access schemes, and the high costs of compliance with rules of origin associated with these schemes. Finally, the lack of product variety among South Asian textile producers limits intraregional sourcing.

To encourage intraregional sourcing, SAARC governments and industry actors need to work together to lower the costs of production. Indeed, with its high prices and production costs, which are attributable to low scales of operation, low productivity, high costs of energy and administration, transportation bottlenecks, and an array of specific duties, South Asia's textile sector is uncompetitive. At the same time, trade facilitation reforms are critical in helping move these goods across South Asia cheaply and in a timely fashion.

All the region's exporters seem to be more interested in cornering global rather than regional markets. While local market access is not unwelcome, the primary motivation is to break into larger Western markets, which are more demanding. Thus the offer of tariff-free entry into the Indian market under a quota system of 8 million pieces a year has not generated much interest in other South Asian countries since the region exports millions of pieces a year to the rest of the world. In this view, trade facilitation has to be reformed more energetically. However, trade facilitation problems are politically and socially intertwined in the region's history. Therefore, new alliances and cross-border constituencies must be created to mobilize the demand for reforms. A second solution is to encourage focused investments in intraregional textile production networks.

Despite the attractiveness of greater intra-SAARC investments in textile production in hubs where clothing is made, investment levels remain extremely low. The burden of history has been an important factor in some South Asian countries' preference for investment from outside the region. A central challenge to expanding regional integration is to find and cultivate a common ground, and identify pathways to positive-sum alliances. East Asia's experience in regional cooperation is a very important and instructive guide in this regard.

Conclusions and Policy Recommendations

This chapter has examined the existing state of T&C trade and investment within South Asia with the goal of identifying key patterns, obstacles, and opportunities for enlarging regional integration in this important industry. In a WTO-driven world, where regional trade agreements have come to proliferate as a way of marshalling local and regional advantage, South Asia stands apart as a region driven by centrifugal tendencies and fragmentation rather than coordination and collective action.

Fieldwork in South Asia has revealed potential drivers of integration which can help overcome the burden

of history and foster greater regional integration, especially in the T&C industry. These are explored below.

Growing Domestic Markets and the Rise of Organized Retail Operations in South Asia

India's expanding domestic market and the rise of organized retail in the country have created great potential for sourcing from within the SAARC region to meet the opportunities created by growing local demand. The rise in mall space in cities and the emergence of giant retailers buoyed by the income elasticity effects of demand for clothing from a new class of young consumers have led to a proliferation of domestic brands and private labels in the Indian market over the last half decade (Mukherjee and Patel 2005, Tewari 2006). This is fueling the creation of tight new supply chains and production networks in the region.

The presence of suppliers in Bangladesh, Pakistan, and Sri Lanka would be a natural source of advantage since each country has product niches that it dominates. The rise of private labels, the demand for variety, quick turnaround time, and rapid replenishment on the part of retailers dovetails with this regional specialization and geographic proximity. Indeed, some suppliers in Bangladesh and Sri Lanka reported being approached by purchasing departments of large Indian retailers with orders and for the exploration of joint investments. If these trends deepen, they could create opportunities for the development of intraregional production networks.

From a program and policy perspective, this potential demand-pull for finished clothing from South Asia into Indian retail networks can be the impetus by which India would phase out its long negative lists and specific duties, improve its logistics, and streamline its inspection and certification procedures, among other things. None of these problems is easy to resolve, but this potential demand can create a strong lobby from importers and exporters that could bring new pressure to bear on the region's governments to improve trade facilitation in South Asia.

A second choice is to encourage joint ventures or cross-border equity stakes between importing country producers and producers in other South Asian countries. This may lower some cross-border movement costs, but any significant cross-border investment cannot happen without an investment treaty between SAFTA's member countries. SAFTA's leadership could work with international financial institutions to push constituencies toward developing an investment protocol and to encourage the formation of an investment fund.

Harnessing the Growing Professionalism, Global Exposure, and Education of "New Entrepreneurs" in South Asia

The second potential driver relates to a new wave of professionalism and boundary-crossing exposure and education of the next generation of entrepreneurs in South Asia. One of the most striking findings of the fieldwork was the growing transformation of attitude among these people. They are often educated abroad and have interacted more widely and openly with colleagues in other countries. Their education has also infused them with a shared language and vision of progress, success, and meaning. These have made them more willing to work with each other than their parents' generation had ever been. They are also more aware of what is going on in each "rival" country.

Since it may well take the next generation of entrepreneurs from the region to overcome the burden of history and begin to work together, this new wave provides an opportunity for international organizations to join governments in providing a platform on which these professionals and entrepreneurs can meet. Joint marketing trips, leadership development courses, and exposure to cutting-edge business practices, technologies, design, and value addition, are examples of the activities that could bind the region's younger generation in the T&C industry.

Regional and international organizations can help lay the conditions for the broader development of the private sector by helping SAARC governments promote trade facilitation and regional cooperation. Executive training events focused on younger entrepreneurs and salient issues that matter to them, such as global market development, design, branding and product development, management leadership, financial, technical upgrading, and information technology management, should be promoted. Other programs might include funding for collaboration or

taking cross-regional teams of entrepreneurs to third countries (the main markets such as US, EU, Japan, or PRC) for exposure and networking. These could also involve setting up intraregional quality circles between teams of young entrepreneurs from the region. These programs could include joint skill development and design development training initiatives.

Knowledge Networks and Labor Markets in Skills

The high transaction costs of doing business with each other has dulled interest among many exporters in developing the regional market, but they do not seem to have prevented a growing intertwining of the region's labor market. Indeed, there is a relatively high degree of interpenetration of skilled workers and managers across South Asia. This diffusion of managerial and technical staff is an excellent sign of deepening integration in the industry. This is creating the conditions for the diffusion of ideas, best practices, and exchange of information, and has the potential to create an intraregional "knowledge field," where firms and workers understand each others' markets, production processes, and norms. A shared language of experiences and production practices could emerge to the great benefit of intraregional communication, and these are the kinds of developments that chip away at political barriers and make demands for broader change.

However, the proliferation of these skill and knowledge networks has run up against problems. Several Bangladeshi respondents with Indian managers reported being extremely anxious whenever their managers went home to India. They were worried whether the Bangladeshi authorities would allow them to return, and whether they would be granted visas, work permits, and for how long. In the incipient and nascent creation of cross-border manufacturing services and interpenetrated labor markets, it will be very important for policy makers to fix this problem of visas before it disrupts the bridges that are being built.

Geographic Indication and Intellectual Property Rights in Textiles

An important and unexpected theme that emerged from the fieldwork was that some local textile and design traditions were at risk of being appropriated by entrepreneurs from outside the region. For example, some firms mentioned that Western designers were bringing fabrics, weaves, or designs that were traditional to South Asia such as *ikkat,* chicken, and *zari* embroidery as well as clothing such as the *Sherwani*. While learning from each other is central to innovation in the clothing sector and has long been a part of how business gets done in the fashion and design industry, some South Asian firms pointed out how traditional products were being made in other regions and sold as beach wear in stores like J. Crew and K-Mart. There are similar issues with regard to the use of certain looms and fabrics.

Rather than have SAARC members fight among themselves about which products are local to which country in the region, it may be possible to consider intellectual property in textiles as a bond to bring them together around a common regional brand. Working together to secure a "geographic indication" (at WTO eventually) in selected textiles and products, as well as in processes traditional to the region may be a way to develop regional identity, or it could initiate a process of working together. The T&C industry undertakes very little research in this area, which merits deeper understanding.

Leveraging Strategic Regulatory Shifts and Upcoming Demands for Structural Change after 2008

As several studies (including World Bank 2006, James 2007) have noted, the EU and US restrictions on the PRC boosted the clothing exports of some SAARC members. But with the elimination of these safeguards in 2008, many industry analysts and associations see a looming crisis. With competition from the PRC intensifying after 2008 and the growing importance of Cambodia and Viet Nam, South Asian firms will be under pressure to cut costs and shore up profitability in international markets. They will have to come together and harness each others' comparative advantages. This demand for structural adjustment may create the space to foster closer regional cooperation.

In view of the above, SAFTA or SAARC can form interregional focus groups and task forces to develop a common understanding of this problem and work out an agenda of action. SAFTA or SAARC can also play a facilitating role among the region's governments

by sharing information and tracking changes in trade flows, prices, and demand. Finally, SAARC governments should take significant steps toward streamlining tariffs and negative lists, and toward shoring up the competitiveness of the region's textile industry through modern production methods, technology, and the removal of supply bottlenecks on quality inputs and skilled human capital.

Intraregional FDI in Textiles as a Driver of Greater Investment and Trade within SAARC and Beyond

It is clear that the textile trade is the glue that binds SAARC's member countries. About 7% of the region's exports of textiles are consumed within the region, in contrast to less than 0.6% of the region's clothing exports. Recent modeling studies of South Asia (such as Mirza and Hertel 2007) have also suggested that textiles constitute an important engine of growth, and that increased investment can generate growth multipliers for the region's T&C industry and boost employment and exports. If the region can make world-class, low cost, but high-quality fabric of a wide variety available to clothing manufacturers within SAARC, it will lead to improved international competitiveness in the industry, improved import competition, and wider intraregional trade.[11] Greater market access in SAARC will help achieve these results, and because the barriers to both market access and investment are linked, they must move in tandem with efforts to improve the investment environment and to facilitate regional FDI in textiles.

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[11] With regard to clothing, the emerging dynamics are more mixed. However, the rise of organized retail foreshadows the possible intensification of intraregional trade in clothing in the coming years.

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CHAPTER 4

Four Country Investment Studies

Background Information

The countries of South Asia have shared, basic similarities in economic structure, including the protectionist policies that have long characterized their development strategies. When these countries undertook economic liberalization in the late 1980s and early 1990s, they had poor investment and trade links. In addition, they could be characterized as having low per capita incomes, labor abundance, similar comparative advantages, and a reliance on markets outside the region for their exports. This reliance has caused their exports to compete with each other while low per capita incomes have constrained the potential for intra-industry trade, which is generally associated with higher-income countries.

Nonetheless, prospects for greater intraregional trade and investment are other than bleak, a view buttressed by the fact that over the past decade, real gross domestic product of South Asian countries has been growing at rates comparable to those of East and Southeast Asian economies (Table 4.1). The growth of

Table 4.1: Growth Rates of Real Gross Domestic Product, FY1995–FY2007
(%)

Region/Country	FY1995–FY1997	FY1998–FY2000	FY2001–FY2003	FY2004–FY2007
Central and West Asia	**0.96**	**5.39**	**7.09**	**10.12**
East and Southeast Asia	**6.26**	**4.08**	**4.85**	**7.35**
South Asia	**5.79**	**5.54**	**4.97**	**6.85**
Bangladesh	4.97	5.37	5.00	6.35
Bhutan	5.77	6.90	8.30	7.47
India	6.53	5.83	6.03	8.80
Maldives[a]	8.97	7.27	6.17	7.65
Nepal	4.57	4.50	3.13	3.68
Pakistan	4.45	3.86	3.27	7.52
Sri Lanka[a]	5.23	5.03	2.87	6.53
Australia, Japan, and New Zealand	**3.13**	**2.52**	**2.61**	**2.73**

Note: The fiscal years for Bangladesh, Bhutan, and Pakistan run from 1 July to 30 June; for Nepal, from 16 July to 15 July. FY before a calendar year denotes the year in which the fiscal year ends (e.g., FY2007 ends on 30 June 2007).

The fiscal year for India runs from 1 April to 31 March; FY before a calendar year denotes the year in which the fiscal year starts (e.g., FY2007 starts on 1 April 2007).

[a] Calendar year.

Source: Asian Development Bank (2008).

South Asian economies, coupled with their burgeoning population, which stood at 1.3 billion as of mid-2007, is setting the stage for increased demand for goods and services. In this regard, intraregional trade and investment will have to be promoted to keep up with demand.

The potential for expanding intraregional trade exists. Indeed, the average growth rates of real exports and imports of goods and services in South Asia for the period FY2004–FY2007 have exceeded those posted by other regions of Asia (Tables 4.2 and 4.3). In addition, the huge population of South Asia is an untapped market and a resource in terms of labor and skills. In the same manner, the region's natural resources also beg to be used in the face of the expected increase in demand.

Another aspect is that a larger proportion of products that are traded within the region is now composed of manufactured products, and this shift is coupled with the increasing industrialization of South Asia. This process promotes intra-industry trade, economies of scale, and ultimately, intraregional flows of foreign direct investment (FDI). However, this situation demands further cooperation among the countries of South Asia with regard to addressing the perennial constraints that have hindered greater integration in the region. To this end (as said at the start of this volume), the Asian Development Bank initiated a comprehensive analysis on intraregional trade and investment in South Asia as part of its efforts toward facilitating economic cooperation in the region, of which the result is this volume.

Objectives of the Studies

The broad objective of four parallel country investment studies on Bangladesh, India, Nepal, and Sri Lanka—the following four chapters—is to derive country- and sector-specific policy recommendations to enhance intraregional trade and investment in South Asia. The studies will augment the relevance and applicability of the region-wide policy conclusions of the other project components of the Study on Intraregional Trade and Investment in South Asia (i.e., the other chapters in this book). Intraregional FDI plays a critical role in the economic integration of South Asia and should be given due focus and consideration.

In particular, the four studies explore the prospects and challenges for FDI in general and in the textiles and clothing (T&C) and automobile industries in particular; examine each country's trade and investment regimes, with a particular emphasis on regional economic integration; identify the factors that have impeded the process of regional economic integration; assess the prospects for better regional economic cooperation, particularly through intraregional FDI; and suggest policy recommendations for strengthening trade and investment linkages in the region.

The four chapters are structured as follows. The first section presents an overall macroeconomic profile of each country and aims to discuss the overall macroeconomic conditions and business climate, trade and industry profiles, the infrastructure and resource endowments of each country, and regional trade agreements into which each country has entered. The second section examines more closely each country's experience with FDI, beginning with its first forays into economic liberalization until the present. The third section talks about the potential, impacts, and constraints with regard to each country's economy and its FDI, with particular emphasis on intraregional FDI in the T&C and automobile industries. The fourth section brings out the policy and institutional reform implications of the analysis thus far. The last section concludes.

Chapter 9 summarizes country-level policy recommendations from the four country investment studies and the T&C industry study. The chapter also presents efforts toward regional cooperation that have to be undertaken at the regional level.

Brief Review of Literature

Attracting FDI is generally thought of as a boon to developing countries since it creates employment, increases exports, and introduces new management and production techniques; these outcomes have been supported by the empirical literature. However, what are of greater interest are the linkages between regional economic integration and FDI. Indeed, if there is an uptick in FDI as a result of greater economic integration, such should be the primary aim of each country. Blomstrom and Kokko (1997) argue that the impact of regional economic integration on FDI

Table 4.2: Growth Rates of Real Exports of Goods and Services, FY1995–FY2007 (%)

Region/Country	FY1995–FY1997	FY1998–FY2000	FY2001–FY2003	FY2004–FY2007
Central and West Asia	**(2.16)**	**15.52**	**10.37**	**6.45**
East and Southeast Asia	**10.71**	**10.84**	**5.59**	**10.71**
South Asia	**9.49**	**8.71**	**8.13**	**15.64**
Bangladesh	18.43	9.67	6.50	20.23
Bhutan	—	—	7.23	33.70
India	11.80	16.70	11.10	17.05
Maldives[a]	12.00	7.07	7.53	11.90
Nepal	—	—	—	—
Pakistan	(2.54)	2.46	16.84	4.60
Sri Lanka[a]	7.73	7.67	(0.40)	6.35
Australia, Japan, and New Zealand	**6.48**	**4.82**	**3.08**	**5.37**

— = data not available, () = negative.

Note: See Table 4.1.

[a] Calendar year.

Source: Asian Development Bank (2008).

Table 4.3: Growth Rates of Real Imports of Goods and Services, FY1995–FY2007 (%)

Region/Country	FY1995–FY1997	FY1998–FY2000	FY2001–FY2003	FY2004–FY2007
Central and West Asia	**(0.92)**	**3.97**	**9.68**	**13.57**
East and Southeast Asia	**10.23**	**4.76**	**4.19**	**8.82**
South Asia	**11.58**	**4.88**	**5.24**	**17.27**
Bangladesh	20.27	5.67	2.47	17.88
Bhutan	—	—	4.00	18.73
India	12.97	10.43	10.20	23.13
Maldives[a]	15.55	4.50	5.53	25.20
Nepal	—	—	—	—
Pakistan	4.59	(4.43)	5.48	12.96
Sri Lanka[a]	4.57	8.20	3.80	5.68
Australia, Japan, and New Zealand	**8.14**	**5.11**	**4.77**	**6.75**

— = data not available, () = negative.

Note: See Table 4.1.

[a] Calendar year.

Source: Asian Development Bank (2008).

results from the competitiveness of local firms, the motives of FDI, and the policy environment present in each regional grouping. Some also believe that regional economic integration attracts FDI because firms are attracted to the larger market share that the regional arrangement offers (Jaumotte 2004). Indeed, this larger market share is achieved when there is a reduction in trade barriers.

Turning to intraregional FDI, regional integration may attract FDI from within the region if the integrated area offers efficiency. In this view, countries would be willing to invest in another country within the region if it can offer comparative advantage over the home country. This comparative advantage might be in the form of reduced costs through technological advances, labor abundance, or geographic proximity. Again, the removal of barriers to trade and investment among countries in a particular region is imperative.

Blomstrom and Kokko (1997) also state that predictable and transparent business environments among countries in a regional arrangement may stimulate FDI. In this regard, provisions should take into account issues of expropriation of profit, dispute settlement, harmonization of laws across countries, and taxation, among others. In addition, the actual implementation of these regulations is a crucial factor in attracting FDI.

Studies have shown that regional arrangements among developing countries can give rise to FDI. Indeed, the bulk of FDI among developing countries is intraregional, and from 2002 to 2004, intra-Asian flows accounted for more than four fifths of the total flow of FDI. Within Asia, intraregional FDI accounted for about half of total flows to Asia (UNCTAD 2006). These flows have been supported by the liberalization of Asian economies as well as the harmonization of policies and business-support measures.

For South Asia specifically, Din and Nasir (2004) argue that the lack of trade complementarities, restrictive trade policies, lack of a regional transport network, and political instability were serious impediments to the greater economic integration of South Asia. There is a need, among other things, to reduce trade barriers, harmonize customs, promote the transparency of bureaucracy, and broaden the scope of the South Asian Free Trade Area.

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CHAPTER 5

Bangladesh Country Investment Study

Khondaker Golam Moazzem
Md. Tariqur Rahman

Country Economic Profile

Overall Macroeconomic Conditions and Business Climate

The economic development of Bangladesh during the last two and half decades is the result of structural changes in the economy, reforms in domestic economic policies, changes in international policies, and consequently, the emergence of a group of entrepreneurs in the private sector. During this period, economic growth increased from a mere 3.7% in the 1980s to more than 6.0% after 2000, with gross domestic product (GDP) reaching $78.95 billion in FY2008 (Table 5.1).[1] The services sector continues to be the main driver of economic growth with a share of nearly 50% of GDP since the 1980s. The growth centers in services include retail and wholesale trading, transport, hotels, telecommunications, and health care services. A declining share for agriculture and an increasing contribution by industry have been evident during the past 25 years. For industry, output continues to come primarily from manufacturing, which has accounted for at least 60% of total industrial

Table 5.1: Major Macroeconomic Indicators, Bangladesh, FY1981–FY2008

Indicator	FY1981–FY1990	FY1991–FY2000	FY2001–FY2005	FY2006	FY2007	FY2008
Gross Domestic Product ($ million)	22,382	38,741	52,600	61,975	68,415	78,951
Per Capita GDP ($)	266	321	402	447	487	554
Share of GDP (%)						
Agriculture	31.5	26.7	22.0	21.8	21.1	20.9
Industry	21.3	24.3	26.5	29.0	29.8	29.7
Manufacturing	13.7	15.1	16.0	17.1	17.8	16.0
Services	47.3	49.0	51.6	49.1	49.1	49.5
GDP Growth (%)	3.7	4.7	5.5	6.7	6.5	6.2
Growth of Value Added (%)						
Agriculture	2.5	3.2	2.9	4.9	3.2	3.6
Manufacturing	5.0	6.9	5.7	10.8	11.2	7.4
Services	3.7	4.5	7.4	6.4	6.7	6.7

Source: Bangladesh Bureau of Statistics (various years).

[1] The fiscal year for Bangladesh runs from 1 July to 30 June. For the purposes of this chapter, FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2007 starts on 1 July 2006 and ends on 30 June 2007.

production since 1981. Growth in manufacturing was 7% during the 1990s, and then increased to 11.2% in FY2007 due to high growth in the clothing, frozen foods, leather and leather products, and light engineering subsectors. Manufacturing growth, however, has slowed to 7.4% in FY2008.

Along with significant changes in GDP growth during this period, all major macroeconomic indicators, such as savings, investment, and employment, have substantially improved. Although gross domestic savings rose from 8.7% in the 1980s to about 13.9% in the 1990s and then to 20.1% in FY2008, the rate of increase after FY2001 was at a slower pace amid a relatively high level of GDP growth (Table 5.2).[2] This may indicate the generation of relatively less income and savings in the lower income category, which also relates to increasing income inequality. However, a relatively higher level of national savings in recent years, such as 29.2% in FY2008, is attributed to the robust growth of remittances. Interestingly, the gap between domestic and national savings has continued to widen, from 2.8% in FY1981–FY1990 to 9.1% in FY2008, resulting from the much faster growth in national than domestic savings. The slow rate of growth in domestic savings was related to increasing domestic expenditure due to high inflation.

Similarly, gross domestic investment improved substantially from 16.7% in the 1980s to 24.2% in FY2008, largely from private sector transactions. While public investment is critically needed in infrastructure and social services, it remained at the 5%–6% level.[3] Low public investment has led to poor physical infrastructure, especially in terms of power and gas availability, which remains a serious concern among firm owners and investors in the country.

The savings–investment gap in the country continues to increase, after shifting toward a positive direction since 2001. During the 1980s and 1990s, savings fell short of investment by about 5.2% and 2.6%, respectively. However, a reversal trend began from FY2001 with savings outperforming investments by 0.5% in FY2001–FY2005 and then reaching a peak of 5% in FY2008.[4] This indicates that a huge surplus, approximately $3.9 billion, is available for investment. However, in an underinvested economy like Bangladesh, such a situation is undesirable

Table 5.2: Savings and Investment, Bangladesh, FY1981–FY2008

Indicator	FY1981–FY1990	FY1991–FY2000	FY2001–FY2005	FY2006	FY2007	FY2008
Gross Domestic Savings (% of GDP)	8.7	13.9	18.8	20.3	20.5	20.1
Gross National Savings (% of GDP)	11.5	17.2	24.1	27.7	29.2	29.2
Gross Domestic Investment (% of GDP)	16.7	19.7	23.7	24.7	24.3	24.2
Public Investment	5.5	6.7	6.5	6.0	5.6	5.0
Private Investment	11.3	13.0	17.2	18.7	18.7	19.2
Savings–Investment Gap (%)	(5.2)	(2.6)	0.5	3.0	4.8	5.0
Gross Domestic Capital Formation (% of GDP)	16.8	19.7	23.6	25.5	24.1	–

() = negative, – = data not available.

Source: Bangladesh Bureau of Statistics (various years).

[2] Domestic savings in FY2008 totaled $15.9 billion (Tk1,088 billion).

[3] In FY2006, total private investment was $15.1 billion (Tk1,038 billion) and total public investment was $4.0 billion (Tk272 billion).

[4] The savings–investment gap would be negative if gross domestic savings were taken into account instead of gross national savings.

and more important, it signals the need to boost private investment by addressing the principal constraints identified by leading business executives, which include corruption, inefficient government bureaucracy, inadequate supply of infrastructure, policy instability, and lack of adequate access to financing (CPD 2007a). It appears that growth cannot proceed at a much higher rate unless productivity of labor and capital is enhanced. The country's capital–output ratio stood at 3.7 in FY2007 and contributed only marginally to economic growth.

Since early 2007, businesses have projected less favorable prospects, mainly because of uncertainties and risks resulting from the change in the political regime in January 2007, high inflation, and economic losses due to natural calamities. The caretaker government took various measures supportive of the private sector and against corrupt business practices to improve confidence in the business environment.[5]

In addition, the high rate of interest charged by banks[6] is a major concern among investors. The high interest rate spread is due to bank inefficiencies, market segmentation, and lack of competition in the financial sector (Bangladesh Bank 2008). Since Bangladesh Bank has directed commercial banks to reduce the interest rate gap, they have responded by reducing lending rates of term loans and working capital, and by pegging the upper limit of interest rates at 14.0%.

Since 2003, Bangladesh has followed a flexible exchange rate regime that is partly "managed" by the Government to reduce vulnerability to financial shocks. Since then, the Bangladeshi currency, the taka, has gradually depreciated against most major currencies, such as the United States (US) dollar, euro, and Indian rupee, making imports more expensive.[7] Importers of textile machinery, chemicals, and raw materials (including yarn and fabric) were very much affected by this depreciation. Prices of rice and other imported food items from India also soared. However, the devaluation of the currency brought benefits to exporters of various commodities.

A high and increasing rate of inflation continues to plague the country, reaching an average of 8.0% during first 5 months of 2008. Food inflation hit 9.1%, mainly because of a rise in food prices in both domestic and international markets, and nonfood inflation reached 6.5%. Food and nonfood inflation usually move in opposite directions, but recent months have registered a different trend with both indexes increasing simultaneously due to oil and fertilizer price increases in the global market, and the short supply of food grains, particularly rice.[8] According to the Centre for Policy Dialogue (CPD 2007a) 92% of top business executives felt that the high rate of inflation had increased their costs of production in 2007, making domestic products less competitive.

Trade Profile

Bangladesh is increasingly being integrated into the global economy through the introduction of various trade liberalization policies since the 1980s. As a result, the trade-to-GDP ratio has increased, reaching 47% in FY2008 from 17% in FY1991. The contribution of exports was about 19.4% of GDP, with a growth rate of 15.9% in FY2008. The comparable figures for imports were 27.6% and 25.1%, respectively. Total export value surpassed the $10.0 billion mark in FY2006, rising to about $14.0 billion in FY2008. Imports were recorded at $21.6 billion in FY2008.

A large part of the country's international trade is related to clothing, which has backward linkages with the textile sector: 77% of total exports come from clothing and a considerable share of total imports comes from textiles, yarns, and clothing, and textile machinery. In the US market, 61% of the top 10 clothing products consist of clothing exports from Bangladesh, while in the European Union (EU) market,

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5 However, some initiatives of the caretaker government were not positively taken by entrepreneurs, especially the drive against corrupt business practices (CPD, 2008).

6 The average weighted interest rate for lending was 12.8% in June 2007, up from 10.7% a year earlier.

7 Except for FY2007, when the taka appreciated against the dollar by about 1%.

8 Inflation, however, reached its peak in September 2008 (10.06%) and decelerated thereafter (8.9% in December 2008).

the comparable share was as high as 85% (Rahman et al. 2008). However, the textiles and clothing (T&C) sector produces only a limited number of products, such as shirts, trousers, sweaters, and jackets. Diversification of exports, both in the case of clothing and non-clothing products, is becoming essential for attaining robust growth and improved resilience to domestic and external shocks, especially since the country's exports are targeted mainly at the US, EU, and Canadian markets.

In comparison, the trade of Bangladesh with South Asian countries is very small, accounting for only 3% of total intra–South Asian exports in 2007.[9] Among South Asian countries, India is the major export destination for Bangladeshi products, accounting for 70.4% of the country's intraregional exports (Table 5.3). Most of the products exported to India are finished products; exports of intermediate products and raw materials are rather low. Because of their similar manufacturing structures, comprising mostly low-technology products, it is difficult for Bangladesh and other regional countries to find markets for their products within the region.

The country's imports from South Asia are high and increasing. Bangladesh is the leading intraregional importer, accounting for about $2.9 billion worth of products in 2007, comprising 27.2% of total regional imports (Table 5.4). However, in terms of regional importance in country imports, a different picture appears. Of Bangladesh's imports, only 15.5% come from South Asia. Contrast this with Nepal where 59% of total imports come from the region. This is followed

Table 5.3: Intraregional Exports of South Asian Countries, 2007
($ million)

Partner Country	Exporting Country					
	Bangladesh	India	Maldives	Nepal	Pakistan	Sri Lanka
Bangladesh		2,406.0	0.0	14.2	179.0	22.7
India	209.7		1.5	698.7	517.5	515.3
Maldives	0.0	95.6		0.0	4.5	50.9
Nepal	4.5	1,671.4	0.0		3.0	0.0
Pakistan	73.5	984.2	0.0	3.2		55.4
Sri Lanka	10.2	2,372.9	14.1	0.1	161.9	
Total Exports to South Asia	297.9	7,530.0	15.6	716.2	865.8	644.4
% of Intra–South Asian Exports	3.0	74.8	0.2	7.1	8.6	6.4
Total Exports to the World	12,719.0	153,120.0	162.9	1,008.5	19,352.6	7,740.0
% of Country Exports to the World[a]	2.3	4.9	9.6	71.0	4.5	8.3

[a] Denotes exports to South Asian countries as a share of total exports.

Source: International Monetary Fund (2008).

[9] Nepal's intraregional export share is relatively high (55% of total exports); almost all its exports at regional level are targeted at India. India and Pakistan, in contrast, have very little focus on the regional market (5.1% and 4.6% of total exports).

by Sri Lanka where 24.9% of imports are from South Asia. Overall, the trade of Bangladesh within the region, especially with India, has been increasing and there is scope for further improvement in trade with India under an effective regional trade agreement (RTA) or bilateral free trade agreement.

The pattern of intra-industry trade within South Asia is highly erratic. Bangladesh and other countries in the region trade only a limited number of products, such as leather products, T&C, and some basic machinery and tools.[10] Bangladesh's major exports to South Asian countries are textile and textile articles, which have considerably increased in recent years, from an average of $40.3 million in FY2001–FY2005 to $122.7 million in FY2006, and further to $155.1 million in FY2007. Other major export items in FY2007 include chemical products ($107.5 million), vegetable products ($27.6 million), base metals and metal products ($24.5 million), machinery and equipment ($19.9 million), and mineral products ($16.1 million). Exports of other products, such as live animals ($12.6 million), raw hides and skins ($4.1 million), and plastic products ($3.5 million) are also increasing over time. This implies that there is potential for the establishment of certain industries through the development of regional production networks.

Table 5.4: Intraregional Imports of South Asian Countries, 2007
($ million)

Source Country	Importing Country					
	Bangladesh	India	Maldives	Nepal	Pakistan	Sri Lanka
Bangladesh		211.1	0.0	4.9	87.8	10.9
India	2,646.6		128.6	1,838.6	885.6	2,610.1
Maldives	0.0	2.5		0.0	5.3	15.5
Nepal	15.7	768.5	0.0		3.5	0.1
Pakistan	196.9	240.6	4.4	3.3		178.1
Sri Lanka	13.5	566.8	56.0	0.2	61.0	
Total Imports from South Asia	2,872.6	1,789.5	189.0	1,847.0	1,043.2	2,814.6
% of Intra–South Asian Imports	27.2	17.0	1.8	17.5	9.9	26.7
Total Imports from the World	18,476.3	249,576.0	1,739.1	3123.3	39,204.9	11,301.0
% of Country Imports from the World[a]	15.5	0.7	10.9	59.1	2.7	24.9

[a] Denotes imports from South Asian countries as a share of total imports.

Source: International Monetary Fund (2008).

[10] In Southeast Asia, the rising intensity of trade has been accompanied by increasing intra-industry trade, mainly due to sharp increases in component production and trade in the region. This increase in vertical intra-industry trade originates mainly from vertical investment linkages triggered by multinational corporations and their affiliates in Southeast Asia. In 2001, intraregional trade in East Asia was 8.8% of its global trade. The sharp rise in parts and components trade is a reflection of the deepening and widening of production networks in the region.

In terms of imports from South Asia in FY2007, the major products included: textiles and textile articles ($510.5 million), vegetable products ($268.0 million), products of the chemical and allied industries ($218.2 million), machinery and mechanical appliances ($211.8 million), and base metals and related articles ($197.6 million).

As seen earlier, Bangladesh's major trading partners in the region are India and Pakistan. Major exportable products to India are chemical fertilizer, raw jute, frozen fish, jute manufactures, woven clothing, naphtha, betel nut, leather, and toilet soap. Imports from India include textiles and textile articles, base metals, vehicles, articles of stone, plastic articles, chemical and mineral products, prepared food stuffs, vegetable products, and live animals. Major exports to Pakistan include textiles and textile articles, products of the chemical or allied industries, raw hides, skins and leather, and vegetable products. Major imports from Pakistan include chemical and allied products, textiles and related products, base metals, and machinery. Bangladesh's pattern of trade at the regional level indicates that there are possibilities for development of intra-industry linkages, where regional investors may contribute.

Industry Profile

Industrial production has increased over time, as reflected in the rise in the Quantum Index of Industrial Production for manufacturing, from 112.6 in FY1991 to 255.2 in FY2003 and then to its highest level so far of 384.8 in FY2008. Growth of large-scale manufacturing enterprises has been marginally higher than that of small-scale firms since FY2006, possibly due to their direct link with international markets, higher-quality products, and improved compliance standards.

Growth of the Quantum Index was 10.8% during FY1991–FY2005 with growth rates as high as 133.8% for printing of silk and synthetic products to a minimum of 10.7% for manufacture of radios, televisions, and telephones. Some products, such as yarn and T&C, recorded accelerated growth rates. However, production is concentrated in a few sectors, including T&C, paper products, drugs and pharmaceuticals, and tobacco, which constitute about 65% of total production. Recently, production of new products (e.g., sugar, petroleum, jute goods, mild steel, soap, leather products, and ships) has increased substantially in response to rising demand in the international and domestic markets.

Various types of service-related activities likewise contribute considerably to GDP, notable among which are retail and wholesale trade, with a share of 14.4% in FY2008 and a consistent level of growth of at least 5.7% since the early 1990s. The growth of retail and wholesale trade (7.2% in FY2008) is mainly driven by the sale of various types of imported finished goods, usually from the People's Republic of China (PRC) and India. Community, social, and personal services, which include engineering and related professional services, legal services, personal services, and recreation and entertainment services, accounted for 7% of GDP in FY2008. They gradually achieved higher growth, rising from 2.8% during the 1990s to 4.7% in FY2008.

Banking performed well, with a growth rate of 9.0% in FY2008, since debt financing is the major source of financing of manufacturing and services-related industries. Various types of transport services contributed about 10.4% of GDP during the same period. Growth of transport and communications has likewise been high in recent years (8.7% in FY2008), due to increasing demand for services of vehicles for commercial, industrial, and other purposes. Vehicle demand is usually met through the import of second-hand vehicles. The high growth rates in manufacturing and services have created a demand for vehicles that could possibly encourage investment in the automobile industry.

Textiles and Clothing Industry

Fabric and Yarn

T&C constitute the major industrial products of Bangladesh, and account for about three fourths of total exports. Exports of clothing increased from $5.7 billion in FY2004 to $6.4 billion in FY2005, registering growth of 13%; the sector further increased its exports to about $7.9 billion in FY2006 and $9.2 billion in FY2007. However, a wide gap persists between demand and supply of locally made fabric and yarn, and the gap is widening every year (Table 5.5). The gap for fabric reached 2.7 billion meters in FY2005, up from 2.0 billion meters in FY2001. As much as 60% of fabric for woven-wear clothing is imported, from countries such as the PRC and India. A major part of fabric required for knitwear clothing is supplied by local sources. The gap

is expected to widen, given the projected demand increase for fabric and yarn to 9.1 billion meters and 1.5 billion kilograms, respectively, in FY2010.

Unlike other production value chain networks, demand for clothing varies with the change in seasons. Thus, timely supply of clothing products at the retailers' end is essential for manufacturers to be competitive. Bangladesh usually lags behind the PRC, India, and Viet Nam as far as lead time is concerned. This implies that development of backward linkages in textiles is crucial to be competitive in the global market. Although domestic investment in the production of fabric and yarn has increased in recent years, it still falls short of fabric and yarn supply to the required amount for the export-oriented clothing sector. Foreign investors, particularly those from India and Pakistan, would find it suitable to invest in Bangladesh because of their know-how in manufacturing yarn and textile.

According to Rahman et al. (2008), aside from using locally made materials, the majority of enterprises in Bangladesh procure fabric and yarn from multiple sources, in particular India; PRC; and Hong Kong, China. Local suppliers were major sources of yarn for knitwear and sweaters while the PRC was the principal supplier of fabric for woven wear products. During the years following the phase-out of the Multi-Fiber Arrangement (MFA), changes have taken place in the pattern of sourcing of yarn, with increasing interest among manufacturers in local procurement. In fact, 70.3% of knit entrepreneurs bought yarn domestically in 2005 from a share of 66.0% in 2004 (Table 5.6). The PRC and India were no longer considered major sources of yarn by a large number of enterprises, and yarn imports from India declined after 2004. This reflects enhanced domestic capacity in the supply of yarn.[11]

However, there was not much change in the sourcing pattern of woven fabric with about 58.3% of entrepreneurs importing 75.8% of their fabric from the PRC and only about 19.0% of the entrepreneurs procuring more than 71.9% fabrics from local sources in 2005.[12] Thus clothing manufacturers increasingly depend on local sources for yarn, fabric, and other raw materials, and import primarily from the PRC and India. Procurement of yarn and fabric from local sources provides several distinct advantages over imports, such as lower prices, quick delivery, and

Table 5.5: Demand–Production Gap, Bangladesh, FY2001–FY2005

	Fabric (million meters)					Yarn (million kilograms)		
	Demand			Domestic	Demand–Production	Total	Domestic	Demand–Production
Year	Domestic	Export	Total	Production	Gap	Demand	Production	Gap
FY2001	1,595	2,246	3,841	1,845	1,996	640	272	368
FY2002	1,618	2,568	4,186	2,050	2,136	698	299	399
FY2003	1,754	2,779	4,533	2,200	2,333	756	340	416
FY2004	1,865	3,323	5,188	2,750	2,438	865	380	485
FY2005	1,960	3,880	5,840	3,100	2,740	973	450	523

Source: Based on data from the Ministry of Textiles and Jute, Government of Bangladesh.

[11] According to the Bangladesh Textile Mills Association, the number of spindles in spinning mills tripled within a decade, from 1.4 million with a production capacity of 10.7 million kilograms of yarn in FY1994 to 3.8 million with a production capacity of 239.0 million kilograms of yarn. According to the Ministry of Jute and Textiles, there were eight public sector weaving mills and 16 private sector mills with a capacity of 6,883 looms in FY1995 and annual production capacity of 128.6 million meters. In FY2000, there were 312 weaving mills in the country, which produced 830 million meters of fabric.

[12] According to Rahman et al. (2008), in the case of export processing zone (EPZ)-based knit and sweater enterprises, Bangladesh is the most important source for yarn, the share being somewhat higher than for non-EPZ enterprises. Fabrics and accessories are often imported because compliance with buyers' specification requires this. Interestingly, in the case of woven enterprises, the PRC is not as important to a large number of EPZ-based enterprises (38%), although it is the major source for as much as 65% for non-EPZ enterprises.

Table 5.6: Changes in Sources of Fabric and Yarn, FY2005

Fabric or Yarn	Country	2004 Level of Use (%)	2004 % of Subsector	2005 Level of Use (%)	2005 % of Subsector
Knit	India	75.7	13.2	76.3	12.5
	PRC	63.6	13.2	64.3	10.9
	Hong Kong, China	100.0	1.9	100.0	1.6
	Bangladesh	89.4	66.0	89.9	70.3
	Others	66.7	5.7	53.3	4.7
	Total	**83.1**	**100.0**	**83.8**	**100.0**
Woven	India	77.9	9.1	75.6	9.5
	PRC	75.9	61.0	75.8	58.3
	Malaysia	70.0	1.3	60.0	1.2
	Hong Kong, China	80.0	5.2	74.0	6.0
	Bangladesh	71.8	19.5	71.9	19.0
	Indonesia	0.0	0.0	80.0	1.2
	Europe	0.0	0.0	80.0	3.8
	Others	90.0	3.9	90.0	3.6
	Total	**75.9**	**100.0**	**75.4**	**100.0**
Sweaters	PRC	87.4	16.7	85.0	15.6
	Hong Kong, China	100.0	3.3	100.0	3.1
	Bangladesh	88.0	76.7	89.5	81.3
	Others	100.0	3.3	0.0.	0.0
	Total	**88.7**	**100.0**	**89.2**	**100.0**
All	India	76.8	8.8	75.9	8.9
	PRC	75.4	36.9	75.2	33.9
	Malaysia	70.0	0.6	60.0	0.6
	Hong Kong, China	86.7	3.8	81.4	3.9
	Bangladesh	85.3	45.6	86.5	48.3
	Indonesia	100.0	0.6	80.0	0.6
	Europe	0.0	0.0	80.0	0.6
	Others	78.3	3.8	71.7	3.3
	Total	**80.7**	**100.0**	**80.8**	**100.0**

PRC = People's Republic of China.

Source: Rahman et al. (2008).

a return policy for defective products. These imply opportunities for investment in developing backward linkages.

Accessories

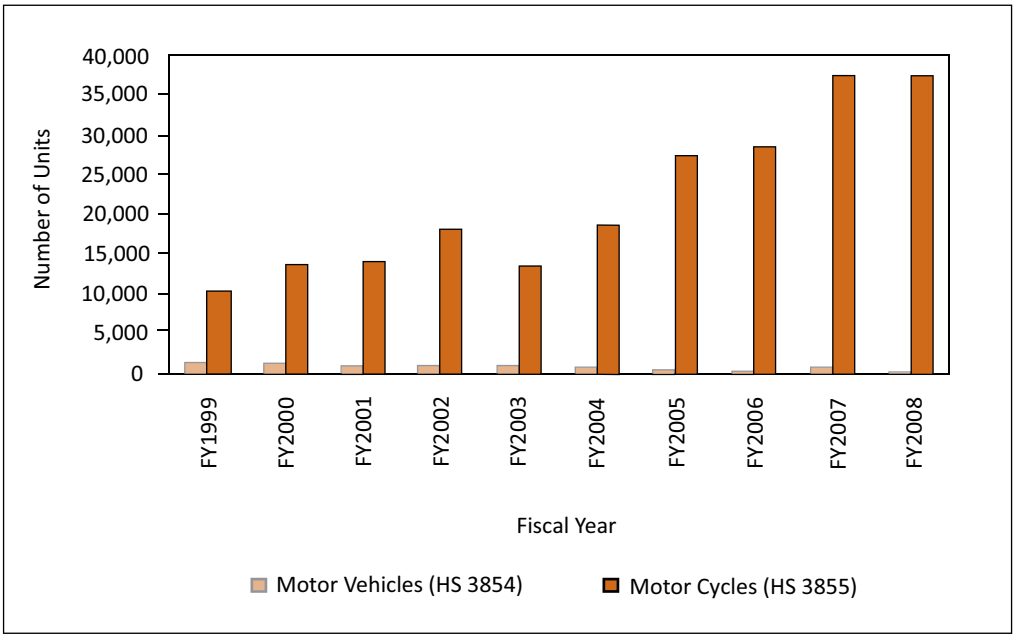
The majority of enterprises sourced their accessories from local suppliers. At times they purchased from other countries, notably the PRC and India, for items such as fancy buttons, labels, zippers, and hangers, in order to maintain the required standards. However, a sizable share of accessories from local sources meets the quality standards of imported supplies. This implies that accessory manufacturers of other South Asian countries may find it attractive to invest in this sector in Bangladesh, especially for high-value items.

In general, local manufacturers have shown strong capacity in manufacturing yarn, fabric, and accessories. This could help in developing their capability in manufacturing other products, which are usually based on imported raw materials, and possibly develop a local manufacturing base for high-value textiles in the country. In addition, washing, dyeing, and finishing facilities have been developed in the country, which are essential for manufacturing high-value products.

Automobile Industry

The manufacturing base of the automobile industry in Bangladesh is very narrow, with a production capacity of only a small number of motor cars and trucks (Harmonized System [HS] code 3854) and motorcycles (HS code 3855) (Figure 5.1). The number of cars and trucks manufactured in the country has been on a declining trend, from 1,296 units in FY1999 to only 461 units in FY2008 (BBS 2007) (Figure 5.1). Car manufacturing in Bangladesh consists mainly of assembly and it seems that such public sector-led operations have been becoming gradually less profitable, possibly because of inefficient operations resulting in declining production, despite sizable

Figure 5.1: Motor Vehicles Manufactured in Bangladesh, FY1999–FY2008



Source: Bangladesh Bureau of Statistics (various years).

demand. Thus local demand for vehicles is met largely through imports of many used cars manufactured by Japanese companies, such as Toyota, Honda, and Nissan, as well as Indian and Italian manufacturers, such as Piaggio, Mazda, and Swaraj (Mohnot 2007). Increasing demand for passenger cars is fueled by the relatively higher level of income of the country's growing population in urban areas.

The manufacture of motorcycles rose steadily from 10,167 units in FY1999 to 37,524 units in FY2008. Some motorcycles are manufactured in joint-venture plants. Bangladesh takes about 9% of India's total exports of motorcycles to South Asia.

Some equipment and parts for motor vehicles are manufactured locally with 18 establishments in the country contributing $207,290 to gross value added in FY2002. This manufacturing is based on imported products, some of which are in turn exported. In this context, exports of some equipment and other goods in the HS categories 7, 15, 16, and 17 are worth mentioning (Table 5.7). During FY1986–FY1990, average exports of machinery and mechanical appliances were only $0.2 million, a figure that increased to $19.9 million by FY2007. Exports of base metals and articles increased from $0.2 million in FY1986–FY1990 to $24.5 million in FY2007, and exports of plastic and rubber articles likewise improved from $0.01 million to $3.45 million during the same period. Lead acid batteries manufactured by a local company have been exported to India since 1999, although their export was stopped for several years by India's imposition of antidumping duty (subsequently withdrawn).

Infrastructure

Huge investment is required in the country's infrastructure to ensure the required supply and standard of large-scale investment in manufacturing and services. Infrastructure facilities, such as roads, water transport, electricity, and gas, remain limited and their quality cannot cater to the needs of businesses, which in turn increases the cost of doing business. This is reflected in the very poor perception index of Bangladesh in terms of the quality of infrastructure compared to India, Pakistan, and Sri Lanka (Table 5.8). Although the management and operational efficiency of the Chittagong port, which was earlier identified as a major constraining factor to international trade, has improved as a result of various government measures since mid-2007, the capacity of the port will still not be adequate for the country's growing trade for at least the next 5 years.

Public investment in infrastructure development is insufficient, although it is the primary source

Table 5.7: Exports of Motor Vehicles and Related Products from Bangladesh to SAARC Member Countries, FY1986–FY2007

HS Sec. No.	Commodity	($ million)					
		FY1986–FY1990	FY1991–FY1995	FY1996–FY2000	FY2001–FY2005	FY2006	FY2007
7	Plastics and articles thereof; rubber and articles thereof	0.01	0.36	24.65	8.45	6.40	3.45
15	Base metals and articles of base metal	0.23	0.42	64.47	4.95	13.82	24.47
16	Machinery and mechanical appliances electrical equipment, parts thereof; sound recorders and reproducers, television image and sound recorders and reproducers and parts and accessories of such articles	0.20	0.36	70.91	1.40	10.77	19.92
17	Vehicles, aircraft vessels and associated transport equipment	0.23	0.00	38.90	0.43	0.41	1.19

Source: Bangladesh Bureau of Statistics (various years).

of investment in all main physical infrastructure components, such as roads, railways, electricity, gas, and ports. Private investment projects, particularly those using foreign direct investment (FDI), are under way for exploration, generation, and distribution of gas and for generation and distribution of electricity. To encourage more local and foreign investment in infrastructure, the Government produced a "private sector infrastructure guideline" in 2004.

It is pertinent to mention here that electricity, gas, and water supply in the country grew at 5.5% in the 1990s, but growth declined slightly to 5.4% in FY2007. Production of electricity slowed due to lack of investment from the public sector. Poor electricity supply, such as frequent outages, disrupts production in industrial units, increases production costs, and affects company profits. In the case of the T&C industry, frequent outages and loss of profit were found to be correlated, although the correlation between the two variables is not so significant (Rahman et al. 2008). Generation of electricity has to be increased substantially to meet the requirements of industry and services. Thirty power plants are planned to be operational by 2012, of which 17 are now under construction. Once operational, a maximum of 4,445 megawatts power supply will be added to the national grid. Delays in project implementation by the private sector have, however, raised questions regarding the efficacy of government guidelines. As most of the constructed or planned power plants will use gas as raw material, gas supply will be critical.

Resource Endowments

Natural gas and coal are the two major energy resources of the country. Total gas reserves are about 300 billion cubic meters, of which 10.8 billion cubic meters are used every year. On a sector basis, transport accounts for the largest share of commercial energy use at 23%, followed by households at 17%, and industry at 10%. Existing gas reserves, which are the main sources of commercial energy, might be inadequate in light of the expanded use of natural gas by various sectors. This implies the need for initiatives to explore new gas reserves. As regards coal, the country's reserves of 300 million tons remain largely untapped. This signals the need for their accelerated use in coal-based power plants to increase electricity generation. Hence, there is scope and need for foreign investment in natural gas and oil exploration, coal mine development, and coal power generation.

Regional Trade Arrangements

Bangladesh is involved in initiatives at various levels, and is a founding member of initiatives such as the South Asian Association for Regional Cooperation (SAARC). Bangladesh was also involved in the operationalization of the SAARC Preferential Trading Arrangement (SAPTA) and thereafter the South Asian Free Trade Area (SAFTA), which became operational in July 2006. Although SAFTA was expected to improve intraregional trade by 35%, its benefits are likely to accrue mostly to

Table 5.8: Perception Index for Quality of Infrastructure, South Asia, 2008–2009

Country	Overall Infrastructure	Railways	Ports	Air Transport	Roads
Bangladesh	2.2	2.3	2.6	3.4	2.8
India	2.9	4.4	3.3	4.7	2.9
Nepal	1.9	1.3	2.9	3.5	1.9
Pakistan	3.1	3.0	3.7	4.2	3.5
Sri Lanka	3.8	3.2	4.5	4.8	3.6

Source: World Economic Forum (2008).

developing country members, while the impact on least developed countries in the region ranges from negligible to negative (Mehta and Bhattacharya 1999, RIS 2004). No major shifts in the size and volume of intraregional trade have resulted so far. One of the major limitations is the inclusion of major tradable items in a country's negative list. Still, exports from Bangladesh to India are expected to increase in the coming years, especially as India has agreed to provide a special and differential treatment facility to Bangladesh and will import 8 million pieces of duty-free clothing.

The Bay of Bengal Initiative of Multi-Sectoral Trade and Economic Cooperation (BIMSTEC) is another regional trading initiative in which Bangladesh is a member. Some sectors have been identified for preferential trading between member countries, such as T&C, drugs and pharmaceuticals, gems and jewelry, horticulture and floriculture, processed food, automobiles and parts, rubber, tea and coffee, coconuts, and spices.

The Asia Pacific Trade Agreement (APTA), formerly known as the Bangkok Agreement, is another regional trading initiative in which Bangladesh is a member. Member countries are currently negotiating their national concession list. As a least developed country (LDC), Bangladesh will enjoy tariff concessions in markets for 48 products (at the six-digit level) with a margin of preference ranging from 14% to 100%. Various studies have shown that intraregional trade in APTA will increase almost fivefold (UNESCAP 2004).[13]

However, slow progress in effective operation of such RTAs has led member countries to negotiate bilateral trade agreements within and outside the region. Bangladesh is currently discussing various aspects of a bilateral free trade agreement with India and Pakistan.[14] The establishment of free trade agreements is unlikely to automatically lead to economic gains. Success will depend on how the agreement is crafted and how it is able to cater to and reconcile the often conflicting interests and concerns of member countries.

As an LDC, Bangladesh receives special preference in various regional and subregional trading arrangements. For example, LDCs enjoy duty-free market access to Australia, Canada, EU, Japan, and other economies. Also, if the Hong Kong Ministerial Declaration is finally enacted in the World Trade Organization (WTO), LDCs will enjoy duty-free market access for 97% of their products in the markets of industrial countries. However, this is not likely to meet the interests of Asian LDCs to a large extent, especially Bangladesh, because of the very narrow export base, even if the remaining 3% may cover most of the export items of Bangladesh. This makes it important to include some of Bangladesh's major exportable items in the 97% list. However, negotiations on nonagricultural market access under WTO would have negative impacts on Bangladesh's exports since demand for its major exportable products, particularly from the EU market, would decline. Against this, the Trade Related Intellectual Property Rights (TRIPS) agreement provides LDCs with an exemption from certain obligations until 2013 and in the case of the pharmaceutical industry until 2016, which would help Bangladesh develop its own industry.

FDI Policy and Environment

FDI is always considered one of the major sources of investment that will enhance production and exports, generate employment and income, and enable the country to acquire better technology. To this end, the Government has taken various steps to encourage it.

History

FDI on a limited scale was present in Bangladesh even before independence, especially in the tea plantation and tea processing and financial sectors. During the initiation of economic liberalization in the early 1980s, the Government took steps to attract FDI in all major sectors. The Foreign Private Investment (Promotion and Protection) Act of 1980 and the Bangladesh Export Processing Zones Authority Act of 1980 were passed to provide guidelines on foreign investment

[13] A subregional initiative, BCIM (Bangladesh, PRC, India, and Myanmar), is now in negotiation at the second-track level.

[14] Outside the region, India has signed draft framework bilateral trade agreements with ASEAN countries.

in domestic tariff areas and export processing zones (EPZs). These allowed FDI in various economic activities of the country with no limit on equity participation; provided economic incentives, such as tax holidays; and admitted the use of international norms and procedures in cases involving investment guarantees and settlement of disputes. Since the early 1990s, private sector investment, including foreign investment, has been encouraged in "thrust" sectors (see below), where special facilities and incentives have been offered.

Performance of FDI

The annual flow of FDI was roughly $30 million–$40 million during the early 1990s. It increased to about $200 million–$300 million in the late 1990s, reaching a high of $845 million in FY2005. FDI inflows for FY2006 and FY2007 were $791 million and $699 million, respectively. The higher FDI stock after 2000 was mainly the result of the increasing flow of FDI in industries such as oil and gas exploration, telecommunications, textiles, and chemicals. FDI in EPZs, although small ($110 million in FY2006) compared to that in the domestic tariff area, contributes much in terms of production, exports, and employment generation.

For their part, portfolio investment flows have not shown any consistent trend.[15] The share of Bangladesh in the total FDI stock of South Asia has been declining gradually from a high of 33.3% ($690 million) in 1980 to its lowest share of 4.21% ($4,404 million) in 2007 (Table 5.9). Total inward FDI stock was only $4.1 billion at the end of 2006, from $2.2 billion in 2000. Although Bangladesh has initiated various FDI liberalization measures, similar to other South Asian countries, it has not received the same level of FDI owing to a lack of infrastructure, limited availability of skilled workers, unstable political conditions, and administrative bottlenecks.

FDI inflows into Bangladesh of late have been concentrated in the services sector (transport and communications, and trade and commerce) with 60.3% of the total $791.8 million FDI for 2006, followed by industry with 39.5% (Table 5.10). Agriculture and fishing received only a marginal portion (0.2%) of total FDI in 2006. Textiles are the leading manufacturing sector for FDI in Bangladesh, accounting for nearly 9% of total FDI.[16] There is still a large demand for FDI for the development of infrastructure facilities, especially in electricity and gas, where higher levels of production are needed to support the growing industrial production base.

Table 5.9: FDI Stock in South Asian Countries, 1980–2007
($ million)

Region/Country	1980	1985	1990	1995	2000	2005	2006	2007
SAARC	2,070	3,044	4,972	13,250	28,389	60,783	72,835	104,613
Bangladesh	690	695	706	829	2,162	3,508	4,133	4,404
% of South Asia	33.32	22.83	14.20	6.25	7.62	5.77	5.67	4.21

SAARC = South Asian Association for Regional Cooperation.

Source: 1980–2006 values are from World Bank (2008); 2007 values are from UNCTAD (2008).

[15] Net portfolio investment in some years has even been negative, indicating substantial outward flows, mainly in the form of income repatriation, such as dividends.

[16] Bangladesh ranks 103 among 140 countries based on an FDI performance index in 1990. The same year, its FDI potential index was ranked slightly higher, at 102. In 2003, its FDI performance index was ranked 132, though it has the potential to be ranked 115 (Sahoo, 2006).

Table 5.10: Aggregate and Sectorwise FDI Inflows, 1995–2006
($ million)

Sector	1995	1998	2001	2002	2003	2004	2005	2006
Agriculture and Fishing	0.0	1.4	1.1	1.6	4.1	1.7	2.3	1.3
Industry	48.7	375.0	324.6	200.8	253.3	263.5	427.6	313.1
Power, Gas and Petroleum	3.2	235.2	192.4	57.9	88.1	124.1	208.3	208.2
Manufacturing	45.5	139.8	132.2	142.9	165.2	139.4	219.3	104.9
Services	43.6	200.1	28.8	125.9	92.8	195.2	415.4	477.2
Trade and Commerce	41.3	164.3	27.6	63.7	44.0	66.6	130.5	130.2
Transport and Telecommunications	1.7	25.3	0.9	48.5	45.9	127.5	281.9	347.0
Other Services	0.6	10.5	0.3	13.7	2.9	1.1	3.0	0.2
Total	92.3	576.5	354.5	328.3	350.2	460.4	845.3	791.8

Note: Enterprise Surveys by the Bangladesh Bank are conducted on a calendar year basis.

Source: Bangladesh Bank, *Enterprise Surveys* (various years).

FDI in Textiles and Clothing

Although the T&C industry has potential for investment and its current share is high compared to that in other sectors, its FDI is not so large in absolute terms. The share of T&C to the total FDI inflows of Bangladesh has also been declining since 2002, where T&C had a share of 28.2% ($92.5 million). This sharply declined to 13.3% in 2003 ($46.6 million) and further in 2006 to 8.9% ($70.2 million) (Table 5.11). Through the years, the majority of investments in T&C were reinvested earnings (59.8% in 2006), followed by intracompany loans (26.2%) and equity capital (14.0%). Major investors in T&C include the Republic of Korea; Hong Kong, China; and India. In view of the persistent gap between demand and supply of textiles, there is scope for foreign investment in diversified textile products.

FDI in Automobiles

FDI inflows in the automobile industry are minimal, with investment of $0.4 million recorded in 2006. Investments are usually for manufacturing vehicles, transport equipment, and metal and machinery products (Table 5.12).

Foreign companies follow various ownership strategies for their investment, taking into account the size of capital and the market, as well as market risks. About 57% of foreign-owned firms are joint-venture investments, making the incidence of joint ventures relatively high in the country. FDI registered with the Board of Investment (BOI) comprises mainly large-scale joint-venture projects (75%) while FDI registered with the Bangladesh Export Processing Zone Authority largely involves small-scale projects with full foreign ownership (82%).[17] The relatively better environment in EPZs provides foreign firms with certain advantages that make it worthwhile for them to operate independently. Investment in domestic tariff areas, in contrast, involves various types of risks, asymmetric information on the domestic market, and fewer incentives and facilities, making joint-venture arrangements in tariff areas less attractive to foreign firms.

[17] In joint-venture projects registered under the BOI, the distribution of assets between foreign and local entrepreneurs is 67:33. This implies that foreign firms hold more risks originating from asymmetric information and other ways.

Table 5.11: FDI Inflows in Textiles and Related Sectors, 2002–2006
($ million)

Sector	2002	2003	2004	2005	2006
Textiles and Clothing	92.5	46.6	37.6	96.6	70.2
Equity Capital	17.0	1.1	1.8	8.9	9.8
Reinvested Earnings	34.2	33.2	28.1	27.8	42.0
Intracompany Loans	41.3	12.3	7.7	59.9	18.4
Total FDI Inflows	**328.3**	**350.2**	**460.4**	**845.3**	**792.5**

Source: Collected from the Board of Investment, Bangladesh.

Table 5.12: FDI Inflows in Motor Vehicles and Related Sectors, 2002–2006
($ million)

Sector	2002	2003	2004	2005	2006
Vehicle and Transport Equipment	0.2	1.9	0.0	1.5	0.4
Equity Capital	0.0	0.5	0.0	1.2	0.1
Reinvested Earnings	0.2	1.3	0.0	0.1	0.3
Intracompany Loans	0.0	0.1	0.0	0.2	0.0
Metal and Machinery Products	0.4	0.1	0.7	0.1	0.0
Equity Capital	0.2	0.0	0.0	0.0	0.0
Reinvested Earnings	0.1	0.0	0.7	0.1	0.0
Intracompany Loans	0.1	0.1	0.0	0.0	0.0
Total	**0.6**	**2.0**	**0.7**	**1.6**	**0.4**

Source: Collected from the Board of Investment, Bangladesh.

In terms of sources of FDI flows, the top four investors in Bangladesh each with contributions of more than 10% of the country's total FDI inflows in 2006 included US (22.17%), Egypt (13.3%), United Arab Emirates (UAE) (11.1%), and Norway (10.5%) (Table 5.13). More than half of Bangladesh's total FDI comes from these four countries. Investments are mainly in services, such as telecommunications as well as oil and gas exploration. Egypt and the UAE are quite new investors with hardly any investments in Bangladesh prior to 2003. They have overtaken the United Kingdom (UK) and the Republic of Korea, which were the top sources of FDI in Bangladesh after 1995. There is no consistent trend among source countries of their percentage shares and volumes. In 2005, Singapore was the third-highest FDI source in Bangladesh, contributing $97.5 million or 11.5% of total FDI. A year later, its share plummeted to less than 5%, with a contribution of just $35.9 million. In 2006, smaller investors with investments of less than 10% were UK (8.9%), Republic of Korea (6.8%), Hong Kong, China (6%), Malaysia (5.6%), Singapore (4.5%), Japan (2.9%), and Denmark (1.9%).

Current FDI Regime

Intraregional FDI in Bangladesh

FDI from South Asian countries to Bangladesh is small, reaching $14 million in 2004 or 3.0% of the country's FDI inflows. Of the total FDI in Bangladesh from the region, India remains the lead investor with $6.8 million (48.2%), followed by Pakistan with $3.8 million (27.0%), and Sri Lanka with $3.5 million (24.8%).

Table 5.13: FDI Inflows, 1995–2006
($ million)

Country	1995	1998	2001	2002	2003	2004	2005	2006
UK	20.3	40.9	52.9	18.5	83.6	91.0	152.8	70.7
US	15.2	232.9	29.1	24.5	32.1	61.8	141.8	175.7
Singapore	0.1	0.5	1.6	12.7	3.2	2.3	97.5	35.9
UAE	0.1	0.2	0.9	0.0	16.7	12.8	55.5	88.0
Norway	0.0	23.7	0.0	26.4	21.9	59.6	53.5	83.0
Hong Kong, China	2.7	13.1	5.8	17.1	11.7	13.9	53.1	47.4
Egypt	0.0	0.0	0.0	0.0	0.0	19.9	48.4	105.4
Japan	6.6	15.7	2.2	11.9	17.5	30.0	46.4	22.8
Malaysia	0.0	5.0	0.3	11.4	13.4	39.0	33.1	44.5
Republic of Korea	18.2	70.9	16.8	30.7	24.5	18.5	29.9	53.9
Denmark	0.8	0.0	4.0	3.1	14.0	18.8	18.3	15.4
Others	28.4	173.5	240.9	172.0	111.6	92.8	115.0	50.1
Total	92.3	576.5	354.5	328.3	350.2	460.4	845.3	792.4

PRC = People's Republic of China, UAE = United Emirates Republic, UK = United Kingdom, US = United States.

Note: Figures are on a calendar year basis.

Source: Collected from the Statistics Department, Bangladesh Bank.

According to Mohnot (2007), the majority of South Asian companies involved in manufacturing automobile and related materials are not interested in relocating their plants to other places in the region, although they are aware of the development of RTAs in South Asia. These entrepreneurs are interested in manufacturing their products using their existing domestic base and then exporting these items to regional markets. Three companies—Maruti Udyog, Escorts, and Hino Pak Motors—are currently exporting their products to Bangladesh, but do not show any interest in setting up a manufacturing plant in the country. Without the availability of sufficient steel, it would be difficult for foreign automobile manufacturers to establish plants in Bangladesh. A case in point is the Indian multinational enterprise, Tata, which was interested in setting up a steel plant. However, both parties failed to reach an agreement since the Government could not assure Tata its required gas supply for 10 years, while the Government considered the price of gas ($2– $4 per million British thermal units) offered by Tata as not economically viable.

FDI Policy

There are several laws to protect the interests of foreign investors as well as other acts to provide various incentives and facilities. Major laws relating to FDI in the country include the Foreign Private Investment Act of 1980, the Export Processing Zones Authority Act of 1980, the Companies Act of 1994, and the Industrial Policy of 2005. Under the Industrial Policy of 2005, the private sector is seen as the engine of growth. In view of increasing competition in the global market, private investment is encouraged in manufacturing high-quality, diversified, and high-value-added products, at the same time as following appropriate production techniques to enhance productivity.[18]

[18] Other rules and regulations are related to FDI, such as regulations of Bangladesh Bank and the National Board of Revenue (for taxation and customs).

Generally, private investment proposals are submitted to BOI after the legal formation of the company. Registration is the first formal commitment for an investment project based on a feasibility study. However, a large share of projects registered with BOI has not been realized, mainly because of the lengthy period required for project approval, especially for larger projects. This implies the need for the Government to ease this serious bottleneck so as to encourage foreign investment.

Priority Sectors for Investment

Under the Industrial Policy of 2005, the Government identified 33 "thrust" sectors that are currently contributing or may substantially contribute to the national economy, especially in terms of production, employment, and export earnings. The Government provides tax support to these sectors, such as tax exemptions, exemption from dual taxation, tax holidays, and taxation at a reduced rate or accelerated depreciation.

To enhance investment and production in small and medium-sized enterprises (SMEs), the Government announced its SME Policy in 2005. Under the SME Policy, 11 priority areas were chosen as "booster sectors" that would receive promotional support from the Government. Some of these sectors were also identified as priority areas in the country's Industrial Policy of 2005.

Trade Policies

Since the early 1980s, the Government has introduced trade-related policies to gradually liberalize the country's trade regime. The period FY1991–FY1995 was the fastest phase of liberalization ever (CPD 2007b). The major steps taken toward trade liberalization include the simplification and flexibility of the tariff structure. All trade-related indexes, such as the most-favored-nation (MFN) effective tariff rate, weighted import tariff rate, and quantitative restrictions, were lowered during the 1990s from their levels in the 1970s and 1980s. Further reductions were made in the MFN effective tariff rate from 88.6% in 1991 to 13.5%, and the weighted import tariff rate from 42.2% to 13.8% over the same period. The number of tariff slabs charging import duties was reduced gradually from 15 in FY1993 to four (0%, 7.5%, 15% and 25%) in FY2005. At the same time, duties were lowered: maximum import duty has been substantially reduced from as high as 300% to 25%. With all these reforms, the share of trade in GDP has increased from 17% in FY1991 to 44% in FY2007.

The import duty arrangement has been restructured substantially through the FY2008 national budget. One of its positive outcomes is the complete withdrawal of the 4% infrastructure development surcharge and a considerable reduction in the supplementary import duty. A four-tier tariff structure is followed, with the highest tariff on finished products. Bangladesh has simplified its tariff structure following the classic method of imposing additional duty on consumer goods and vice versa on intermediary and final products.

The imposition of nontariff measures on imports from the region is not widely evident. However, entrepreneurs in the region have complained about the nontariff barriers (NTBs) that they face in Bangladesh. For example, Indian entrepreneurs have claimed that their exports of electronic items, jute goods, machinery, plastic goods, textiles, and chemicals face NTBs in Bangladesh. Imports of yarn from India were banned through the land route (via Benapole), and the resulting higher transportation costs made these products more costly than local yarn and less available to domestic textile manufacturers. In turn, entrepreneurs in Bangladesh have referred to NTBs that they face in exporting to regional markets, such as complicated procedures for the certification of Bangladeshi products targeting the Indian market.

Fiscal and Financial Incentives

Under the liberalized regime, many sectors that were earlier closed to foreign investors have been opened to them. Exchange controls in current account transactions were also liberalized. Likewise, import controls were reduced and import permits were abolished. Import sales taxes and most excise duties were replaced with value-added tax. Tariff rates were also reduced and simplified. Revenue collection has been streamlined and all parties in the value chain made liable for payment of taxes. Consequently, tax collection has improved, but overall duty collection has fallen because of reduced import duties.

Fiscal incentives are similarly provided to attract investment. These include a 10-year tax holiday, a

5-year concessionary tax after completion of the initial 10 years, duty-free import of machinery and raw materials, and avoidance of double taxation based on double taxation treaties and other incentives as provided by BOI. In addition, the following gives an idea of the nonfiscal incentives offered: 100% foreign equity, a nonrestricted exit policy, full repatriation facilities of dividend and capital in the event of exit, and import of raw materials on a documentary acceptance basis.

Screening, Admission, and Establishment Policies

For joint ventures or 100% foreign investment projects, there is no requirement of prior approval or a non-objection certificate for setting up units. However, to take advantage of various financial and fiscal incentives, facilities, and institutional support, these investments need to be registered with BOI. BOI also provides one-stop services to investors. However, investors frequently claim that the quality of the BOI service does not adequately meet their requirements, and as a result delays to projects are common.[19]

Performance Requirements

Industries are allowed to procure raw materials from any source since there is no local content requirement for FDI in Bangladesh, except for some drugs in the pharmaceutical industry. However, the Government encourages the use of local raw materials in clothing and other nontraditional exports by providing either cash compensation or duty drawback facilities to export items (Bhattacharya 2005).

Labor Laws

At present, 47 labor laws are in force. They relate to wages and employment, trade union and industrial disputes, the working environment, labor administration, and related matters. Of these 47, the main labor laws are the Workmen's Compensation Act of 1923, Payment of Wages Act of 1936, Maternity Benefit Act of 1936, Employment of Labor (Standing Orders) Act of 1965, Shops and Establishments Act of 1965, Factories Act of 1965, and Industrial Relations Ordinance of 1969. It appears that industrial units are increasingly complying with labor-related laws in the country (although not fully). However, there are incidents when basic rights of workers are not properly maintained, especially when the relation between workers and employers has weakened.

Property Rights (Including Intellectual Property Rights)

Any foreign investment, if expropriated, is protected under guaranteed compensation as stipulated in the Foreign Investment Act of 1980. However, no foreign property has been expropriated since the Act was passed in 1980. Risks of expropriation are almost nil since the country follows the principles of a market economy (Bhattacharya 2005).

Bangladesh is a signatory to the Multilateral Investment Guarantee Agency, which insures investors against political risk. The insurance and finance program of the US, including the Overseas Private Investment Corporation, operate in Bangladesh. The country is also a member of the World Intellectual Property Organization and the World Association of Investment Promotion Agencies. Hence, property and other rights of foreign investors are safeguarded according to international standards (Bhattacharya and Moazzem 2005). A regional agreement, the Promotion and Protection Act of South Asian Investment, which was designed to create favorable conditions for investment, is currently under consideration.

Export Processing Zones

As of April 2008, the country has eight EPZs with a total of 273 factories in operation, of which 140 units are in the Chittagong EPZ and another 92 units in the Dhaka EPZ. There are fewer industrial units in the rest of the EPZs in operation, with a total of 172 units at different stages of construction and operation. Various incentives and facilities are offered to these industries owing to their contribution to production, exports, and employment.

Major firms that locate in EPZs come mainly from Bangladesh and the Republic of Korea, with 67 and 63 units, respectively. Among South Asian

[19] Investors often express their concern regarding the inefficiencies of the BOI, especially with regard to its failure to provide a one-stop service facility. The BOI on the other hand argues that most ministries do not provide it with the authority to give clearance for investment in the country.

neighbors, India has 14 units, Pakistan has six, and Sri Lanka and Nepal have one each. Total investment in EPZs in Bangladesh from South Asian countries is $20.9 million, and employment is approximately 6,100 workers.

In terms of export earnings, EPZs have consistently added to export receipts, and their contribution has been increasing over time from $228 million or 6.6% of the country's total export receipts in FY1995 to $2.1 billion or 17% of total export earnings in FY2007. A sizable share of exports from the EPZs originates from the Dhaka and Chittagong EPZs. A convenient location for an EPZ is important for foreign investors. Thus undercapacity in some of the other EPZs in the country should be investigated and appropriate measures taken.

Bilateral Investment and Avoidance of Double Taxation Agreement

Bangladesh has signed several bilateral investment agreements, mainly with Organisation for Economic Co-Operation and Development countries, a few eastern European countries, and some Asian countries. As of 1 June 2008, the country was signatory to 25 bilateral investment treaties (BITs) and is negotiating BITs with 16 other countries. In addition, it has signed double taxation treaties with 23 countries, including those with existing bilateral investment agreements. Negotiations on double taxation treaties are ongoing with 21 other countries. In South Asia, Bangladesh has both BITs and double taxation treaties with India, Nepal, Pakistan, and Sri Lanka. However, there is little relationship found between countries having BITs, double taxation treaties, or other agreements with Bangladesh, and sources of FDI for the country (Bhattacharya and Moazzem 2005). It appears that along with signing international investment agreements, the business environment in the country should first be improved in order to accelerate FDI inflows.

FDI and the Economy: Potential, Impact, and Constraints

Analytical Framework and Rationale

Foreign investors usually take interest in those projects that domestic investors are less capable of undertaking; those that require bulk-scale capital, and have high risk; and those that have high expected returns. Thus most FDI received by developing countries does not match their needs and objectives. Developing countries perceive FDI as an investment tool for transfer of technology, generation of employment, and contribution to the balance of payments. Hence, some argue that the needs of the developing countries can be best fulfilled by FDI from developing countries with their focus on labor-intensive, manufacturing type-industries (RIS 2004). RTAs provide regional investors with the advantage of preferential market access to induce them to concentrate on intraregional investment. This underlines the necessity for examining possible areas of investment in RTA member countries. The extent to which RTAs widen the scope of intraregional investment depends on the preferential structure of tariffs, the composition of products made by manufacturers of the FDI-recipient country, as well as the skill and wage differentials among those countries.

FDI Potential

South Asian countries have both similarities and differences in terms of potential export baskets (Kemal 2004). For unique products of a particular South Asian country with the potential for export, horizontal FDI can be encouraged. But where South Asian countries have similarities in their export products, vertical FDI can be the option for export-oriented sectors with intra-industry trade potential.

Bangladesh has adequate potential for exporting substantial amounts of jute products. A total of 886.1 billion tons of raw jute was grown in the country in FY2007, of which 67.3% was used for domestic purposes and the rest exported. Major export destinations include Pakistan (39.9%), PRC (27.3%), and India (21.1%). However, most of the jute mills owned by the public sector operated at an average capacity utilization rate of only 50% in 2007, while private jute mills operated at an even lower rate of 19%. These low rates of utilization stem from managerial inefficiency (especially of public sector jute mills), lack of working capital, and a huge volume of historical bad debts. Of the small number of private sector jute mills and public–private joint initiatives that are performing well, managerial ability, labor use, cost effectiveness, and marketing strategies are common reasons for success (CPD 2008).

There is a strong possibility of using more raw jute in local mills to exploit the unutilized capacity in existing mills. This could be done by management restructuring of public sector jute mills, winding up historical unpaid debts, and developing the quality of products. Foreign investors, especially those from India and Pakistan who have extensive experience in manufacturing jute goods, could set up jute mills in the country and export their products to both regional and other markets. Since Bangladeshi jute goods enjoy duty-free market access in India under SAFTA, there is a good chance of increasing exports of jute goods to India.

Development of vertically linked regional production chains can also be looked into. Countries in the same region often have a comparative advantage in exporting similar types of products. For example, Bangladesh, India, Nepal, Pakistan, and Sri Lanka have a comparative advantage in the manufacture and export of yarn, textiles, fabrics, and woven products. These countries may therefore take the initiative to specialize in parts of the value chain within the textile sector, where they enjoy the strongest comparative advantage. Maximizing areas of comparative advantage in terms of resource and skill endowments could lead to complementarities creating vertically linked regional production chains. Since a short lead time is a major advantage of clothing manufacturers, strong backward linkages are essential for clothing-exporting countries like Bangladesh.

During a regional dialogue on trade and investment in South Asia that was organized by the Centre for Policy Dialogue (CPD) in 2006, the former BOI chairman mentioned that India ranked number 3 in textiles and 27 in clothing in terms of specialization in the world market, while Bangladesh ranked 18 in textiles and 4 in clothing. Hence, entrepreneurs from the two countries could manufacture T&C under an integrated production network. There is scope for establishing specialized T&C units under 100% single or joint-venture initiatives, where specialized yarn and textiles can be supplied from India. In addition, 100% foreign-owned enterprises could be established in Bangladesh by Indian entrepreneurs focusing on manufacturing textiles that are currently used in clothing or in fashion and design.

In the automobile industry, given the increasing demand for motorcycles in the local market, there is scope for expanding the manufacturing bases in the country, where foreign investors, especially regional entrepreneurs, could take an interest. For example, there is potential for developing joint-venture projects with well-known companies from India (e.g., Bajaj, TVS, and Hero Honda) and from the PRC (e.g., Xing Fu). Currently, these companies sell their products in Bangladesh through local distributors. However, prospects for expanding the manufacturing base of automobiles and trucks are constrained by the lack of locally available steel. The supply of the required amount of steel could be ensured by establishing a steel plant or by importing steel from nearby sources, such as India. In the case of the former, the possibility of a steel mill, at least in the short term, remains uncertain mainly because of the lack of adequate gas supplies. In terms of the latter, imports of iron, steel, and ore from India overland would require the development of rail networks and the improvement of trade facilitation in border areas. Still, India's technology and capital in steel could be invested in Bangladesh given its large domestic market, vibrant construction industry, and potential for developing its steel industry.

Bangladesh also has the potential to capture intraregional investment in the leather industry. However, the major raw materials of leather are sourced mainly from the domestic and Indian markets. Investors from the region may enter into joint ventures to set up manufacturing units in the country. Availability of low-cost labor and the small gas requirement of leather manufacturing plants are the main selling points for developing the country's leather industry.

South Asian entrepreneurs, especially those from India and Sri Lanka, may also consider investing in tea gardens in the northern part of the country, as a local firm already has, in Dinajpur and Panchagar.

To ensure the long-term energy security of the country, huge investment in natural gas exploration is required. At the same time, given the huge coal reserves that remain largely unutilized, coal-based power plants could be established to increase electricity generation. Hence, there is scope for foreign investment in exploring natural gas and oil, and in developing coal mines.

Economic and Social Benefits

Technology Spillovers

Although there is no general technology transfer requirement for FDI in Bangladesh, there are

some sector-specific requirements. For example, international oil companies investing in the country are required to transfer technology to the national oil company, Petrobangla, in the form of regular training courses to develop local capacity, and to donate some of their heavy machinery at the end of their contracted period of work.

In terms of technology spillover impacts of FDI, nearly half the chief executive officers of large companies that participated in a survey in Bangladesh felt FDI to be an important source of new technology. However, they also acknowledged that technology transfer in the country from FDI has been very modest, although some cases of reverse-engineering methods of technology and skill transfer may occur (Bhattacharya and Moazzem 2005). This is because employment generated by most of the FDI in manufacturing remains concentrated in low-end jobs, and because in the overwhelming majority of cases, FDI, particularly that in EPZs, is not well integrated into the local supply chain (Bhattacharya and Moazzem 2005).

Trade and Investment Effects

Bangladesh shows no one-way relationship between trade and FDI either in terms of complementarity or substitutability between the two. Most FDI in the country is targeted at infrastructure, mainly to meet domestic energy or telecommunications requirements. These investments have largely originated from outside the region; there is no intraregional FDI in these sectors. Notwithstanding the demand for FDI in manufacturing, especially from other countries in the region, the response of regional entrepreneurs for investment in Bangladesh is not encouraging. Even though large amounts of yarn, fabric, and other related raw materials for T&C have been imported from India, Indian investment in T&C is not that large. Moreover, Indian traditional clothing manufacturers have little interest in investing in the manufacture of textile for the country's domestic market.

Consequently, the existing features of the trade-investment interrelationship between Bangladesh and other South Asian countries cannot be fully matched with recent theory (for example, Fontagné and Pajot 2000, Forte 2004). It is argued that with identical patterns of trade, there are fewer opportunities for trade expansion among countries. In these cases, regional cooperation in trade and investment can be enhanced by exploiting the comparative advantages that exist among the members at different stages of the production network of any particular product. In this context, with a large potential for investment in T&C and automobiles in Bangladesh, entrepreneurs from India and Pakistan could shift to or establish production bases in Bangladesh.

Country Reputation and Linkages

An influx of FDI into a country draws attention to the country's potential and prospects for economic development. The image of the country is developed through the performance of major industry sectors, domestic and foreign investment, achievements in human development, and political stability, among others. Similarly, promotional campaigns for Bangladesh, akin to those carried out by India through its "Incredible India" advertising or by Malaysia through its "Malaysia, Truly Asia" endorsement, can be used to attract tourists to Bangladesh and to explore investment opportunities.[20] Business executives' current perceptions of adherence to rules and regulations, particularly with regard to foreign investment, are favorable (CPD 2007a), indicating the country's positive reputation as a good business location.

Risks and Negative Effects

One of the key negative impacts of FDI is the outward flow of capital by foreign companies in the form of profit repatriation, outward transfer of dividends, and debt amortization, which creates pressure on the country's balance of payments. The outward transfers were as high as $632 million in 2005 due to dividend transfers of $418 million and private debt amortization of $208 million. Such effects are less evident with intraregional investment because of their very low investment levels.

[20] The number of tourists to Bangladesh has increased in recent years, most of whom are business travelers. However, the country is still a poor travel and tourist destination, especially as regards the travel and tourism regulatory framework and travel- and tourism-related human, cultural, and natural resources, although somewhat positive in terms of the business environment (World Economic Forum, 2008).

Constraints

Poor Infrastructure Network

Poor physical infrastructure increases the cost of production and reduces the competitiveness of firms. In Bangladesh, the country's infrastructure has not adequately expanded commensurate with the rise in economic activity during the last several years. Infrastructure-related problems include frequent power failures and poor transportation facilities, which seriously hamper production and delivery of products. According to Rahman et al. (2005), poor power supplies have lowered profitability in readymade clothing.

Long Negative List of SAFTA Member Countries

An analysis of the items on the sensitive lists of SAFTA member countries reveals that these items constitute a substantial share of total tradable items and total trade value. Many of the most important tradable items have remained on the negative list. For example, clothing, which is a major export item for Bangladesh, has remained on the negative list of partner countries, such as India. Except for India, which removed 264 items from its sensitive list in August 2008, in the process reducing its sensitive list to 480 items, each of the other major economies of South Asia (Bangladesh, Nepal, Pakistan, and Sri Lanka) still has over 1,000 items on its sensitive list (*The Indian News* 2008).

Bottlenecks in the Process of Registration and Implementation of FDI Projects

The rate of implementation of FDI projects that are registered every year with BOI is one third of total projects. More important, the rate of implementation of projects registered from South Asia is much lower compared to other countries on average, possibly owing to the more stringent bureaucratic scrutiny that these projects undergo.[21] Foreign investors often argue that the long delay prior to government approval, especially of FDI proposals, entails huge costs for them.

Import Requirements

Although import licenses are not required for imports to Bangladesh, prior permission or approval may be required for some imported products, in addition to the standard letter of credit authorization import procedure, and import permit and clearance from the Chief Controller of Import and Export.[22] Importers have complained of delays in the release of import or clearance permits. For some categories of restricted items, importation can only be made by registered industrial consumers, including export-oriented readymade clothing, hosiery, and specified textile industries operating under the bonded warehouse system; pharmaceutical (allopathic) industries; and international-standard hotels.

Diverse Standards Requirements

The signing of a free trade agreement does not ensure a high degree of intraregional trade unless NTBs are eliminated. These include different kinds of standardization and certification processes, customs rules and regulations, tax laws and regulations, and duty structure. This implies that the harmonization of rules and procedures at customs points; mutual recognition of standards, and testing and certification; and prior consultation with regard to countervailing duty and antidumping duty are essential (Rahman 2005). In the absence of a harmonized trade regime in South Asia, investors are not encouraged to invest in the region.

Standards

Bangladesh has 1,612 standards, of which some 8% are mandatory. Testing and certification procedures for the mandatory standards are the same for domestic and imported products. Bangladesh has

[21] In 2006, the former BOI Chairman (in a dialogue organized by the CPD) said that the rate of implementation up to 2004 was much lower in the case of India's registered investment proposals, where only 19% were in operation, 40% were not in action, and 37% were untraceable.

[22] Many of the clearance requirements for items on the restricted list are based on health or safety grounds and therefore seem to be "automatic" in nature.

notified WTO of its acceptance of the Code of Good Practice of the WTO Agreement on Technical Barriers to Trade. At present, some 36 Bangladeshi standards are identical to the International Organization for Standardization and another 15 are identical to the International Electrotechnical Commission standards. (Bangladesh has been a member of the former organization since 1974, but is not yet a member of the latter.)

In June 2007, there was a notable development toward improved market access of Bangladesh products into India and a substantial reduction in NTBs in the area of quality controls and standards. A memorandum of understanding was signed by the Bureau of Industrial Standards (BIS) of India and the Bangladesh Standards Institution (BSTI) in an effort to standardize quality controls. The memorandum provides BSTI with the mandate to perform tests and certify Bangladeshi goods for export into India. Prior to this memorandum, Bangladeshi exports were tested by BIS laboratories in India (*The Financial Express* 2008).

Labeling and Packaging

All imports in Bangladesh are required to carry a label indicating the country of origin. The label must also indicate quantity, weight, measure, trade description, component materials, and date of manufacture and expiry. Bangla or English is permissible for labeling. For imports of food and beverages, the dates of manufacture and expiry must be clearly printed. Marking of the ingredients and composition of milk food is required in Bangla. In addition, imports of milk food with fat content and baby food must be in tin containers, and imports of nonfat dried milk must be in bags or tins. For imports of pesticides and insecticides, labels must contain information on the manufacture and ingredients, as well as a warning, antidote, and directions for use in Bangla.

Sanitary and Phytosanitary Standards

Sanitary certificates and radioactivity test certificates are required for imports of food and edible products. A sanitary certificate issued by a competent authority of the exporting country must indicate that the specific product is free of injurious insects, pests, and diseases. The Bangladesh Atomic Energy Commission conducts radioactivity tests on samples on the arrival of food items and issues a clearance certificate for the release of the items by the customs authority. Foreign certification of radioactivity testing is also accepted in Bangladesh.

Nontariff Barriers

Exports from Bangladesh face various types of restrictions in terms of standards requirements, permission, and quality in South Asian markets. Hence, it is important to reduce NTBs in other South Asian countries to enhance intraregional trade and investment.

Availability of Skilled Human Resources

To improve the productivity of capital to ensure higher levels of growth in manufacturing, upgrading of technology alone will not be sufficient. A highly skilled labor force is likewise essential to fill the human resource needs of growing sectors and sectors with potential, such as textiles, clothing, information technology, and telecommunications.

Policy Recommendations

General

Despite the various initiatives that have been provided in previous decades to liberalize the economy, there is still much to be done to improve the business environment in Bangladesh. Government efforts to lower import tariffs (especially for raw materials and intermediate products) and to provide support for exports need to be continued. High tariffs on finished goods and low tariffs on raw materials will discourage the import of finished goods and enhance domestic production. Duty-free imports of raw materials and other forms of fiscal and nonfiscal incentives that are currently provided to export-oriented firms need to be continued to encourage inward investment.

Based on the revealed comparative advantage for intraregional trade in South Asia, several sectors of Bangladesh have been identified with the potential for trade and investment. These include T&C, woven fabric, tea, jute, and leather. Some of these sectors provide unique investment opportunities for export, such as jute, while others provide avenues for complementary investment arrangements with other SAFTA member countries, such as T&C. Countries in the region may set their strategies under an integrated

framework, where they could enjoy preferential market access under SAFTA. Such examples are evident in free trade agreements between India and Sri Lanka, and between India and Nepal, where companies from both countries are engaged in businesses based on comparative advantage, complementarity, and uniqueness.

However, the development of these potential sectors will depend largely on the development of physical infrastructure. Key to all these are the improvement and expansion of the country's energy sector, without which it would be difficult to develop and sustain any progress in the different potential sectors. Hence, the Government should make an all-out effort to develop the power and gas sectors by enhancing private and public sector investment, including FDI. Moreover, it seems that alternative sources of power generation, such as coal, should be explored. This implies that the Government should approve the country's coal policy without any delay and encourage FDI in the sector.

In addition, it is important to reduce the lending rate of banks to keep the cost of doing business at a minimum. This may be done through effective fund management by banks. Moreover, the Government should take a more proactive role in developing the country's human resource base through skills upgrading and capacity improvement in order to provide businesses with their required pool of skilled workers.

Sector Specific

Bangladesh enjoys preferential market access in most developed-country markets as an LDC, but it is still unable to fully capitalize on this privilege due to its lack of capacity to develop high-quality products at a competitive price. The only area where Bangladesh is able to exploit its export potential is in T&C. Since Bangladesh is part of the global value chain of textile-related products, it should explore ways to enhance integration in South Asian regional trade.

In order to secure intraregional FDI from countries like India and Pakistan that have experience in manufacturing T&C products, Bangladesh should target the high end of the T&C market, as well as the lower end where it has comparative advantage. While India's comparative advantage in textile lies in the production of cotton and the manufacture of yarn and woven fabric, Bangladesh's comparative advantage is in the manufacture of knit fabrics, accessories, and yarn to some extent, as well as in dyeing and finishing. Development of backward linkages in textiles is important if Bangladesh is to remain competitive in the world market (Rahman et al. 2008).

A long negative list among South Asian countries, which include major exportable items, has stalled the development of intraregional trade and investment. It appears that intraregional investment in textiles in Bangladesh would increase if India left textile-related products off its negative list. Although under the tariff rate quota, Bangladesh could export 8 million pieces of clothing to the Indian market every year, considering the huge potential of India as an emerging market, this preferential access seems inadequate. It is also important to develop a harmonized standards system within the region, especially for the products that have high trade potential in this region.

Summary and Conclusions

The expected boost to regional trade after the enforcement of SAFTA has materialized only to a limited extent. One of the major reasons for this is minimal intraregional investment, especially in manufacturing, despite market-oriented policies that have been instituted by Bangladesh and other SAFTA member countries to attract investment, in particular FDI. It is important to take initiatives to build the confidence among investors of the region to enhance intraregional investment.

Based on the revealed comparative advantage of South Asian countries, some sectors in Bangladesh have been identified as potential sectors for intraregional investment. Integrated efforts among the countries in the region will be required to develop production networks, where each country will invest and contribute to their respective areas of comparative advantage in those networks. At the same time, the domestic business environment needs to be improved, especially in terms of developing infrastructure facilities, such as electricity and gas supplies; keeping inflationary pressures in check; and ensuring political stability.

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CHAPTER 6

India Country Investment Study

B. N. Jha

Country Economic Profile

Overall Macroeconomic Conditions and Business Climate

India has become one of the fastest-growing economies of the world. According to the Organisation for Economic Co-operation and Development (OECD) (2008), gross domestic product (GDP) at market prices has registered annual growth rates averaging about 8% every year since FY2003 and shows that the country has moved to a consistently higher growth plane; in FY2006, the growth rate was at its highest at 9.6%.[1] Due to the global financial crisis, growth is expected to slow marginally in FY2008, but the growth story is intact (Table 6.1).

The impressive growth of India's economy has also been accompanied by a rise of foreign exchange reserves, which have grown from just $6 billion in FY1991 to $312 billion as of April 2008. This has led to a relaxation of rules with regard to the use of hard currency, including its use for investment abroad by Indian firms. This situation augurs well for intraregional investment. In the same manner, India's savings and investment rates have also begun to move toward the levels seen in East and Southeast Asia. Indeed, an important feature of India's recent GDP growth has been the sharp rise in both gross domestic investment and savings. During the 5-year period FY2002–FY2007, the ratio of gross domestic investment to GDP grew by 13.1% while the ratio of gross domestic savings to GDP grew by 11.3%. This spurred investment: during the same period, private investment grew by 10.3% and private corporate investment by 9.3%. While India's ratios of investment and savings are both around 30% of GDP, there is still an enormous need for urgent investment in priority sectors, which will call for attracting large amounts of foreign direct investment (FDI).

Table 6.1: Key Economic Indicators, FY2004–FY2007
(% change over previous period)

Items	FY2004	FY2005	FY2006	FY2007
Gross Domestic Product	7.5	9.4[a]	9.6[b]	9.0[c]
Imports at Current Prices	48.6	32.1	21.8	29.9
Exports at current prices	28.5	23.4	21.8	23.7

[a] provisional estimate.

[b] quick estimate.

[c] revised estimate.

Source: Reserve Bank of India (2008).

[1] The fiscal year (FY) of the Indian Government runs from 1 April to 31 March. FY before a calendar year denotes the year in which the fiscal year begins, e.g., FY2007 starts on 1 April 2007 and ends on 31 March 2008.

The Bombay Stock Exchange's Sensex also saw a high level of activity in FY2007, rising from 13,072 points in March 2007 to 18,048 in February 2008 and crossing the 20,000 mark thereafter. However, the stock market was first adversely affected by the slowdown of the United States (US) economy and by rising fuel and food prices, and then by the growing global financial crisis.

While the macroeconomic fundamentals of India are broadly sound, there have been some negative developments, which are adversely affecting the pace of growth. The major threats include high inflation, which reached over 12% in August 2008; the slowdown of the US (and now global) economy; and the slowdown in the consumer goods segment of industry. Despite these negative factors, the Indian growth scenario remains fairly intact and the investment climate remains optimistic.

Trade Profile

India's Foreign Trade Policy for FY2004–FY2009 and its Second Annual Supplement, which was released in FY2006, aim to double India's trade within 5 years. To achieve this goal, India aims to simplify procedures, reduce transaction costs, neutralize the incidence of levies and duties on inputs used for exports, and develop global hubs for manufacturing, trading, and services. One of the initiatives undertaken in FY2006 is the Focus Market Scheme, which is intended to offset high freight costs and other barriers. Another is the Focus Products Scheme. This supports the marketing of some products originating from rural and semi-urban areas, which suffer from high infrastructure bottlenecks and other associated costs. A special agriculture scheme to promote agricultural exports from rural areas has also been expanded to include the promotion of village and cottage industry products for export. In April 2005, the Government also encouraged state governments to promote India's international trade. Earlier, in FY2000, special economic zones (SEZs) began to be set up to provide an internationally competitive environment for exports and to encourage a stable SEZ policy regime. In 2005, the Special Economic Zones Act was passed.

Prior to economic liberalization in 1991, the peak customs duty rate was as high as 150% and was primarily aimed at protecting Indian companies from international competition. This was justified on the grounds that the country was acutely short of hard currency, but after liberalization began, customs duties in India were brought down continuously and comprehensively, and are likely to vary between 8% and 10%.

The Government has also taken steps to improve trade facilitation and electronic data interchange measures. One of the most important has been to make trade-related data available to interested parties with a minimum time lag. Various offices of the Directorate General of Foreign Trade provide information to exporters regarding developments in international trade, such as World Trade Organization agreements, rules of origin, sanitary and phytosanitary requirements, and antidumping issues, in order to assist them in developing strategies to address the highly competitive global environment. Trademarks for handlooms on lines similar to "Woolmark" and "Silkmark" will also be developed, and steps have been taken to move toward an automated electronic environment for filing, retrieving, and authenticating documents with other community trade partners, including customs and banks.

During FY2006, Indian exports reached $121 billion with merchandise exports growing by more than 20% during the last few years. This growth rate is more than twice the growth of GDP and, if this trend continues, the export target of $150 billion set in the Foreign Trade Policy is likely to be achieved. Among the major areas of growth in Indian exports are petroleum products, engineering goods, and gems and jewelry. With regard to imports, oil is a major item and has recorded higher growth than non-oil imports. Imports of fertilizers, wheat, newsprint, nonferrous metals, capital goods, machine tools, project goods, and transport equipment have also registered growth. There has been a decline in the imports of pearls, and precious and semiprecious stones.

Overall, the trend in India's foreign trade shows that Asian countries are increasingly accounting for a substantial share of India's foreign trade and trade flows are being directed toward developing nations (Table 6.2). With regard to exports, the share of Asia and the Association of Southeast Asian Nations (ASEAN) countries represents close to half India's total exports, with Europe and the US coming next. There

Table 6.2: International Trade by Region, FY2006 and FY2007
($ million)

	FY2006				FY2007			
	Exports		Imports		Exports		Imports	
Region	Amount	% Share	Amount	% Share	Amount	% Share	Amount	% Share
ASEAN	12,604	9.98	18,090	9.75	16,384	10.05	22,675	9.01
Central Asian Republics	191	0.15	143	0.08	232.3	0.14	112	0.04
Central Africa	203	0.16	29	0.02	257.51	0.16	49	0.02
East Africa	2,944	2.33	233	0.13	4,202	2.58	319	0.13
East Asia	1,489	1.18	7,580	4.08	1,410	0.87	8,381	3.33
East Europe	80	0.06	59	0.03	106	0.07	35.78	0.01
EU-27	26,785	21.21	29,809	16.06	34,507	21.17	38,432	15.28
Latin America	4,265	3.38	6,116	3.30	5,660	3.47	6,561	2.61
North East Asia	19,360	15.33	31,494	16.97	26,450	16.23	44,755	17.791
North America	19,961	15.81	13,503	7.28	21,988	13.49	23,003	9.14
Other CIS Countries	1,286	1.02	3,717	2.00	1,506	0.92	3,668	1.46
Other WE Countries	1,983	1.57	10,217	5.50	2,644	1.62	13,157	5.23
South Asia	**6,464**	**5.12**	**1,506**	**0.81**	**9,622**	**5.90**	**2,112**	**0.84**
Southern Africa	2,816	2.23	2,922	1.57	3,609	2.21	4,835	1.92
Unspecified	352	0.28	842	0.45	556	0.34	1,803	0.72
WANA	23,038	18.25	51,152	27.56	30,372	18.64	71,917	28.59
West Africa	2,441	1.93	8,193	4.41	3,477	2.13	9,745	3.87
Total	**126,263**	**100.00**	**185,604**	**100.00**	**162,984**	**100.00**	**251,562**	**100.00**

ASEAN = Association of South East Asian Nations, CIS = Commonwealth of Independent States, EU = European Union, WANA = West Asia and North Africa, WE = West Europe.

Source: Department of Commerce (2008).

Table 6.3: Trade with South Asia, FY2006 and FY2007
($ million)

	FY2006		FY2007	
Country	Exports	Imports	Exports	Imports
Sri Lanka	2,254	470	2,827	631
Bangladesh	1,627	228	2,918	257
Pakistan	1,349	323	1,945	288
Nepal	928	306	1,507	628
Afghanistan	182	34	249	109
Bhutan	57	141	87	194
Maldives	69	3	90	4
Total	**6,464**	**1,506**	**9,622**	**2,112**

Source: Department of Commerce (2008).

has been a conscious effort to diversify India's exports with a view to increase its overall global exports. This should be contrasted with earlier efforts that were aimed largely at tapping Western Europe and North America.

While the trend is toward expanding trade with Asia and ASEAN countries, India's trade with South Asia is low and below what one would have hoped for (Table 6.3). With each of these countries, the share of total trade is less than 1% and this calls for concerted action to improve intraregional trade, both on the part of India and of its South Asian neighbors.

Industry Profile

One of the encouraging trends in the Indian economy in recent years has been the resurgence of industry. Many experts have felt that the success story in manufacturing has been that of the People's Republic of China (PRC) while India has been successful in services. Industry registered an annual growth rate of about 9% during FY2003–FY2007.

Textiles and Clothing Industry

Textiles and clothing (T&C) constitute South Asia's largest manufacturing sector, accounting for about 14% of industrial production or 4% of GDP; it is a major employer that provides direct employment to about 35 million people; and it is a leading export sector, contributing 16% of the country's export receipts. The cotton/man-made fiber textile industry is the largest organized industry in the country in terms of employment and number of units produced. It has a large number of subsidiary industries that are dependent on the sector, such as machinery, accessories, stores, dyes, and chemicals. Textile exports contribute substantially to export earnings, and the export basket includes cotton yarn and fabrics, man-made yarn and fabrics, wool and silk fabrics, made-ups, and a variety of clothing. In 2005, after the expiry of the Multi-Fiber Arrangement, textile exports increased by 22% from the previous year.

An important segment of textile in the country is jute, and India is the largest producer and second-largest exporter of jute goods in the world. This sector supports the livelihood of about 4 million farm families and provides direct and indirect employment to 500,000 workers. The annual exports of jute products are about $300 million and the production of jute is concentrated in the eastern states of India.

A very important segment is the clothing industry, which is now one of India's largest foreign exchange earners, accounting for nearly 16% of the country's total exports and employing around 3 million people. The present need is to expand the manufacturing and marketing bases. Innovation and good export growth should be achieved through research and development and through tapping new markets, especially in South Africa, Central Africa, the Commonwealth of Independent States, Eastern Europe, Latin America, and Australia.

Automobile Industry

While the automobile industry has been in India since the 1920s, it remained small for decades with only three key players in the motor car subindustry: Hindustan Motors, Premier Automobiles, and Standard Motors. There has been no innovation due to a restrictive licensing policy, and the three key players operated comfortably with old technology. There was also no growth because of the absence of a large middle-income group. Major changes occurred in 1982 when Maruti Udyog Limited was set up with government assistance, and was mandated to collaborate with Suzuki Motor Corporation. The collaboration was in the areas of technology and the production of fuel-efficient vehicles suitable for India. The motor car subindustry was invigorated when licensing curbs were removed at economic liberalization, which led to several joint ventures in car manufacturing. The automobile industry has since become a major sector, accounting for 4% of GDP and 17% of national direct tax revenues.

Automobile exports from India have been registering an upward trend, and 1,238,499 vehicles were exported in FY2007. With India established as a base for automobile manufacturing, its automobile components industry has also grown. Indeed, there are around 500 firms in the organized sector producing practically all parts, as well as more than 10,000 firms in the small unorganized sector (according to the Department of Heavy Industries/ Automotive Component Manufacturers' Association of India). Automobile components have also been one of the fastest-growing segments of the automobile industry, registering an annual growth rate of 20%

in FY2001 to FY2005, while exports of automobile components grew by 29% in FY2003 to FY2006. The rate has since slowed somewhat with 18% annual growth in FY2006 and 7% in FY2007. India is also one of the largest manufacturers of tractors in the world as well as one of the few countries in the global economy that has attained self-sufficiency in tire production.

India's Auto Policy of 2002 envisaged a globally competitive automobile industry that would double its contribution to the economy by FY2010. It aimed to attract investment to the industry, partly by the automatic approval of foreign equity investments of up to 100% in some sectors. Other government initiatives in recent years include a reduction of excise duty on small motor vehicles and duty for raw materials, and infrastructure development. In the last few years, India has become an attractive destination for foreign direct investment (FDI) in the automobile industry, primarily because it possesses the engineering skills needed for cost-efficient manufacturing.

Infrastructure

Weak infrastructure used to be one of the major reasons for the slow growth of the economy. Roads were in poor condition, ports were afflicted with low handling capacity, power shortages were common, airports were nowhere near international or even regional standards, and communication was poor. Improvements in infrastructure required massive infusions of funds and the private sector suffered both from inadequacy of such funds and apprehension in investing in infrastructure projects, which have a long gestation period. The majority of investments in infrastructure, therefore, came from central government funds and the public sector. The situation changed substantially after economic liberalization, when private players became involved in infrastructure development.

Power is a key sector in India, where there has been a constant gap between power required and generated. In FY2006, India produced 1,322.1 billion kilowatt- hours of electricity from its three main sources: hydroelectric power, thermal energy, and nuclear energy. The deficit in power supply in terms of peak availability was 14.8% and in terms of total energy availability was 8.4%. Huge investments in power have always been identified as a necessity in sustaining economic growth. The recent entry of private firms in power generation will greatly augment the Government's efforts, but the gap between demand and supply is expected to remain for quite some time. Thus a boost in FDI in the power sector can be expected to boost economic growth.

Since poor roads in India have always been a bottleneck to rapid growth, road improvement and expansion are a priority. Toward this end, the National Highway Development Programme aims to expand about 14,300 kilometers of national highways to four and six lanes.

The civil aviation sector has witnessed developments in the last few years. It is estimated that the combined number of domestic and international air passengers almost doubled from 2004 to 2007, and cargo traffic increased by more than 45% during the same period. India has now embarked on a major upgrading program with the most notable effort being the privatization and modernization of Delhi and Mumbai international airports. There have also been proposals to substantially upgrade the Kolkata and Chennai airports by the Airports Authority of India, which is also set to modernize 35 nonmetropolitan airports.

Like airports, India's ports are in need of upgrading to meet the requirements of international trade and to generate economic activity through port-hinterland connectivity. India has a coastline of 7,517 kilometers, 12 major ports, and about 200 nonmajor ports, which handled about 650 million tons of cargo during 2006. Despite recent measures to upgrade and modernize their handling facilities, the average turnaround time pales in comparison to the best ports in Asia.

In conclusion, a comprehensive policy that will address the infrastructure and transport problem in India is needed. In developing infrastructure and transport, attention needs to be paid to intraregional connectivity.

Resource Endowments

Perhaps the most attractive resource of India is its human resources. It is possibly the world's largest resource of educated, English-speaking, hard-working, skilled, and ambitious workers. Another advantage is that this workforce is young and should be available to work for a long time. There is also a large network

of universities, colleges, and research institutions from which over 2.5 million English-speaking students graduate annually. There is a strong pool of about 300,000 engineers and 150,000 information technology (IT) professionals, constituting the world's second-largest pool of scientists and engineers.

Regional Trade Agreements

After the SAARC Preferential Trading Arrangement (SAPTA) was signed in 1994 and came into effect in 1999, concessions were granted on 226 products. By 2000, this number had risen to 4,700 products but even then there have been no corresponding increases in intraregional trade, which shows that the tariff cuts under SAPTA have not been enough. Indeed, many of the products to which concessions were given are not widely traded in the region. In this view, the South Asian Association for Regional Cooperation (SAARC) called for the establishment of a South Asian Free Trade Area (SAFTA). The SAFTA Agreement came into effect on 1 January 2006, aiming to reduce import duties to 20% by 2006 and to 0%–5% by 2013. However, it allows the less developed economies to reduce the rate of duties to 0%–5% by 2016.

With regard to formal trade agreements, India and Pakistan have no such agreement, but India has granted most-favored-nation status to Pakistan since 1996. Pakistan maintains a positive list of importable items from India and its trade with India is restricted to a list of about 1,800 items. Pakistan's official exports to India stood at $287.94 million in FY2007, while it imported $1.94 billion worth of Indian goods the same year. Unofficial trade by smugglers is believed to be several times higher, traders say. The two states share comparative advantages in many goods, yet less than 1% of Pakistan's exports flow to India.

India and Sri Lanka have forged a free trade agreement, a result of which was increased investment from India to Sri Lanka. Sri Lanka offers a skilled workforce, cheap raw materials, and traditional experience in rubber, tea, coffee, and spices. Indian investors can enjoy these advantages and reexport the processed products to India. The majority of Indian investment in SAARC countries is in Sri Lanka and the biggest Indian investment in recent times has been the Indian Oil Corporation's investment of $75 million. India is also providing a $100 million line of credit to Sri Lanka as a commodity loan aimed at assisting Sri Lankan importers to source goods and services from India under soft loans. It is also intended to stimulate Sri Lanka's small and medium-sized entrepreneurs, as well as fostering relationships with their Indian counterparts. The coverage of the credit line can also be further expanded to strengthen ties at the industry and sector levels, especially in tea, rubber, and spices.

FDI Policy and Environment

Ever since India adopted economic liberalization in 1991, government policy has been to attract FDI. India has been trying to project itself as an attractive FDI destination and as a major emerging economy. According to the Investment Commission of India (2008), the following are the strengths of the economy:

i. Free market democracy;

ii. Fifth largest economy in the world;

iii. Stable policy environment;

iv. Large and growing domestic market;

v. Sustained GDP growth of over 7%–8%;

vi. Resilient economy;

vii. Capacity to absorb FDI inflows;

viii. Firms growing in confidence and capability to partnering with FDI firms and facing global competition;

ix. Strong reservoir of English-speaking workforce and technical human resources;

x. Strong rule of law and independent judiciary;

xi. Efficient financial system; and

xii. Strong foreign exchange reserves.

History

FDI used to be looked at with suspicion and apprehension since there was fear that foreign investors were not interested in development but in profit and repatriation of revenues and in spreading their hegemony. Also, foreign investors were attracted to sectors that the Government was not keen on opening to the private sector, much less to foreign investors. On the other hand, foreign investors were not really interested in the priority areas of the Government. Thus self-help and self-sufficiency were the prevailing economic policy. Major changes in thinking and policy in India occurred only after the adoption of economic liberalization in 1991.

Performance of FDI

From August 1991 to February 2008, India attracted $79 billion in FDI. During FY1991–FY1999, only a relatively modest amount of $17 billion was received (Table 6.4). It was only in FY2006 that FDI rose substantially to $15.7 billion and then to $24.6 billion in FY2007. This upward trend is expected to continue and the target set for FY2008 is $35 billion. This shows that it has taken time to instill confidence among foreign investors in India and that it has taken the system some time to absorb such investments. It appears that with concerns having been considerably addressed, India should attract FDI at a faster pace in the coming years. Table 6.5 shows the top country sources of FDI.

One of the major gains of FDI in India has been technology transfer, and there has been a conscious effort in this direction. Countries from where such transfers have occurred include the US, Germany, Japan, United Kingdom, and Italy. Sectorwise, the major beneficiaries of technology transfer have been electrical equipment, chemicals, industrial machinery, transportation industry, and general engineering industry. Table 6.6 shows FDI inflows by sector.

With regard to FDI from India to other South Asian countries, the Government has considerably liberalized its policy mainly by simplifying procedures on outward

Table 6.4: Annual FDI Inflows, FY1991–FY2007
(equity capital components only, $ billion)

Fiscal Year	Value	Growth Rate (%)
1991–1999	16,698	
2000	2,908	
2001	4,222	65
2002	3,134	(33)
2003	2,634	(18)
2004	3,759	45
2005	5,546	72
2006	15,726	184
2007	24,579	56
Total (2000–2007)	**62,508**	
Total (1991–2007)	**79,206**	

() = negative.

Source: Department of Industrial Policy and Promotion.

Table 6.5: Top Sources of FDI, FY2005–FY2007
($ billion)

Country	FY2005	FY2006	FY2007	FY2005–FY2007	% of Total Inflows
Mauritius	2,570	6,363	11,096	20,029	43.99
Singapore	275	578	3,073	3,926	7.43
United Kingdom	266	1,878	1,176	3,320	7.19
United States	502	856	1,089	2,447	8.38
Netherlands	76	644	695	1,415	4.42
Japan	208	85	815	1,108	3.40
Cyprus	70	58	834	962	1.72
Germany	303	120	514	937	2.56
United Arab Emirates	49	260	258	567	1.24
France	18	117	145	280	1.58

Source: Department of Industrial Policy and Promotion.

investment. However, Indian investment in South Asian countries is much lower than its investment in Southeast Asia and Africa in spite of the advantages that South Asia has to offer in terms of geographic proximity, linguistic and cultural affinity, good markets, lower transportation costs, similarity of experience, and relevant technology.

Indian firms have preferred to establish their international bases in Western Europe and North America because of the ease of conducting business in those regions and with a view to enhance their global profile. Indian firms also took note of the issues associated with South Asian countries, such as security concerns, political instability, poor transport connectivity, absence of an independent judicial process, and fears relating to protection of investment. In addition, a policy and framework of enabling and facilitation that will assist intraregional trade are lacking.

Current FDI Regime and FDI Promotion Policy

After economic liberalization, many policy makers started to view FDI as necessary in providing a thrust to economic growth. Joint ventures between foreign and domestic firms emerged as the main model since it combines the advantages of attracting foreign capital while protecting and promoting national firms. Over the years, FDI has become not only a source of finance but also a resource for securing technology and better management practices.

Priority Sectors

FDI in infrastructure is of the highest priority since, despite recent substantial investments, inadequacies remain. Continued upgrades in infrastructure require considerable investment, which cannot be met by domestic savings alone. To facilitate FDI in infrastructure, 100% FDI under the automatic route is allowed for most infrastructure sectors, such as highways and roads, ports, inland waterways and transport, and urban infrastructure. However, some infrastructure sectors, such as telecommunications, airports, and airlines, have defined caps.

Labor Laws and Mobility

While relatively cheap labor and a large reservoir of technical personnel have been cited as major boons for investment in India, rigidity in labor laws has been a persistent constraint to investment in the country. Reform to labor laws has been called for but it remains a sensitive subject. In the past, opposition from labor, strikes and lock-outs, and inability of employers to hire and fire according to the needs of their industry created a negative environment. However, the above obstacles have increasingly become less relevant. For

Table 6.6: Sectorwise FDI Inflows, August 1991 to July 2007
($ million)

Sector	FDI Inflows	% of Total FDI
Services (financial and nonfinancial)	9,442.75	19.00
Electrical Equipment (including computer software and electronics)	8,963.73	18.19
Telecommunications	4,880.15	9.64
Transportation	3,856.17	7.58
Fuels (power and oil refinery)	2,891.80	5.75
Chemicals (other than fertilizers)	2,464.52	4.64
Construction Activities (including roads and highways)	1,912.31	3.90
Drugs and Pharmaceuticals	1,255.10	2.52
Food Processing Industries	1,283.16	2.40
Housing and Real Estate	1,124.37	2.25
Cement and Gypsum Products	996.14	2.03
Metallurgical Industries	909.21	1.83
Hotels and Tourism	653.02	1.31
Consultancy Services	584.03	1.24
Textile (including dyed and printed)	629.58	1.19
Miscellaneous Mechanical and Engineering	605.74	1.13
Trading	555.22	1.05
Paper and Pulp Including Paper Products	370.54	0.67
Commercial, Office, and Household Equipment	279.54	0.55
Rubber Goods	255.86	0.51
Glass	258.25	0.48
Industrial Machinery	249.15	0.47
Machine Tools	197.18	0.40
Agricultural Machinery	191.96	0.37
Ceramics	147.65	0.28
Fermentation Industries	125.99	0.25
Medical and Surgical Appliances	115.51	0.24
Timber Products	107.12	0.22
Soaps, Cosmetics, and Toiletries	96.02	0.20
Fertilizers	84.05	0.17
Earth-moving Machinery	75.07	0.16
Leather, Leather Goods, and Pickers	60.49	0.11
Vegetable Oils and Vanaspati	53.86	0.10
Glue and Gelatin	36.04	0.07
Sugar	33.82	0.07
Prime Movers Other than Electrical	30.89	0.05
Industrial Instruments	22.06	0.04
Photographic Raw Film and Paper	18.06	0.03
Scientific Instruments	14.93	0.03
Dye Stuff	16.01	0.03
Boilers and Steam-Generating Plants	9.29	0.02
Defense Industries	0.05	0.00
Mathematical, Surveying, and Drawing	0.00	0.00
Miscellaneous Industries	4,551.69	8.89
Total	**50,408.08**	**100.00**

Source: Department of Industrial Policy and Promotion.

example, the issue of hiring and firing is becoming less important since companies are now looking at retaining good and skilled staff.

With the services sector becoming more vibrant as new players come in and with the phenomenal growth of construction, the situation has moved from many people chasing few jobs to many jobs available for trained and skilled workers, who are relatively few in number. Introduction of stiff competition from private sector entrants in aviation, telecommunications, banking, and insurance has also had a sobering effect on public sector employees, who now increasingly recognize the need to be competitive in order to survive and succeed in a highly competitive market. Their capacity, as that of trade unions, to be unduly unreasonable has been considerably weakened. However, there is a continued requirement for higher productivity of labor with the emphasis of shifting toward better training, development of skills, and longer weekly working hours.

Nontariff Barriers

While India has been actively pursuing bilateral and regional free trade agreements, the gains from such trade can be limited by the presence of the following nontariff barriers (NTBs):

i. import policy barriers and negative lists, which are the most important NTBs affecting trade in South Asia. While more numbers are being added to the positive list, many items, which have substantial potential for intraregional trade, remain excluded;

ii. standards, testing, labeling, and certification requirements, which Indian products face not only in Western markets but also in some Southeast Asian countries;

iii. antidumping and countervailing measures;

iv. export subsidies and domestic support such as high agricultural subsidies; and

v. government procurement policies.

Other factors such as local taxes, domestic infrastructure, complex and lengthy procedures, and inspections, add to the cost of compliance with international standards, making life difficult for exporters.

Screening, Admission, and Establishment Policies

India claims that it has some of the most liberal and transparent FDI policies among developing economies. Indeed, FDI up to 100% investment is allowed under the automatic route in a number of sectors. Exceptions include the manufacture of cigars and cigarettes from tobacco and manufactured tobacco substitutes, electronic aerospace and defense equipment, and manufacture of items exclusively reserved for the small-scale sector, which require prior government approval. Most financial and services sectors are open to FDI up to 100% under the automatic route. Retail trade is currently closed to FDI, but 100% FDI is allowed in the wholesale and cash and carry subsectors. Sectors closed to FDI include railways, atomic energy, postal services, gambling and betting, lotteries, basic agriculture and plantations, and legal services.

Fiscal and Financial Incentives

Like most countries vying for FDI, India offers financial incentives to foreign investors. Investors are exempt from paying income tax up to 100% of FDI in many sectors for up to 10 years. Other incentives include free repatriation of all foreign investments, dividends, and profits as well as sale of shares on the stock exchange by nonresidents.

Performance Requirements

India has begun to remove mandatory requirements and relies increasingly on encouragement through incentives. The overall incidence of performance requirements on FDI approvals declined sharply during the 1990s and the performance requirements imposed today are 100% export obligations for export processing zones (EPZ) in return for various concessions and incentives. Performance requirements other than those imposed on firms entering EPZs or other such schemes have been abolished.

Property Rights

The patent system in India is governed by the Patents Act of 1970 (amended in 1995) and the

Patents Rules of 1972 (amended in 1999). Many foreign firms that have the desire to invest in India have had strong concerns regarding weaknesses in India's patent laws and the protection of intellectual property. The laws' amendments in 1995 and 1999, coupled with an independent judicial process, have removed most of these fears. However, concerns still remain with regard to piracy, which is more of a problem of implementation than legislation. India is also a signatory to the World Intellectual Property Organization's Trade-Related Aspects of Intellectual Property Rights Agreement, the Paris Convention for the Protection of Industrial Property, and the Patent Cooperation Treaty.

Institutions

India has set up several institutions whose objectives are to deal with issues relating to FDI and to assist foreign investors. Of the institutions involved in screening and facilitating FDI, most important is the Foreign Investment Promotion Board, which processes proposals that are not included in the automatic route. The Foreign Investment Implementation Authority was established as a one-stop service center for foreign investors and is a coordinating and problem-solving agency. The Investment Commission of India is another important institution, and is working for the promotion of investment. The Secretariat for Industrial Assistance functions as a gateway to industrial investment, and the India Brand Equity Foundation is a center for comprehensive information on India, and offers publications relating to India's economic and business opportunities. For Indian outward investment, a single-window clearance system has been adopted, with the Reserve Bank of India as the nodal authority for such clearance and reporting.

Special Economic Zones

FDI of 100% is permitted under the automatic route with regard to setting up SEZs and Free Trade Warehousing Zones subject to the Special Economic Zones Act of 2005 and the Foreign Trade Policy. Indian policy allows the establishment of SEZs by the public or private sectors, or joint partnerships between private firms and state governments.

Before the 2005 Act, there were 16 SEZs in the country with Andhra Pradesh, Kerala, and Madhya Pradesh having one each; Uttar Pradesh two; Gujarat and West Bengal three each; and Tamil Nadu five. After the 2005 Act, the number of SEZs boomed to 206 and there are several SEZs for a varied range of sectors, including those for IT and electronics, hardware and software, and multi-products. Exports from SEZs stood at $8.7 billion in FY2006. Between April and December 2007, SEZ exports reached $16.8 billion and are projected to reach $30 billion in 2008.

Recently, protests against SEZs have erupted in some provinces, such as West Bengal and Goa. The complaints are founded on three beliefs. First, the establishment of SEZs is just a way of land grabbing by large companies. Second, the land acquired for SEZs is agricultural land, which will adversely affect agriculture and the farmers. Third, the land holdings of small farmers are acquired at rates far below the market rate, benefiting large companies while being unjust to farmers.

While there is some merit to these complaints, it is also true that many of the complaints are motivated and even exaggerated for ideological or political reasons, or for obtaining higher compensation. The Government is trying to balance things by adjusting policies and provisions, such as putting a ceiling on land acquisition for the establishment of SEZs, by avoiding agricultural land, and by ensuring that prices at which land is sold are at par with prevailing market prices.

Investment Treaties

India has entered into double taxation agreements with several countries. In South Asia, the countries are Bangladesh, Nepal, and Sri Lanka. These agreements provide protection from double taxation and have facilitated the flow of investment into India. Indian firms are also encouraged to invest in countries with which India has such agreements. Relief from the tax burden in both countries helps in competitiveness and reduces paperwork. A Comprehensive Economic Cooperation Agreement was also signed with Singapore and talks for such agreements are also ongoing with other countries including nations from the Bay of Bengal Initiative for Multi-sector Technical and Economic Cooperation and from ASEAN, the Republic of Korea, Mauritius, and Sri Lanka. In June 2007, negotiations on a Foreign Investment

Protection and Promotion Agreement with Canada were concluded. In addition, the US and India are also exploring the possibility of forging a bilateral investment agreement.

Policy Regarding Outward FDI

In tandem with the liberalization of the economy, a policy toward outward Indian investment has also been liberalized. Indeed, considerable liberalization and streamlining of procedures was undertaken in 1995 and the Reserve Bank of India has been made the nodal agency for administering the overseas investment policy. This provides a single-window system for overseas investment approvals to promote transparency within the framework of the foreign investment policy. All proposals for direct investment abroad are now processed by the Bank.

FDI and the Economy: Potential, Impact, and Constraints

As mentioned earlier, at the time of economic liberalization there were several apprehensions about FDI that were related to the real intentions of foreign investors. There was also considerable fear about the loss of jobs and the belief that Indian firms would not be able to withstand competition from multinational corporations. Some of these doubts have not been dispelled, but the overall consensus now is that FDI is good for India and for Indian firms. Indeed, Indian firms have not only withstood competition, but have survived and succeeded, even to the extent that several of them are boldly going out to invest globally. FDI has also helped with inflows of capital and the infusion of better technology and management practices. Consumers have also benefited in terms of more varied choice and lower prices.

Notwithstanding all these demonstrable benefits, FDI into India has been below expected levels. The good thing is that during the last couple of years, India has been attracting much higher volumes of outside investment, both FDI and equity investment. While the Indian story is considered a success, there are still substantial concerns regarding slowdown of reforms, financial discipline by the states, and reform of labor laws, among others. The continuing weakness of infrastructure is still a nagging problem and inadequate power availability remains a concern. How India deals with these issues will substantially determine the flow of FDI and the pace of growth.

Analytical Framework and Rationale

The basic rationale for attracting FDI is to generate additional and enhanced economic activities so as to promote economic growth and to generate additional income and employment by supplementing domestic savings and investment. Additional spillover benefits include the transfer of technology and modern management practices. Indeed, all countries in South Asia are now seeking FDI and have been exploring various measures to attract FDI into their economies. However, there has not been much of a concerted effort in promoting and facilitating intraregional investment. Such investment will extend the presence and strengthen the competitiveness of Indian companies in, for example, textiles, tea, rubber, agroprocessing, and automobiles. Indian firms will gain by having increased demand, access to local raw materials, and joint marketing efforts. There are strong advantages inherent in intraregional investment, but there are also constraints in the form of poor transport linkages for intraregional transportation, weak communications linkages, low level of interaction and cooperation between financial institutions, and weak mutual trust. Political uncertainty in some neighboring countries and security concerns have also been major deterrents. The situation, however, is changing for the better, although very slowly.

FDI Potential

According to the Investment Commission of India (2008), India has several areas where substantial FDI is required. For power, a 100,000 megawatt generation, transmission, and distribution system has to be developed and $200 billion is required over seven years. In telecommunications, over 150% growth is projected during the next 5 years in telecommunications devices and software for internet, broadband, and direct-to-home services, among others, with an accompanying investment cost of over $22 billion. There are also multibillion-dollar requirements for the development of roads, ports, civil aviation, petrochemicals, and natural gas. Elsewhere, there is immense potential in financial, knowledge, and health services. There is also $130 billion worth

of investment opportunities in manufacturing (e.g., metals, steel, T&C, and automobiles and automobile components). All in all, the country offers investment opportunities estimated to be in excess of $850 billion over the next 5 years (Investment Commission of India 2008).

Several sectors have a strong potential for intraregional investment, provided that the necessary policy and implementation measures are adopted. According to Tata Consultancy Services (1999), these include textiles, the automobile and knowledge industries, medical services, education, finance, and telecommunications. But perhaps T&C can be the core export from South Asia since every country in the region has a demonstrated comparative advantage in the industry, and gained strong global market share after the removal of global textile quotas in January 2005. Coordination and some form of integration between South Asian countries should help promote T&C exports, and these should lead to technological upgrading, as well as quality and marketing improvements.

One avenue for cooperation is in jute products, of which 70% is produced in South Asia. In view of the increasing replacement of jute products by synthetics and other substitutes, jute-producing countries can help each other through cooperation. For example, Nepal's raw jute can be used for making value-added jute composites like carpets and laminates as well as fine yarns, which are then used to make fabrics for upholstery; green jute can be used to make medium-density fiberboard. There is also scope for setting up a modern jute manufacturing plant in Bangladesh with technological support from India in spinning and blending or in the production of new uses.

India can make significant investments in neighboring South Asian countries in the automobile and automobile components industry, especially in Pakistan and Sri Lanka. There is also enormous potential for the development of hydroelectric power in Nepal in collaboration with India (and possibly private and multinational corporations). One can draw positive conclusions from the Chukha Hydropower Project undertaken by Bhutan and India, which has given a boost to Bhutan's GDP and has helped India obtain power. South Asia's considerable human resources also provide for potential FDI in the development of knowledge-based industries. India has made considerable advances in software, which could encourage Indian companies to invest in Bangladesh, Nepal, and Sri Lanka for the purposes of opening training centers and setting up branches of its IT-related industries. Financial services and telecommunications also hold promise for Indian investment in other countries, which should provide for economies of scale and cross-border business.

Bangladesh can invest in India in the area of gas power distribution from Bangladesh into India. There could also be joint investments between Indian and Sri Lankan firms in plantations of coffee, tea, rubber, and spices. Sri Lankan firms can also invest in fisheries and ceramics, while Nepal can invest in setting up woolen weaving plants in India.

Economic and Social Benefits

Technology Spillovers

One of the major advantages of FDI is technology spillover, which is most apparent in the automobile industry, where major multinational corporations brought in technology along with investment. This was necessary given the need to adhere to global technical standards. Over a few years, these technological standards have become commonplace all over Indian industries. Improved management know-how is another spillover, as is most evident in finance and telecommunications, which have attracted global institutions and service providers.

Trade and Investment Effects

Most foreign investors primarily eyed India to take advantage of its large market. Indeed, the motive for FDI in the automobile and white goods industries was primarily to sell to India's billion people. However, as these investors have strengthened their presence in India and have carved a share of the market for themselves, they have now started to view India as an outsourcing base for Indian-made products to the global market. Consequently, the automobile components sector, which initially catered to car manufacturers in India, is gearing to meet the global parts requirements of foreign manufacturers.

Country Reputation and Linkages

FDI has tended to enhance India's reputation. Indeed, the automobile and T&C industries had a very negative image until foreign players arrived, and domestic firms in these industries were forced to comply with quality standards. Today, the "Made in India" label has global acceptance.

Foreign Exchange Gap

During the 1980s and 1990s, one of the major constraints faced by India was the shortage of foreign exchange. After economic liberalization, the inflow of FDI has grown along with a concomitant increase in reserves, which stood at over $247.7 billion in November 2008. These huge reserves have led to relaxation of some existing restrictions on foreign currency and should enable Indian firms to invest more abroad, including in South Asia.

Risks and Negative Effects

There are apprehensions over the risks involved in further opening the country to FDI. For example, with regard to opening retail to FDI, there is the potential risk that that traditional Indian *kirana* (grocery) stores will be unable to survive once the global retail chains come to India since these shops, particularly in big cities, will not be able to compete with large supermarkets with a global supply chain and economies of scale. Store owners and personnel will lose their businesses and sources of income, but consumers will benefit from the availability of global products that are generally better than India's. There is also the possibility of lower prices with the entry of foreign retailers. Although these adverse effects on small shops cannot be ruled out, there will still be a place for them. Indeed, even in big cities, small shops that offer niche products and services do survive and succeed. More important, strong competition could force these small shops to upgrade the quality of their products and services. Foreign investors, who may be guided mainly by profit, might also undertake uncontrolled and unsafe exploitation of limited natural resources.

There are also apprehensions regarding higher education that revolve around the high fees that may be charged by foreign higher educational institutions. Ordinary Indians might not be able to afford them.

Constraints

Early constraints regarding FDI were related to enabling and protection issues. Current concerns relate to the accelerated inflows of FDI, and to widening, deepening, and further hastening of reforms, which will enable India to attract higher inflows of FDI in the coming years.

With regard to outward FDI to South Asian countries, the Research and Information System in Developing Countries (RIS) (1990) identified several areas of constraints. These are related to high tariffs and NTBs; information gaps; inadequate finance and credit facilities; and lack of standardization for letters of credit, of adequate investment guarantees, of credibility in regional capabilities, of skilled human resources, and of entrepreneurship. The telecommunications tariff between South Asian countries is also very high and connectivity needs to be improved.

There are continued weaknesses and bottlenecks in some core areas of infrastructure, particularly in power and roads. Indeed, the land and air links among South Asian countries are very weak and cross-border facilities are not well developed. The shortage of power is also a major constraint to economic growth and, while there has been substantial investment in power, the need for further investment has been increasing and will continue to be an area of concern, if India is to accelerate its development. Further investments are also required in the development of rural roads to increase economic activities. The ports also have considerable bottlenecks, and improved port–hinterland connectivity is required.

Although India has opened up considerably and is very receptive to FDI, some sectors still need to be liberalized, such as retail and higher education. Further, even among sectors already opened up, there are entry caps (e.g., 49% for telecommunications services and airlines, and 47% for airports). The regime needs to be further liberalized so that there is an easy flow of trade and investment within the region. There is a need for strong interaction at the sector, industry, and enterprise levels. Finally, India's various state governments should make more commitment and effort to attract FDI.

Policy Recommendations

General

It was seen that in addition to addressing the above constraints (especially in infrastructure), new areas, such as retail and higher education, also need to be opened to FDI. Sector caps, such as in telecommunications, airports, and airlines, should be relaxed. There is also a need to increase productivity to remain competitive with not only industrial but also other emerging economies, such as Brazil and the Russian Federation. For productivity enhancement, one important measure will be specific skill development in various sectors and this will have to be a joint effort by the private sector and the Government. Work hours per week may have to be extended with appropriate increases in wages so that while productivity is enhanced, workers receive better pay and allowances. International quality and safety standards must also be complied with.

Work stoppages from strikes must also be avoided by cementing the notion that such stoppages are not in the best interest of the nation or labor. In the same manner, industries must regard labor as a major resource and partner. Management should be fair in dealing with labor and this could be attained through consensus building, which is expected to be more effective than the law. This will have to be a combined effort of central and state governments, political parties, the private sector, and labor unions. In addition, with India having a federal government, the development of the entire country can only be fulfilled if all its states join in the reforms wholeheartedly.

Finally, private investment in rural areas needs to be promoted, and this may take the form of establishing rural credit banks and rural insurance, strengthening marketing and supply chains, and setting up cold storage and agroprocessing units, among others. The objective should be to involve the private sector in making rural areas centers of economic growth and active participants in India's growth story. Indeed, it is expected that if rural India grows, increased economic activity will ensue from the generation of additional demand both for goods and services. According to this view, there will also be additional demand for investment in the country.

Sector Specific

To facilitate intra-SAARC investment and market access in T&C, Tewari (2007) suggests establishing a well-thought-out and transparent investment protocol for South Asia, lowering tariffs and taxes, reducing the long negative lists, prioritizing cross-border investments in T&C and accessories, and ensuring quick and cost-effective transport of locally made fabric and accessories. The deepening of the skills of managers, technical personnel, and designers in T&C has to be encouraged. In addition, special attention should be paid to the improvement of labor standards and compliance with codes of conduct.

In the automobile industry, there is much scope for intraregional cooperation and India has made remarkable strides, which will ultimately benefit its neighbors. As most major automobile manufacturers have set up production bases in India, they can be interested in outsourcing their components from India into other South Asian countries. Efforts should also be made to establish joint ventures, and firms like Bajaj, Hero Honda, and TVS can be invited to consider the feasibility of setting up units in some South Asian countries. The SAARC region can also make progress in automobile and components manufacturing if the industry could be promoted regionally through mutual investment efforts.

Summary and Conclusions

India opened its economy to FDI in 1991, a few years after other Asian countries. While there have been some concerns, most of these have been addressed and the majority of the constraints have been removed, although it took some time to develop broad consensus and stability in the policy regime, as well as to create an appropriate, enabling, and facilitative environment. Accordingly, inflows of FDI were low in the initial years but the pace has since picked up to show a sharp increase.

Constraints relating to earlier enabling and protection issues have been addressed but new concerns have arisen with regard to the accelerated flow of FDI. There are also continued weaknesses and bottlenecks in some core areas of infrastructure, such as ports, and inefficiencies brought about by delays in the formation of consensus and government decision

making. Low labor productivity and the lack of skilled workers are also constraints. Greater uniformity with regard to policies and improved financial discipline by state governments should serve to increase FDI inflows. While India has liberalized and is very receptive to FDI, there are specific sectors that need to be opened up (e.g., retail and higher education), while sectors with FDI entry caps have to be further liberalized.

With regard to outward FDI, Indian firms have been gaining confidence and have started to invest significantly abroad: it is estimated that investment from India was around $15 billion in FY2007. In this view, South Asian countries should come up with a comprehensive plan for attracting inward FDI from India.

FDI and trade policies further need to be supported by a comprehensive policy both to facilitate intraregional connectivity and to address the infrastructure and transport constraints affecting intraregional trade and investment. Improved intraregional trade facilitation, including the presence of state-of-the-art facilities at all border posts, is needed.

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CHAPTER 7

Nepal Country Investment Study

Ramesh C. Chitrakar

Country Economic Profile

Overall Macroeconomic Conditions and Business Climate

Nepal introduced economic liberalization only in the early 1990s when the Government reduced its intervention in the economy and encouraged exports. Trade liberalization, foreign exchange and banking deregulation, and privatization have been the major planks of this liberalization. Nepal also reduced the average import tariff rates to the lowest in South Asia and these policies have started to show some positive impacts with the ratio of exports to gross domestic product (GDP) rising from 6.1% in 1990 to 14% in 2001. The financial sector also grew with the establishment of banks and finance companies, including joint ventures, and the cost of funds has since come down as financial markets have become more competitive. The Nepalese rupee is fully convertible on the current account and convertibility on the capital account is under consideration. However, Nepal's landlocked location, technological backwardness, and internal political conflicts have prevented it from fully developing its economy. Its special relationship with India, embodied in a trade treaty, offers significant access to the largest market in the region. Its membership of the World Trade Organization (WTO) in 2004 is also expected to further open the economy.

Speeding up economic and inclusive growth is the top priority of the Government. Foreign direct investment (FDI) could potentially play a crucial role by supplying capital and expertise. To achieve this, the Government has introduced a "one-window" system to facilitate and encourage FDI. However, business taxation is a serious impediment in attracting FDI because of poor tax administration. The principal taxes include income tax, customs duties, excise tax, and value-added tax, which foreign investors consider a burden.

Nepal is still among the poorest and least developed countries in the world, but the segment of the population living below the poverty line has decreased, from 42% in 1996 to 31% in 2004. The economy has also seen significant changes and improvements in terms of diversification. The share of agriculture has decreased from 62% 20 years ago to less than 40% at present, while the share of industry has increased from 13% in the 1970s to 20% now.

In 2002, unemployment was reported at 5.1%. Because of the lack of employment opportunities in the country, the number of Nepalese workers abroad reached 971,000 in 2006. In addition to India, the main destinations for Nepalese workers are the Gulf countries; Malaysia; Hong Kong, China; and the Republic of Korea. Israel has also emerged as a new destination. As a result of the increasing number of such workers, remittances reached roughly $1.37 billion, or about 16.2% of GDP, in 2006 (Government of Nepal, Ministry of Finance 2007).

One of the economic challenges of Nepal is reducing the savings–investment gap (Table 7.1). Gross domestic savings and gross investment as shares of GDP stood at 9.7% and 28% in FY2007, respectively.[1] These ratios have resulted in a savings–investment gap of 18.3% in FY2007, up from 10.7% in FY2002. The slow pace of growth in the country may be

[1] The fiscal year for Nepal runs from 16 July to 15 July. FY before a calendar year denotes the year in which the fiscal year ends (e.g., FY2007 ends on 15 July 2007).

Table 7.1: Key Economic Indicators, FY2002–FY2007
(%)

Indicators	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
Real GDP Growth	0.2	3.8	4.4	2.9	4.1	2.6
Ratio of Gross Domestic Savings to GDP	9.5	8.6	11.8	11.6	9.0	9.7
Ratio of Gross Investments to GDP	20.2	21.4	24.5	26.5	26.8	28.0
Savings–Investment Gap	(10.7)	(12.8)	(12.7)	(14.9)	(17.8)	(18.3)

() = negative.

Source: Government of Nepal, Ministry of Finance (2007).

attributed to declining expenditures due to the Maoist insurgency. However, low expenditure in areas like education, health, and economic infrastructure has suppressed private sector investment. Regional disparities within Nepal, poverty, and the conflict have also contributed to the sluggish pace of capital formation. Real GDP growth was just 2.6% in FY2007.

Remittances play an important role in filling the savings–investment gap as reflected in the rapidly rising ratios of remittances to savings. This increasing ratio also means that dependency on foreign earnings can be lessened through strategic plans and programs that can mainstream remittances and funnel them into productive use. A conducive environment where returnees can invest their income and use their skills in productive endeavors is just as important as developing effective migration and remittance policies.

Trade Profile

Exports and Imports

Trade with India constituted 62.2% of total trade in FY2007, up from 54.6% in FY2003. However, the share of trade with overseas countries, which also include member countries of the South Asian Association for Regional Cooperation (SAARC) other than India, decreased from 38.0% in FY2003 to 30.5% in FY2007 due primarily to the decline in textiles and clothing (T&C) exports from $184.4 million in FY2003 to $94.4 million in FY2007 (Tables 7.2 and 7.6). Also, despite significant structural changes in Nepal's merchandise exports, the country remains dependent on export of a few items, such as carpets, clothing, hides and goatskins, woolen and pashmina goods, and some agricultural products. In the case of trade with SAARC member countries, Nepal's exports to SAARC as a share of its total exports ranged from 53.9% in FY2003 to 72.5% in FY2007, and of this, India's share ranged from 97.5% to 98.4%.

Imports from SAARC countries ranged from 55.8% to 67.0% as a share of total imports during FY2003–FY2007. Countrywise, the share of imports from India in the total imports from SAARC increased from 99.1% in FY2003 to 99.5% in FY2007, indicating an overdependence on India. Imports from Bangladesh decreased from 0.5% in FY2003 to 0.1% in FY2006 due to transit problems at Phulbari–Banglabandh Marg, such as poor infrastructure, the need for entry permits for trucks into Bangladesh, and the need for a police escort while in Indian territory. However, the provision for an alternative trading route through Rohanpur Marg by the Bangladeshi Government is expected to boost imports from Bhutan and other countries, which remained stagnant for the period under analysis. (Imports from Bangladesh increased to 0.2% in FY2007.)

After India, Nepal's largest export partner during FY2003–FY2007 was the United States (US) followed by Germany, United Kingdom (UK), and France (Table 7.4). In terms of regions (Table 7.5), again with the exception of India, the US share of exports was the largest but decreasing from 59.6% in FY2003 to 40.5% in FY2006. In FY2007, the European Union (EU) slightly overtook the US with a share of 37.7% compared to a share of 36.3% for the US. Export shares to the EU and Asia were both increasing, albeit slowly.

Table 7.2: Foreign Trade Composition of Nepal, FY2003–FY2007
(%)

Direction	FY2003	FY2004	FY2005	FY2006	FY2007[a]
Exports					
India	52.9	57.1	66.6	68.1	70.9
Overseas	43.7	38.5	30.0	30.2	27.1
PRC[b]	3.4	4.5	3.5	1.7	2.0
Total	100.0	100.0	100.0	100.0	100.0
Imports					
India	55.3	58.0	59.8	66.7	59.6
Overseas	35.8	34.0	30.7	25.2	31.5
PRC[b]	8.9	8.1	9.5	8.1	9.0
Total	100.0	100.0	100.0	100.0	100.0
Total Trade					
India	54.6	57.7	61.7	67.1	62.2
Overseas	38.0	35.3	30.5	26.6	30.5
PRC[b]	7.4	7.0	7.8	6.4	7.4
Total	100.0	100.0	100.0	100.0	100.0

PRC = People's Republic of China.
[a] Provisional.
[b] Includes overland trade with the Tibet Autonomous Region of the PRC and overseas trade with Hong Kong, China and Macau.

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.3a: Exports to SAARC, FY2003–FY2007
(%)

Country/Region	FY2003	FY2004	FY2005	FY2006	FY2007
India	98.0	97.5	98.3	98.4	97.7
Bangladesh	1.5	1.3	0.7	0.6	1.2
Bhutan	0.2	0.3	0.4	0.6	0.7
Maldives	0.0	0.0	0.0	0.0	0.0
Pakistan	0.3	0.9	0.6	0.5	0.3
Sri Lanka	0.0	0.0	0.0	0.0	0.0
Afghanistan	0.1	0.1	0.0	0.0	0.0
Total SAARC Exports	100.0	100.0	100.0	100.0	100.0
SAARC Exports as a Share of Total Exports	54.0	58.5	67.8	69.2	72.5

Table 7.3b: Imports from SAARC, FY2003–FY2007
(%)

Country/Region	FY2003	FY2004	FY2005	FY2006	FY2007
India	99.1	98.7	99.5	99.6	99.5
Bangladesh	0.5	0.8	0.2	0.1	0.2
Bhutan	0.1	0.0	0.0	0.1	0.1
Maldives	0.0	0.0	0.0	0.0	0.0
Pakistan	0.2	0.2	0.2	0.2	0.1
Sri Lanka	0.2	0.2	0.0	0.1	0.0
Afghanistan		0.0	0.0	0.0	0.0
Total SAARC Exports	100.0	100.0	100.0	100.0	100.0
SAARC Imports as a Share of Total Exports	55.8	58.7	60.1	67.0	59.9

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.4: Major Trading Partners, FY2003–FY2007
('000 NRs)

Exports	Countries	FY2003	FY2004	FY2005	FY2006	FY2007
1	India	26,430,000	30,777,100	38,916,900	40,714,700	41,874,800
2	US	12,686,537	9,695,977	7,570,742	6,993,442	5,571,274
3	Germany	3,555,327	3,567,036	3,121,753	2,843,770	2,573,710
4	UK	1,070,737	1,677,085	1,050,009	1,184,079	998,689
5	France	453,961	581,762	617,800	1,297,493	903,951
6	Italy	530,869	589,370	582,847	712,327	684,308
7	Canada	383,651	546,403	528,726	644,633	593,703
8	Japan	474,247	525,601	534,997	572,094	559,457
9	Bangladesh	411,335	421,308	290,877	234,323	521,498
10	Spain	200,144	206,015	223,091	282,625	382,556
Imports	**Countries**	**FY2003**	**FY2004**	**FY2005**	**FY2006**	**FY2007**
1	India	70,924,200	78,739,500	88,675,500	107,143,100	117,740,400
2	PRC[b]	11,375,973	10,941,473	14,145,609	13,014,427	17,718,164
3	Indonesia	3,976,734	3,253,785	5,222,737	5,647,780	11,172,109
4	Singapore	9,039,197	8,698,647	7,746,820	3,375,219	5,496,878
5	US	1,707,673	1,433,261	1,763,841	1,677,499	4,259,983
6	United Arab Emirates	583,054	407,933	771,774	1,095,681	3,918,139
7	Thailand	2,988,929	4,320,169	3,117,567	2,602,072	3,459,455
8	Japan	1,890,844	1,690,396	2,565,231	1,935,082	3,228,975
9	Malaysia	4,009,640	3,676,428	2,820,876	2,474,661	2,794,632
10	Saudi Arabia	2,363,956	2,547,901	3,138,492	2,329,692	2,592,689

[a] Trade with India for FY2007 is provisional.
[b] Includes overland trade with the Tibet Autonomous Region of the PRC.

Source: Nepal Rastra Bank and Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.5: Exports and Imports, FY2003–FY2007
(%)

Exports to Regions	FY2003	FY2004	FY2005	FY2006	FY2007
Asia (excluding India)	6.8	17.8	18.8	15.8	19.4
Africa	0.1	2.1	0.2	0.6	1.7
US	59.6	44.3	41.7	40.5	36.3
EU	31.3	32.5	35.5	38.5	37.7
Europe (excluding EU)	1.8	2.8	3.1	3.8	3.5
Oceania	0.5	0.5	0.6	1.0	1.4
Total	**100.0**	**100.0**	**100.0**	**100.00**	**100.00**
Imports from Regions					
Asia (excluding India)	74.1	72.1	74.6	68.9	71.0
Africa	0.2	0.6	0.4	0.5	1.2
US	5.9	7.0	7.1	9.4	12.0
EU	15.2	11.5	10.4	11.2	10.3
Europe (excluding EU)	2.1	2.5	2.9	4.8	2.1
Oceania	3.7	4.5	4.6	4.6	3.4
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

In FY2007, imports to Nepal were primarily from Asia—India, People's Republic of China (PRC), Indonesia, Singapore, and US (Table 7.4).

Problems and Challenges

The preceding analysis clearly indicates the need to diversify Nepal's trade inside and outside SAARC. The country's prospects for further growth in trade remains high as its shares in both world merchandise trade and services trade are both 0.03% (UNCTAD 2008). Nepal faces numerous challenges and constraints in realizing its export potential. The first is the trade agreement signed with India in 2002, which has been criticized because of its restrictive sanitary and phytosanitary requirements. Further constraints to Nepalese agricultural exports stem from the complex quarantine rules imposed by India, which act as nontariff barriers. In addition, the uneven implementation and interpretation of the trade treaty's measures by state governments in India are posing additional barriers to Nepalese exports.

Another barrier is the disagreement on customs clearance procedures for cross-border rail operations (i.e., Nepal wants the procedures to be carried out at its newly built inland container depot while India favors these measures to take place at the border). The Banglabandh Marg provided by Bangladesh is also little used due to lack of infrastructure. Similarly, the end of quotas under the Multi-Fiber Arrangement (MFA) since 2005 has greatly hampered Nepal's exports of clothing.

Nepal faces challenges from its integration in WTO, which have to be met in a way that promotes its economic competitiveness. The country also has to address its significant domestic and border regulatory constraints (such as government red tape, public service delays, labor laws, and the industrial relation environment) that lower productivity and make the domestic investment climate unfriendly and uncompetitive. Exports from Nepal, as from other low-income countries, remain concentrated in a few manufacturing items, mainly clothing and carpets, which accounted for nearly 62% of export receipts in 2005. The phasing out of the MFA in 2005 posed an additional challenge. Exports are also concentrated in only a few countries (US for clothing and EU for knotted carpets), making the country susceptible

to volatility in the global economic climate. Other export items include hides and skin to Italy, lentils to Bangladesh, large cardamom to Pakistan, handicrafts and silver jewelry to the US, and pashmina shawls and other pashmina goods, as well as paper and paper products, to the UK and US.

Nepal's proximity to the PRC and India offers opportunities for trade. However, trade data show that exports to India and the Tibet Autonomous Region of the PRC have not been increasing relative to imports. This is mainly because of decreased exports of some products, such as vegetable ghee to India and the Tibet Autonomous Region, as well as textiles to the latter. Nepal's inability to improve competitiveness arises from various factors related to geography, policy, and institutions: the country suffers from low productivity and a poor business climate due to government instability, inefficient government bureaucracy, corruption, and inadequate supply of infrastructure (World Economic Forum 2007). Other critical constraints include delays in customs and transshipment, high costs of transport and power, a rigid and formal labor market, lack of labor–employer cooperation, terrorism, and poor work ethic of the labor force (World Bank 2004).

Industry Profile

The economy is largely supported by agriculture and buttressed by many niche products such as medicinal herbs and high-quality tea. In terms of manufacturing, the share in GDP decreased from 9.0% in FY2001 to 7.5% in FY2007 with a preliminary estimate of 7.0% for FY2008. In contrast, the contribution of services increased to reach about 51% of GDP in FY2007. Tourism is the main source of foreign exchange, contributing about $155 million, or 4.5% and 1.4% of total foreign exchange earnings and GDP, respectively, in FY2007. The growth of industry was stifled until the recent peace agreement among political parties. Power generation has great potential in view of the estimated realizable hydroelectric power of 43,000 megawatts (MW). Indeed, the development of electricity for export also promotes energy-intensive manufacturing activities in Nepal, and electricity with India is already being traded. Several areas in niche agricultural products, power generation, and tourism are the main potential areas for FDI. Opportunities lie in other sectors as well, such as readymade clothing and textiles.

Textiles and Clothing Industry

Within this industry, the textiles subsector includes fabrics, pashmina, yarns, made-up textiles, and jute goods. Spinning, weaving, and finishing of fabrics alone accounted for about 85% of the subsector's value added in 1997 (UNCTAD 2005). According to the Nepal Textile Association, the total production of fabrics in the country stood at 50 million meters in 2000, down from 80 million meters during the 1990s. Many firms closed, with the remaining businesses running at minimum capacity. The reduction was due to stiff competition from imports, due to the liberalization of trade and smuggling from the PRC and India. Despite considerable upgrading of machinery and technology, domestic producers were unable to keep up with rapid technological developments in the rest of the world. As a result, domestic fabric manufacturers could not supply the needs of clothing producers in Nepal. In fact, only about 6% of their demand was met by domestic production in 2000. Indeed, this is unsurprising given that there is virtually no FDI in the textile subsector (UNCTAD 2005).

Clothing is another important subsector. The major products include men's and boys' shirts and trousers as well as ladies' dresses. Exports of clothing reached their peak in 2002. Fabrics and accessories used in exported clothing are entirely imported and mostly from India. Only packing materials are sourced locally, indicating limited backward linkages. The growth in the industry was the result of quotas from the US and spillovers from India. When the quota to the US is filled in India, orders are placed in Nepal through India's intermediation. Table 7.6 shows the breakdown of T&C exports and imports.

The share of clothing in manufacturing grew from 26% in 1994 to 37% in 2000, but declined to its 1994 level in 2003, and went down further to just 16% in 2004 (SAWTEE 2006). The clothing industry has been facing stiff competition in recent years and has been struggling to survive. Indeed, the end of the quota system in T&C on 1 January 2005 led to a reduction in T&C exports and the closure of T&C firms. In fact, the share of T&C exports in total overseas exports fell from 58.6% in FY2003 to 35.8% in FY2007 though the T&C share of Nepal exports to India increased from 11.9% in 2003 to 17.8% in 2006, but decreased again to 13.8% in FY2007 (Table 7.6). Thus, in order to improve the export performance of T&C, the country

Table 7.6: Exports and Imports of Textiles and Clothing, FY2003–FY2007
($ million)

Item	FY2003	FY2004	FY2005	FY2006	FY2007
Total Overseas Exports (excluding India)	**314.4**	**311.5**	**276.6**	**256.2**	**264.0**
T&C Overseas Exports	**184.4**	**157.4**	**120.8**	**102.0**	**94.4**
Readymade Clothing	155.0	128.9	90.0	73.2	60.6
Woolen and Pashmina Goods	20.5	19.8	20.7	22.4	27.5
Towels	4.5	3.4	1.9	1.4	1.0
Cotton Sacks and Bags	2.0	2.0	3.7	4.7	5.1
Textiles	2.4	3.3	4.5	0.3	0.3
Share of T&C in Total Exports (%)	**58.7**	**50.5**	**43.7**	**39.8**	**35.8**
Total Exports to India	**352.4**	**413.7**	**551.2**	**547.2**	**642.7**
T&C Exports to India	**39.4**	**48.7**	**70.2**	**97.5**	**88.4**
Jute Goods	25.3	25.3	38.2	35.4	42.3
Polyester Yarn	8.8	15.0	26.9	46.7	34.4
Readymade Clothing	5.3	8.4	5.2	15.3	11.7
Share of T&C in Total Exports to India (%)	**11.2**	**11.8**	**12.7**	**17.8**	**13.8**
Total Imports from India	**945.7**	**1,058.3**	**1,265.6**	**1,440.1**	**1,807.2**
T&C Imports from India	**77.7**	**71.4**	**61.6**	**72.8**	**87.2**
Textiles	55.8	50.1	31.1	27.6	26.5
Readymade Clothing	5.9	6.6	12.8	14.6	11.2
Raw Cotton	1.2	1.3	2.0	1.5	1.1
Threads	14.7	13.5	15.7	29.1	48.5
Share of T&C in Total Imports from India (%)	**8.2**	**6.7**	**4.9**	**5.1**	**4.8**

Note: Average of buying and selling rates at mid-July each year given by the *Economic Survey Fiscal Year 2007/08* was used to convert Nepalese rupees into US dollars.

Source: Government of Nepal, Trade and Export Promotion Centre (2007).

Table 7.7: South Asia's Market Share in US Imports of PRC-Restricted T&C, 2004–2006
(%)

	Volume			Value		
Country	**2004**	**2005**	**2006**	**2004**	**2005**	**2006**
Bangladesh	4.9	5.2	6.2	3.1	3.7	4.7
India	2.2	2.7	2.9	2.8	3.6	3.9
Nepal	0.1	0.1	0.1	0.1	0.1	0.1
Pakistan	2.4	2.5	3.2	2.0	2.2	2.4
Sri Lanka	1.5	1.7	1.9	2.0	2.4	2.5
SAARC Total	**11.1**	**12.2**	**14.3**	**10.0**	**12.00**	**13.6**

Source: Tewari (2007).

needs to focus on the expansion of standard fabric industries by improving quality, minimizing costs of production, and enhancing productivity.

Nepal has been a dismal performer with regard to trade in T&C. For example, its share in US imports of PRC-restricted clothing has been declining and is at the bottom compared to the increasing shares of all other SAARC countries, reaching only 0.06% and 0.07% in volume and value terms in 2006, respectively (Table 7.7). This implies the need for competitive capacity, reducing the costs of production, finding out its comparative advantage in clothing, and integrating with other countries in South Asia.

Automobile Industry

Nepal's automobile industry is estimated at about $80 million a year. The country has all the vehicle brands available in India and allows imports of automobiles from other countries. At the end of FY2007, Nepal had 617,000 vehicles, many of them motorcycles. Vehicle numbers shot up by over 47% annually during FY2005–FY2007, indicating a growing demand and the possibility of some FDI in this sector. Two motorcycle producers operate with PRC collaboration. Automobile players like Hyundai and Yamaha are also present in the country through their supply chain. A Nepalese manufacturer, Hulas Motors, has also emerged, manufacturing light commercial vehicles and mini-utility vehicles, which are sold under the Sherpa, Mustang, and Mini V brands.

Nepal is heavily dependent on vehicle imports, which account for nearly 68% of total demand. It has a good supply of tires, which are mainly produced by Gorkhali Tyre, a government-owned corporation. The expansion of the automobile industry has shown the increasing preference of Nepalese to own motor vehicles. This has also been spurred by the supply of loans from banks and other financing companies. Concerns about emissions and congestion have given rise to increased demand for two-wheeled and smaller motor vehicles. There is great potential for producing cheap vehicles and spare parts, but it is foreseen that the country will depend on outside supplies, particularly from India. The automobile industry is also a good source of taxes and duties for the Government, with rates adding up to as much as 156% of the basic price for most vehicle categories.

Infrastructure

The hilly and mountainous terrain of Nepal has made the construction of infrastructure difficult and expensive. There are also the problems relating to the lack of essential materials and the inability to mobilize people. By mid-March 2007, total road length reached 17,609 kilometers (kms), of which 5,222 kms were metaled, 4,738 kms graveled, and 7,649 kms fair-weather roads. Nepal has 47 airports, of which one is international and three are regional hub centers. In addition, four airports are under construction. The problems of transport and logistics, as well as costly and unreliable infrastructure, have had adverse effects on the private sector, including FDI, by acting as constraints to doing business and increasing transaction costs.

Resource Endowments

Water is the country's most important natural resource with about 6,000 rivers and rivulets totaling 45,000 kms in length. Total average run-off is estimated at about 170 billion cubic meters with an estimated hydroelectric power potential of 83,000 MW. This is one of the largest potential capacities in the world, of which about 50% could be economically harnessed. Another natural resource, forests, covers about 42.4% of the country's landmass and provides 79% of the country's total energy consumption and more than 90% of rural household energy needs. There are only limited deposits of mineral resources, which are being economically exploited. Nepal also has a large deposit of limestone and other minerals including magnetite, lead, and zinc.

The labor force is about 11.1 million (2006 estimate), but skilled labor is severely lacking in many areas. Nepal is a labor-surplus country, which exports its labor; skills development courses are run by private and public institutions under the Council for Technical Education and Vocational Training. The country has a serious brain drain problem, as highly qualified people do not find enough opportunities at home.

It is often argued that Nepal's rich endowment of natural and human resources has not been used optimally. Foreign investment could therefore help the country by using its available resources. Low labor costs are also a significant advantage for investors, even if low productivity is taken into account.

Regional Trade Agreements

As a member of SAARC, the implementation of the South Asian Free Trade Agreement (SAFTA) is expected to offer the country greater market access. The agreement on the SAARC Preferential Trading Arrangement covers around 4,000 items, most of which are nontradable. Trade in goods has already been brought under SAFTA, and SAARC countries are preparing to include trade in services. Nepal also participates in different working groups (such as trade, investment, and private sector cooperation; power and energy; transport and tourism; and the environment) under the South Asia Sub-regional Economic Cooperation. Nepal has a special agreement with the PRC for reduced tariffs on trade with the Tibet Autonomous Region of the PRC.

Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka, and Thailand have also grouped together in the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC) in an effort to achieve a free trade area by 2017. The cooperation between the two regional blocs, SAFTA and BIMSTEC, may be able to bring about substantial investment in South Asia and could also provide a huge market for a small country like Nepal.

How these two regional agreements will shape Nepal's trade and industry remains to be seen. As a least developed country, Nepal has preferential access to the EU under the Everything But Arms initiative. A memorandum of understanding between Nepal and the PRC was signed in November 2001 to facilitate visits by PRC citizens to Nepal, making Nepal the first nation in South Asia to receive approved (tourist) destination status from the PRC.

FDI Policy and Environment

History

FDI is seen as bringing the necessary capital, technology, skills, and best practices into Nepal, as well as a means to access the international market. Therefore, FDI contributes to economic development, leading toward self-reliance and self-dependence, through the expansion of industries and the revenue base. In addition, it contributes to employment generation and other benefits to labor, resulting from the difference in shadow and market wages.

The first attempt by Nepal to attract FDI came in 1987, after the Industrial Policy and Industrial Enterprise Act was promulgated. This provided a legal framework for facilitating FDI in large and medium-scale ventures in every industry except defense; steps were also taken to privatize dozens of government-owned public enterprises, and to open them to private investment (they were previously government monopolies, and included telecommunications, hydroelectric power, and air transportation companies). A new Foreign Investment Promotion Division was created to act as the central body for the approval and monitoring of foreign investment projects. Joint ventures were the preferred form of investment and limitations were set on the level of foreign equity holdings, depending on the size of the industry.

The Government reemphasized the importance of FDI and technology transfer in the development process in the early 1990s and introduced the Foreign Investment and One-Window Policy as well as the Foreign Investment and Technology Transfer Act (FITTA) of 1992, and established the Investment Promotion Board. In addition, a Foreign Investment Promotion Committee was set up to simplify procedures for attracting foreign investment, with applications to be processed within 30 days. A One-Window Committee was also set up at the Department of Industries (DOI) to provide institutional facilities and services under one roof. However, it failed to provide such services and was subsequently criticized for having too many procedures. Nepal does not have a separate investment promotion agency; investment promotion is carried out by the DOI.

As part of FDI policy, the Government entered into investment protection agreements with France, Germany, and UK. Double taxation agreements were signed with India, Norway, and Thailand, and its laws have provisions for arbitration within the framework of the United Nations Commission on International Trade Law to settle FDI-related disputes.

Performance of FDI

Historically, the major areas of FDI have been manufacturing, followed by services (mainly tourism). From 1990 to 1997, the average annual inflow of

Table 7.8: Foreign Investment Projects, mid-November 2007
($ million)

Industry	No.	Total Project Cost	Total Fixed Cost	Foreign Investment	Employment
Agriculture and Forestry	14	26.1	23.6	7.2	850
Manufacturing	494	578.0	419.1	180.9	64,590
Food, Beverages, and Tobacco	76	142.4	123.6	34.2	9,143
Textiles and Clothing	177	138.0	87.0	50.3	35,570
Wood and Wood Products	8	1.8	1.4	0.6	1,440
Paper and Paper Products	23	28.3	23.9	5.2	944
Chemical Products	89	111.0	81.0	45.8	7,075
Nonmetallic Products	20	59.4	35.9	17.3	3,188
Basic Metal Products	25	34.1	22.4	10.7	1,971
Fabricated Metals	55	49.3	34.2	13.3	3,803
Other Manufacturing Units	21	13.7	9.7	3.4	1,456
Electricity, Water and Gas	23	310.1	282.4	54.3	5,146
Construction	37	29.3	21.8	18.0	1,957
Hotel and Resorts	281	250.9	236.2	73.7	16,554
Transport and Communications	31	65.5	45.3	261.6	5,225
Housing and Apartments	18	4.3	1.8	2.5	1,694
Service industries	44	317.3	281.1	210.1	21,402
Total	**552**	**921.4**	**723.8**	**398.2**	**182,008**

Source: Ministry of Industry, Commerce and Supplies (2007).

FDI in Nepal stood at about $7.3 million, but it fell to about $2.7 million a year from 1998 to 2006 (Chitrakar and Bhatt 2007). The share of services FDI in total FDI increased from 30% to 52% during the same period. While the share of tourism FDI in total services FDI decreased slightly from 16% in 1998 to 15% in 2006, the shares of other subsectors in services FDI, namely health and health education, as well as communications and software, increased from 5% to 11% and from 0.3% to more than 5%, respectively. Clearly, Nepal's performance in FDI inflows has been dismal when compared to other developing countries.

In 2004, 63 industries with a total project cost of about $27 million were established from FDI. The following year, the number of industries given permission to operate by the Government grew to 116 with a total project cost of $64 million. In 2006, 186 industries with a fixed capital of $42 million and a project cost of $52 million were granted permission to operate. As of mid-November 2007, 552 FDI projects with a total project cost of $921.4 million and approved employment of 182,008 were allowed to operate (Table 7.8). However, actual investment may be less since the realization rate is estimated at around 50% of approved projects. There are implementation problems in the sense that agreements are signed with foreign investors, but projects remain in the pipeline and never come to fruition. The areas of investment include manufacturing, services, tourism, construction, agriculture, minerals, and energy.

In terms of country of origin, 57 countries had made investments in Nepal by mid-November 2007, of which 39.3% of investments in terms of project costs, 36.4% in terms of total fixed costs, and 44.5% in terms of total FDI were made by SAARC countries (Table 7.9). In addition, SAARC investments contributed 45.2% of employment in FDI projects. India accounted for 97.6% of SAARC investment, implying a need for increasing investment from other SAARC countries. However, India's share is greatly reduced if Indian investments that have been closed (three of them in recent years) are taken into account. Their closure was due to hostile

Table 7.9: FDI Projects from SAARC Countries, mid-November 2007

Country	Number	Total Project Cost ($ million)	Total Fixed Cost ($ million)	Foreign Investment ($ million)	Employment
Bangladesh	15	7.1	3.3	3.4	3,808
Bhutan	3	0.4	0.3	0.1	98
India	376	607.2	469.5	248.7	46,691
Pakistan	12	4.9	3.6	2.1	2,365
Sri Lanka	3	1.2	0.9	0.6	83
Total SAARC	**409**	**620.8**	**477.6**	**254.9**	**53,045**
Rest of the World	**936**	**960.6**	**833.6**	**318.0**	**64,373**
Total World	**1,345**	**1,581.4**	**1,311.2**	**572.9**	**117,418**
Share of SAARC in Total World (%)	**30.41**	**39.3**	**36.4**	**44.5**	**45.18**

Source: Authors' calculations from data from the Ministry of Industry, Commerce and Supplies (2007).

Table 7.10: Trend of Foreign Investment, FY1998–FY2007
($ million)

Origin	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007
Rest of the World	29.0	13.8	16.5	24.1	6.7	17.0	12.8	6.7	13.9	16.7
SAARC	3.3	10.6	3.5	17.3	8.8	6.9	24.3	16.5	21.1	29.1
Total World	32.3	24.3	20.0	41.4	15.5	23.9	37.1	23.2	35.0	45.8

Note: Average of buying and selling rates at mid-July each given by the *Economic Survey Fiscal Year 2007/08* was used to convert Nepalese rupees into US dollars.

Source: Authors' calculations from data from the Ministry of Industry, Commerce and Supplies (2007).

labor relations in the current political environment and unstable policies, where the regulatory framework is changed unilaterally in the middle of operations.

Foreign investment has fluctuated in terms of total investment and the split between SAARC countries and elsewhere. Investment from the former has been growing faster than from the rest of the world since 2003, reaching $29 million in FY2007. Investment from the latter began to increase gradually from FY2006, reaching NRs1,175.64 million ($17 million) in FY2007 (Table 7.10 and Figure 7.1).

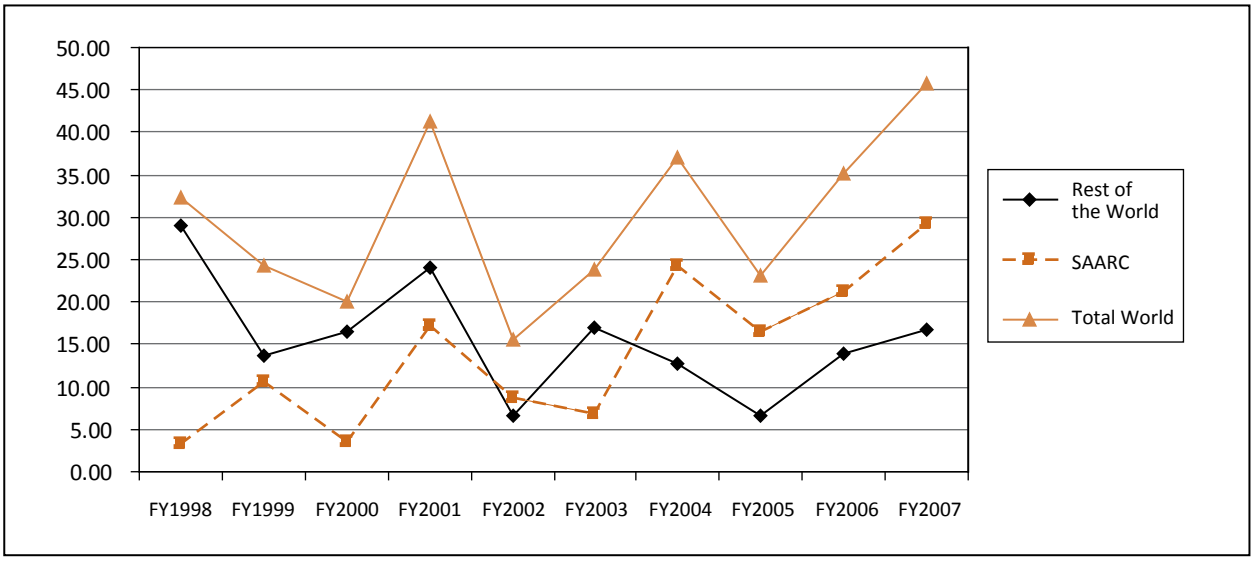
Aside from SAARC, other major sources of FDI include US, PRC, Republic of Korea, Norway, and Japan. Nepal is exerting additional effort to improve its investment climate by means of more liberal policies.

Current FDI Regime and FDI Promotion Policy

FITTA is the main legal framework that guides FDI policy. It provides various incentives to attract foreign investments and has opened up all sectors to FDI except for defense, cigarettes, *bidi*,[2] and alcohol. It also promotes technology transfer from FDI. In addition, it guarantees 100% repatriation of equity invested, dividends obtained from foreign investments, and amount received as payment of principal and interest on foreign loans in convertible currency. FITTA also identified priority sectors (i.e., industries producing goods that meet basic needs; export-oriented industries, which export 50% or more of sales; and hotel and tourism projects).

[2] A small hand-rolled, often flavored, cigarette.

Figure 7.1: Trend of Total FDI, Investment from SAARC Countries, and Investment from Rest of the World, FY1998–FY2007



Source: Authors' calculation from data from the Ministry of Industry, Commerce and Supplies (2007).

FITTA extended the tax holiday from 5 to 10 years and eased visa problems and the settlement of disputes. It originally banned the entry of FDI into cottage industries and projects with fixed assets of less than $300,000, but was amended in 1996 to eliminate the fixed asset limit and expanded the scope of FDI to include all industries except some on the negative list.

The Government made several amendments to FITTA through the Finance Act of 2001 and budget speeches delivered by the Finance Minister before the beginning of each fiscal year. These, along with the establishment of WTO and Nepal's membership of WTO, SAFTA, and BIMSTEC, have made the existing Foreign Investment and One-Window Policy and FITTA virtually useless. In response, the Ministry of Industry, Commerce and Supplies drafted a new policy and act in 2002, which have yet to be implemented. The Government has also taken steps to formulate a new industrial policy, though this also has yet to be implemented. The current 3-year interim plan for 2007–2009 includes policies targeted to encourage foreign investment in areas that provide employment and that lack local capital and technology. The Government has also recently introduced the Non-resident Nepalese Act to attract FDI from such Nepalese. Yet despite these various efforts, FDI remains very low.

Laws relating to FDI allow investors to obtain suitable title to land. There are no legal impediments in registering mortgages or repossessions. However, unlike other countries in South Asia, Nepal has actually withdrawn some of its incentives provided after 1992. For example, the Government used to provide reinvestment allowance in the form of deductions from taxable income of up to 40% of investment in expansion or modernization, but this was withdrawn in 2002. Similarly, the corporate tax rebate of 10% for high local content was removed.

Priority Sectors

The improvement of FDI inflows into services indicates its potential, an increased market, and the continuing need for capital. Other priority sectors for FDI include medicinal herbs, vegetable and flowering seed production, honey production, hydropower, petroleum exploration, and natural gas exploration. These were identified as priority sectors for using domestic resources and aiding in the promotion of sustainable development. The approval of these sectors as priority areas for FDI was relatively easy and was accompanied by the provision of certain income tax rebates. However, automatic approval of priority sectors and more incentives seem to be necessary for attracting FDI to such sectors.

Labor Laws and Mobility

Labor mobility in the context of foreign investment is generally guided by visa policy. Some stipulations include the granting of residential visas to investors with at least $100,000 worth of investment and the provision of business visas to a foreign investor and his dependents until his or her investment is retained.

The formal sector covers a very small portion of the labor market, primarily because of red tape and unclear and unpredictable consequences of company- and labor-related legislation. This has resulted in the segmentation of the labor market into permanently employed staff, who have strong legal workplace protection; and contract workers, who can be hired and fired at will. Agricultural workers and subsistence farmers belong to the latter category, along with the bulk of unskilled workers, who dominate the labor force. It is the informal sector that absorbs the bulk of new job seekers, simply because the formal sector provides very few jobs.

Nepal is a pluralistic society with diverse ethnic, caste, linguistic, and religious communities. The social structure, which is largely fixed or constrained by birth, influences occupational distribution and limits moves between occupations. This has resulted in labor market imbalances that are filled by Indian laborers.

The 1999 National Labor Survey of Nepal showed high labor force participation (86% of the population above 15 years of age) and low unemployment (less than 2% nationally and 7% in urban areas). This apparent low unemployment level is expected in a country where the large majority of the working age population lives in rural areas, depends on subsistence agriculture, and migrates for work when nothing is available at home. However, there are many underemployed, currently estimated at 47% of the total employed labor force. With regard to wages, once these have been negotiated, these cannot be changed for 2 years and the minimum wage for unskilled workers is about $27 per month.

Parliament has enacted the Labor and Trade Union Act, which permits strikes, though strikes have been infrequent since the law was promulgated. In the past, strikes and other political actions closed businesses and transport operations in major cities, severely damaging the business climate and tourism. The Labor and Trade Union Act also requires unions to be affiliated with political parties. Union participation in the formal sector is only 10% of the total labor force, but its leaders exercise significant political influence through their party affiliations. Efforts at collective bargaining have been hampered by unrealistic laws, such as the Bonus Act, which provides that workers must get 10% of yearly profits as bonus regardless of improvements in productivity. In the hydropower sector, the Electricity Act of Nepal has limited bonuses of workers to 2% of yearly profits. However, according to reports by the International Labour Organization, dialogue between trade unions and employers has improved tremendously over the last decade.

Results from a survey conducted by the Federation of Nepalese Chambers of Commerce and Industry showed that all managers identified the Labor and Trade Union Act as placing a significant burden on firms. The law has also made the cost of retrenchment so high that firms attempt to limit the number of permanent workers. Many older firms are therefore severely overstaffed and unproductive, whereas new firms are reluctant to hire new workers. As a result, 50% of the manufacturing workforce is composed of casual workers, who earn the same wage as permanent workers, but who have less job security and fewer fringe benefits. The law was originally intended to protect workers, but has become one of the main obstacles to formal sector development.

Employment of foreigners other than Indians is regulated by the Department of Immigration, and many companies have reported that this arrangement makes it very difficult to bring in skilled and experienced specialists, such as pilots, economists, engineers, or architects. In the other direction, the placement of Nepalese workers in other countries is regulated by the Foreign Employment Act.

In terms of trade in service, imports (debit) of Nepal's cross-border supply of services (Mode 1 based on WTO/General Agreement on Trade in Services [GATS] categorization) is substantially higher than exports (credit), mainly because of the transportation sector, implying high payments for the consumption of transport services. Consumption abroad (Mode 2) is an important mode mainly because of travel services. In the case of commercial presence (Mode 3), data for 1999–2004 show that equity earnings payments are

higher than FDI inflows, implying a negative balance-of-payments effect of FDI. They also indicate the need for caution in bringing in foreign labor. Finally, movement of natural persons (Mode 4) is important for Nepal, with credit values far exceeding debit values. This is mainly because of workers' remittances and implies the need to focus on foreign employment of Nepalese labor (Chitrakar and Bhatt 2007).

Trade Policies and Nontariff Barriers

Nepal's economic liberalization has enabled a favorable environment for manufacturing, infrastructure, and services. The country continues to pursue the objectives of low and nondiscriminatory import tariffs and its effective tariff rate compares favorably with those of neighboring South Asian countries.

Tariff slabs have fallen from over 100% in the 1980s to just 5% in the 1990s. The country's average import tariff rates are probably the lowest in South Asia. Nevertheless, the current most-favored-nation tariff rate structure, ranging from 5% to 40%, which applies to countries other than the PRC and India, is complicated somewhat by the preferential trading arrangement with India. Only a few rates fall outside these rates and the high rates are set for revenue purposes. However, intraregional trade among the countries in South Asia is the equivalent of less than 2% of GDP, compared to 20% for East Asia (World Bank 2004). Some of the reasons for this include political conflict, similar endowments, and competition in the global export market.

Although tariffs have fallen, various nontariff barriers (NTBs) are taking increasingly larger shares in total trade costs (Mirza and Hertel 2007). Trade facilitation, therefore, plays an important role in reducing trade costs, promoting greater regional integration, and stimulating growth and development in the region.

Nepal has made several efforts to facilitate trade with other countries. Indeed, the Indo–Nepal Free Trade Agreement of 1996 and the agreement with India to ease access to the port of Kolkata have significantly facilitated trade between India and Nepal. However, influential competing producer lobbies in some neighboring Indian states have resisted (some would say sabotaged) this trade agreement by means of high local charges, which have created severe and unpredictable problems for Nepalese exporters and importers. In March 2002, India agreed to extend the trade treaty, only after Nepal agreed to a series of concessions.

Another problem that needs to be addressed is the complicated quarantine rules of India, which have negatively affected Nepalese agricultural exports. In addition, delays in customs clearance for cross-border rail operations are also nagging issues. According to the World Bank (2004), customs processing delays at the border and at Kolkata port increase travel time between Kathmandu and Kolkata from 3–5 days to about 8 days. Customs and transshipment delays can also account for as much as 55% of the logistics costs of sending certain types of goods from Kathmandu to Kolkata, instead of 25% on average for other international routes. Nepal has requested India for the use of Jawaharlal Nehru Port at Mumbai. The port is likely to facilitate trade with Europe and the US by reducing transport costs of up to 40% of the costs incurred at Kolkata port. It will also reduce delivery time to the US by 20 days. India has yet to grant Nepal's request and has asked Nepal to submit a report on the modalities of its use (Government of Nepal, Ministry of Finance 2008).

Screening, Admission, and Establishment Policies

Foreign investors setting up 100% foreign-owned enterprises or joint ventures are required to make an application to the DOI and to submit a detailed feasibility report. In granting the approval for foreign investment involving new investment, modernization, diversification, or expansion, projects are assessed on the following criteria: investment in a priority industry as prescribed by the Government; financial and technical viability; contribution to employment generation, and to foreign exchange earnings or savings; competitiveness of products in international markets; appropriateness of technology; terms and conditions of investment and technology transfer; and participation of Nepalese nationals in investment and management.

Fiscal and Financial Incentives

Studies have shown that fiscal and financial incentives play some role in promoting FDI. In this regard, Nepal's FDI regime includes the granting of up to 100% equity participation by foreigners in almost all sectors except

for some in the negative list.[3] Licensing requirements have also been streamlined, and the legal bases for full-scale private development of hydroelectric resources and private exports to India have been laid. Other features include full repatriation of equity, profits, or dividends, and of interest on loans; technology transfer payments; proceeds of divestments; guarantee against nationalization; income tax allowances with a minimum 5-year tax holiday for most industries; no tax on dividends, export earnings, or interest on foreign loans; and only 1% duty on imports of capital goods. In addition, any duty or taxes levied on raw and auxiliary materials that are used for producing goods for the export market are entitled to refunds based on the quantity of exports. A bonded warehouse facility is also available for raw materials. Moreover, foreigners and companies can open foreign exchange accounts in any of the country's commercial banks, although this account can be used only for importing equipment, plant, and other fixed assets necessary for the industry.

Performance Requirements

The Government does not impose performance requirements on foreign investors as a form of incentive.

Property Rights including Intellectual Property

Some risks have been noted regarding intellectual property rights in South Asia's T&C sector. To quote Tewari (2007), "… some local textile and design traditions [referring to Bangladesh, India, Sri Lanka] were at risk of being appropriated by entrepreneurs from outside the region." As a SAARC member, Nepal needs to work with other South Asian countries in promoting such rights since, in textiles, they can be thought of as the glue that can bring members together around a common regional brand.

With regard to intellectual property in Nepal per se, there is limited literature on the subject. However, from the information available, the following can be gathered. The DOI is legally responsible for patents, designs, and trademarks. Nepal has been a member of the World Intellectual Property Organization (WIPO) since 1997, and recognizes the protection of intellectual property as essential in safeguarding the interest of investors and in benefiting from globalization and integration. A copyright act has also been passed in keeping with the Trade-Related Intellectual Property Rights Agreement (TRIPS) and the WIPO Copyright Treaty of 1996. The Act is expected to provide a basis for a stronger intellectual property regime in the future. In addition, Nepal acceded to the Paris Convention in June 2001.

Despite these laws, the protection of intellectual property in Nepal is still inadequate. The main problems identified are the long processes of law enforcement; lack of awareness of industrial rights and copyright; availability of cheap pirated goods; lack of formal education and training of institutions on intellectual property; and lack of a separate law for the administration of traditional knowledge, folklore, genetic resources, geographic indication, and biodiversity. These indicate the need to hasten the process of law enforcement, launch public awareness programs, provide training, include intellectual property as part of the formal education curricula, and establish a responsible and appropriate institution for intellectual property matters.

Institutions

The DOI is the focal contact point for foreign investments and is the agency that administers the provisions set forth in the Patent, Design and Trademark Act and the FITTA. The DOI is also responsible for granting licenses, facilities, and other administrative services to industries, including those established with foreign investments and/or technology transfer arrangements. It also evaluates project proposals and grants permission for industries with fixed assets of up to NRs500 million within 30 days from the date of application. Industries with fixed assets exceeding this limit have to go to the Industrial Promotion Board for approval.

Special Economic Zones

In 2003, a special economic zone (SEZ) project was launched with the twin objectives of attracting foreign

[3] Restricted sectors include cottage industries, personal services, arms and ammunition, explosives and gunpowder, industries related to radioactive materials, real estate, motion pictures, security printing, currencies and coinage, retailing, horse riding, internal courier services, atomic energy, poultry farming, fisheries, and bee keeping.

investment and attaining high economic growth. SEZs include industrial estates, export processing zones, special trade zones, tourism-entertainment zones, information and technology parks, and banking facilities. The activities of the project include developing an SEZ law, conducting feasibility studies for the establishment of SEZs in different areas, and constructing basic infrastructure for such zones. To date, Nepal has SEZs at various stages: the Bhairahawa Export Processing Zone, which is under construction; and the Birgunj, Panchkhal, and Nuwakot SEZs, where prefeasibility studies have been carried out. The Government has also announced that a clothing processing zone will be established in Simara. Studies for setting up SEZs at Nepalgunj, Kailali, and Kanchanpur are planned.

Although none of the SEZs is yet operational, industrial districts are, although they are not intended for FDI. Industrial districts were developed to promote the establishment of industries by providing the necessary facilities in one place.

Investment Treaties

Nepal has entered into bilateral investment agreements with four countries: France in 1983, Germany in 1986, UK in 1993, and Mauritius in 1999. Surprisingly, Nepal has not yet signed any such agreements with its three major investors—India, US, and PRC. Nevertheless, it is in the process of making investment agreements with India, along with five other countries—Belarus, Qatar, Russian Federation, Sri Lanka, and Thailand—and two regional investment agreements with the Asia-Pacific Economic Cooperation and SAARC. Nepal has also signed double taxation agreements and the prevention of fiscal evasion with respect to taxes on income with Austria, PRC, India, Republic of Korea, Mauritius, Norway, Pakistan, Sri Lanka, and Thailand.

FDI and the Economy: Potential, Impact, and Constraints

Analytical Framework and Rationale

This study now analyzes two aspects of FDI in Nepal: the policy environment and economic and social benefits. In addition, it looks into the potential and constraints of FDI; and provides policy recommendations both to address the constraints and risks of investment, and to achieve the full potential of intraregional investment. Recommendations are likewise presented at the sector level on industries that are critical to the country, and on regional policies and agreements to complement and support the recommended country policies.

Based on the available literature, the first aspect is analyzed in terms of foreign investment promotion policy and its related acts and rules, as well as complementary FDI policies and other related policies. Analysis of the economic and social benefits of foreign investment uses the United Nations Conference on Trade and Development (UNCTAD) *World Investment Report* approach, which assumes that FDI is a package of tangible and intangible assets—resources that are critical for development.

FDI Potential

The Government has provided three reasons why firms should invest in Nepal. The first is access to the markets of India and the PRC. India's guarantee of duty-free access to most Nepalese manufacturers and a memorandum of understanding with the PRC with regard to Nepal being an approved tourist destination are important in this regard. As a least developed country, Nepal is also eligible to benefit from the Everything But Arms initiative of the EU.

The second reason is the abundance of the country's natural resources. Indeed, there are five climate zones in Nepal, which offer opportunities for a range of agricultural products. And the country's potential in hydropower is enormous.

The third reason is related to Nepal's policies and people. Policies include low tariff rates and a liberal foreign exchange regime, while investors value the friendliness of Nepalese people and accessibility of the bureaucracy.

Despite the laggard performance of Nepal in attracting foreign investment, especially compared to its South Asian counterparts, the country has potential for FDI, particularly in the services sectors, where FDI inflows witnessed a substantial increase of more than 20% during 1998–2006. Among the subsectors in this area, tourism, health and health education, and information technology (IT)—primarily data entry and computer

software—have the highest potential, as well as freight forwarding, nursing homes, and construction. However, at least for now, Nepal's IT subsector may mainly have to piggyback on India's $10 billion software export industry.

Tourism is a potential source of FDI given Nepal's natural and cultural assets. In terms of health, Nepal has increasingly emphasized that the private sector should provide specialized services while the Government should focus on primary health care. As a result, a number of private health centers have been established, some with foreign participation. In addition, the Government has approved a policy to provide land in the hills on long-term leases to private sector investors for hospitals, health centers, and educational institutes. In terms of pharmaceuticals, opportunities for foreign investment exist since only 30% of the country's demand for drugs is met by local producers. In addition, the National Drug Policy of 1995 mandates a move toward achieving 80% self-sufficiency in the production of essential drugs. There is also potential in the production of ayurvedic formulations and other herbal medicines. Information and communications technology also offers potential for FDI since professionals and workers in the field are readily available. In addition, labor costs in Nepal are very low relative to those in industrial countries.

The flow of FDI in financial services has been notably limited. Nevertheless, the past few years have witnessed an increase in the number of joint-venture banks and finance companies. These institutions have also been making profits and their shares were subscribed several times more than their public issue, which indicate investment opportunities in the sector. Nepal has also made 12 major commitments with regard to the opening of financial services to foreign investment. These include the acceptance of deposits and other repayable funds from the public and lending of all types. Similarly, financial leasing and all payment and money transmission services have been opened up. Guarantees and commitments, and trading for own account or for the account of customers, are also available to foreign investors. Nepal, therefore, has generated a congenial business environment for FDI in financial services and this is expected to promote other businesses in the country.

There is huge hydropower potential in light of severe power shortages in Nepal and India and increasing energy demand in the country. There are up to 42 hours per week load-shedding in Nepal at present, affecting both the economy and consumers. Load-shedding is expected to increase further (it had already gone up to 16 hours per day by late 2008). Two of the foreign investments in power (on a build-operate-transfer basis) are Panda Energy Corporation of the US and Statkraft of Norway. All these factors imply potential for FDI in this sector. Indeed, FDI has been increasing in this area and the Government has also prioritized FDI in biogas, wind, and solar energy. In order to harness the immense potential of hydropower, the sector should be managed in a purely professional and businesslike fashion. However, this does not seem to be happening as hydropower projects in the pipeline are not progressing well.

In agriculture and agro-based industries, there is increasing demand for flowers, flowering seeds, tea, and coffee in both the local and international markets. This would then require investments but also market linkages—hence the potential for FDI in these areas. In terms of tea, exports from Nepal increased from a mere 83 metric tons (MT) in FY2002 to more than 1,000 MT in FY2004, but decreased slightly thereafter. In the case of coffee, Japan and the Netherlands have been the country's major markets. Both the tea and coffee industries in Nepal have not developed due to lack of long-term loans and poor marketing. Thus FDI in tea and coffee will find opportunities in processing, marketing, and cultivation, if it comes with financing, quality control technology, or a marketing network (UNCTAD-ICC 2003).

For flowers and flowering plants, diverse agroclimatic conditions offer good prospects for the production of a wide variety of flowers and flowering seeds for export. The workforce suitable for this industry is also available in the country. Nevertheless, this is a new area and exports have not yet started. The direct air link to northern Europe—the traditional market for flowers—will help this sector.

In addition, the country has immense potential for producing marketable products from its medicinal and aromatic plants, given its rich biodiversity.

Textiles and Clothing Industry

Information on the T&C industry shows approval given to 177 joint-venture firms out of a total of

1,345 such firms approved (based on November 2007 data). The status of these firms is not clear, although many may have closed down due to stiff competition in the international market, the end of quotas in January 2005, and the closing of Indian investment companies that were established in Nepal to benefit from Nepalese quotas. Thus there is little current potential in the sector. However, some potential exists in particular segments, mainly in the production of terry towels, bed linen, and some specialized items of readymade garments.

In terms of textiles, pashmina shawls and other pashmina products offer prominent export potential, but the handmade variety is classified as a traditional cottage industry, and so no direct FDI is allowed. Nevertheless, technological collaboration is possible, and there exists considerable scope for such partnership to bring the country badly needed marketing, design, and quality control expertise. FDI is possible in machine-made pashmina products, as shown by the operation of Emperor's Gold Mount, a PRC company that is in a joint venture with Momento Apparels, one of the largest exporters from Nepal. Since financial investment in the form of joint ventures is allowed in machine-made pashmina, allowing some percentage of FDI in handmade pashmina must be likewise explored through a consultative process with different stakeholders. Pashmina is the third-largest export item from Nepal with a share of 10.4% of overseas exports in FY2007.

Other examples of opportunities for niche products include other textiles, such as curtains, bed sheets, tents, tarpaulins, sails, hand-woven design fabrics; and bed, toilet and kitchen linen. The liberalization of the Indian market also offers huge possibilities for these products, and FDI could also be an appropriate avenue to pursue such opportunities.

Automobile Industry

Although Nepal has two motorcycle producers operating with PRC collaboration, the automobile industry's potential does not look promising given the dominance of Indian imports and India's strong comparative advantage and geographic proximity. However, there may be some potential for producing automobiles targeted at certain market segments, particularly low and medium income groups. The spillover provided by domestic production in terms of backward linkages and training of the domestic workforce are some of the benefits that FDI may provide. More potential exists in producing motorcycles and their spare parts due to their higher demand. Prospects for investment in other sectors, however, remain poor due to the small size of the economy, technological backwardness, remoteness, civil strife, and susceptibility to natural disasters.

Economic and Social Benefits

Based on the limited studies on the impacts of FDI in Nepal and interviews conducted in the course of this study, the economic and social benefits of FDI in Nepal are analyzed in terms of technology spillovers, trade and investment effects, country reputation and linkages, the foreign exchange gap, and employment generation.

Technology Spillovers

As with other countries, one of the main reasons for attracting FDI is to benefit from technology transfer and spillovers. According to Chitrakar (2003), the transfer of technology through FDI appears to have helped Nepal in terms of introducing new production or process technology. Firms engaged in FDI have also been found to be more oriented toward new technology than domestic firms. Also, certain external benefits have resulted from technology transfer, mainly in the form of diffusion of technical knowledge from foreign personnel to their Nepalese counterparts, although this has happened to only a limited extent.

Nepal seems to recognize the need for technology transfer, but the optimal implementation and exploitation of such does not appear to be forthcoming. One of the reasons may be the country's poor absorption capacity, which implies the need for government intervention to stimulate benefits from such activities. Training programs of foreign investment firms also differ according to the country of origin, with Indian firms having more training activities, possibly due to the lower cost of sending personnel to India (given its nearness).

In return for technology transfer, foreign investors receive adequate compensation in terms of technology fees. These fees are in addition to the share that foreign investors derive from profits in

joint-venture undertakings and are charged regardless of the financial status of firms. As a result, higher returns accrue to foreign investors than their domestic counterpart. Thus, establishing a compensation package for technology transfer based on the firm's performance seems to be necessary. Training of the local entrepreneurs is also required to improve and increase their negotiating skills.

Trade and Investment Effects

FDI has helped expand Nepal's financial resources and ensure the availability of financing for trade facilitation through trade credits. In addition to supplementing domestic investments and boosting the domestic economy, FDI also assists in accessing international markets. In this regard, FDI—particularly export-oriented investments—has long been recognized as an important catalyst for trade-related growth. However, data from the Industrial Perspective Plan show that FDI during 1987–2001 was concentrated in nonexport manufacturing activities and travel (World Bank 2004). The number of industries permitted in service industries and tourism reached 88 and 55 in FY2007, respectively, compared to 40 in industrial production (Government of Nepal, Ministry of Finance, 2008).

Country Reputation and Linkages

Foreign investment, particularly in tourism, has helped in establishing and improving the country's reputation. Some upmarket hotel chains (e.g., Crowne Plaza, Hyatt, Radisson, and Taj) have investments in the country, which have helped establish Nepal as an important tourist destination. Similarly, tourism products targeted at Buddhists and Hindus from around the world have helped the world focus on Lumbini, and recognize Nepal as the birthplace of Buddha and the land of Shiva.

In addition, products such as carpets and pashmina have helped establish linkages abroad, mainly the EU and US. These products are well known to the West and are important exports. Clothing likewise was a very important export item of the country until the end of quotas in 2005.

Foreign Exchange Gap

FDI is assumed to bring in foreign currency, thereby helping minimize the foreign exchange gap. However, data for 1999–2003 show that equity earnings payments were higher than FDI inflows, which implies that FDI has not helped much in bridging this gap. The situation subsequently improved, and is expected to pick up further, as a result of the improved peace situation. Immediate results have in fact been felt by the tourism industry, as seen in greater tourist numbers.

Employment Generation, Gains to Labor, and Other Benefits

FDI has helped generate employment and improve other labor benefits, such as the difference between the market and shadow wage rates. In 2007, total employment provided by approved FDI projects in Nepal exceeded 180,000, with manufacturing other than T&C accounting for around 35% of this total, followed by T&C with around 20%, and tourism with 9%. Chitrakar and Pant (2007) show that FDI-funded financial institutions provide higher salaries and more training to their employees: employees from these institutions add about $90 per month to the value of labor plus the skills from training. Given that FDI projects in financial institutions in Nepal number 2,407, the equivalent net labor benefits from FDI in the financial sector is about $209,000 per year. In addition to employment and labor gains, FDI also provides benefits in terms of forward and backward linkages.

Risks and Negative Effects

Negative consequences can arise from incorrectly planned liberalization. In fact, there is still no consensus on whether certain critical services, such as health and education, should be liberalized. Some believe that their liberalization displaces domestic investors and becomes difficult to monitor in terms of the quality of services they provide. However, no domestic firms have been displaced by foreign manufacturing, tourism, or financial firms. Rather, many new domestic banks seem to have been established as a result of demonstration effects (Chitrakar 1994). Hence, Nepal needs to pay close attention to sequencing and pacing, and ensuring that an appropriate regulatory framework is in place.

Yet not all FDI has a positive impact. Experience from manufacturing (Chitrakar, 1994) and banking (Chitrakar and Pant, 2007) shows that performance

differs depending on the firm or bank, indicating a need for selective intervention to steer the firm in the right direction. Such interventions may include providing the necessary help to firms that are facing difficulties, offering training programs in FDI firms, requiring some research and development (R&D) activities in host countries, balancing the inflow and outflow of foreign exchange by FDI firms, and restricting domestic borrowing. The foreign exchange impact discussed earlier also demonstrated the negative effects in 4 out of 5 years under analysis. The outflows of foreign exchange during these years were more than the inflows in terms of foreign investments and loans. Firm-level long-term analyses also show that some of the finance companies with foreign investments perform poorly (Chitrakar and Pant 2007). Economic costs (e.g., domestic investment in the FDI-funded firm, returns to foreign investors, domestic borrowings, technology fees, and repayment of foreign loans and interest) of some of the finance companies with FDI were found to exceed the economic benefits that they generate in terms of FDI inflows.

In addition, multinational corporations might also introduce transfer pricing and negative noneconomic effects, such as cultural dependency or even ethnocide. Although these risks are not specific to Nepal, multinational corporations are thought to influence the culture of the country. Moreover, since foreign firms pay more than domestic firms, this may likely result in engendering income inequality.

Constraints

Nepal has been unable to attract FDI partly because of its small domestic market and infrastructural problems, resulting from its landlocked and mountainous nature. Its low per capita income has further constrained the domestic market. Exports have been limited by low labor productivity, resulting in higher production costs. Other costs include delays in customs and transshipment to India's Kolkata port; high costs of transport and power; a rigid and formal labor market; lack of labor–employer cooperation; weak policy and institutions in the areas of taxation, investment, and trade promotion; terrorism; and poor work ethic of the labor force (World Bank 2004).

The *Global Competitiveness Report 2008–2009* (World Economic Forum, 2008) enumerated the five most problematic constraints to doing business in Nepal, namely: government instability, policy instability, corruption, inefficient government bureaucracy, and inadequate supply of infrastructure. The study also ranked Nepal's overall quality of infrastructure as 130 and business costs of terrorism 132 out of 134 countries surveyed. The country was at ranking 120 on transparency of government policy making, 126 on prevalence of trade barriers, 113 on impact of rules on FDI, and 126 on prevalence of foreign ownership. Other notable constraints include organized crime (128), labor–employee relations (133), firm-level technology absorption (130), extent of marketing sophistication (129), and company spending on R&D (126). Nepal also relies very little on professional management (115).

The only possibility to offset these constraints is to implement policies that aim to improve the investment climate. This is not happening now, and indeed, many foreign investors regard the law as unclear and its policies ineffective. Integrating regionally with other South Asian countries is also necessary for increasing the size of the market. In addition, there is a need to improve infrastructure, governance, and security. Special focus should be given to ensuring improved customs procedures and the supply of electricity.

Nepal also faces challenges resulting from its membership of WTO, which have to be met by promoting the country's economic competitiveness. Nepal's general and specific commitments to allow foreign equity participation in various services sectors are very attractive, but there are still numerous practical difficulties in setting up and operating an entity with foreign equity participation. The Government and people are likewise not yet ready to accept foreign investment easily in some sectors, such as wholesale and retail, as well as community and social services. Some feel that certain sectors like health and education are the responsibility of government, and should be reserved for domestic investors.

The economic and political upheavals, as well as the more than a decade-long conflict, have been greatly responsible for the poor inflows of FDI and the closure of some businesses. They also put pressure on foreign exchange and the balance of payments. The recent terrorist movements by certain Terai groups, including Terai bandh (blockade of roads and shutdown of

markets), the conflict, and load-shedding in electricity supply are likely to have serious impacts on FDI inflows.

Policy Recommendations

General

Studies have shown that foreign investment in Nepal generally has a positive impact, both for the foreign investor and the country. The five most problematic factors of doing business as shown by the World Economic Forum (2008) and by the World Bank (2004) need to be remedied to attract FDI. SEZs also need to start operating to draw efficiency-seeking and export-oriented FDI firms.

About 45% of foreign investment comes from five SAARC countries (Bangladesh, Bhutan, India, Pakistan, and Sri Lanka), indicating the high potential for intraregional investment. However, country-level data show that a large share of total SAARC investment comes from India. Although this is natural, it also indicates the need for a policy to diversify inflows and to attract investments from other countries. However, none of the studies conducted thus far has pointed out why investments are not flowing from other investors. The implementation of SAFTA and the gradual move toward an integrated South Asian economy, leading eventually to a South Asian Economic Union, could be the solution to the problem regarding the flow of goods and services.

Since Nepal is already a member of WTO, it is recommended that the services sector be classified according to WTO classification, and investment in the different subsectors be shown separately under a broad heading. This will help in classifying many of the new services sectors, such as wholesale and retailing, and consulting, which have already been opened up or which are in the process of being opened up, reflecting commitments to WTO. This suggested classification would help in making detailed analysis and intercountry comparisons. Strategies could then be formulated for improving trade and investment cooperation among South Asian countries. This will also help in harmonizing data keeping among SAARC countries.

Since trade costs constitute a major share in the production cost of SAARC countries, especially for least developed countries like Nepal, trade facilitation is necessary in reducing these costs. A study by the World Bank (2004) showed that preshipment transport costs account for 7%–8% of the price received by exporters. Also, travel time from Kolkata to Birgunj can be reduced to 3 to 5 days if trade is carried out through the inland container depot, which in turn helps reduce transport costs by about 30% (World Bank 2004). Trade facilitation is especially important for products like clothing, pashmina, and agro-products, considering the volume of these products and the higher transport costs involved.

Improvements are also necessary in customs clearance procedures for cross-border rail operations with India. Similarly, intergovernment cooperation with Bangladesh is needed to improve the infrastructure of the Banglabandh Marg. In addition, Nepal should reform its Customs Act and Rules to make it consistent with WTO requirements. It should also simplify and harmonize trade documents and procedures. It is also recommended that systematic meetings with traders and training programs in new procedures are organized, and that sufficient resources are allocated to keep open major customs posts on a 24-hour basis.

Since the main issues regarding intellectual property rights are law enforcement and the lack of awareness, there is a need for improved enforcement and the establishment of public awareness programs and training. Similarly, intellectual property rights should be included in the curricula of formal education and an appropriate protection agency should be created.

India's new provisions of bringing its customs rate to zero to provide market access to Nepal, Bangladesh, Bhutan, and Maldives will introduce competition for Nepalese products in the Indian market. This indicates the need to build the country's competitive capacity and productivity through capacity development programs.

Sector Specific

The share of FDI in services to total FDI in Nepal has increased substantially, indicating some potential in the services sector. Tourism is one of the major industries with prospects for further investment growth. Possible areas for increased investment also include health and health education, and the communications and software sectors. The export

of services in information and communications technology is unaffected by distance or other trade barriers resulting from remoteness. Since Nepal has transport and transit problems, and high transaction costs, it is recommended that emphasis should be given to the promotion of investment flows in the services sectors, which requires the maintenance of peace, security and stability, a regular supply of electricity, and good labor–management relations.

Although Nepal has made general and specific commitments to WTO to allow foreign equity participation in various services sectors, this has not materialized due to practical difficulties in setting up and operating firms with foreign equity participation. This implies the need for improving infrastructure and the business environment, and introducing a clear and visionary FDI policy that increases inflows and that benefits the economy and its consumers. Thus, it is suggested that governance be improved in the institutions dealing with FDI.

Though the T&C industry is one of the major exporting sectors of Nepal, there is virtually no FDI in textiles, and the possibility of FDI inflows in this sector seems to be very slim since other SAARC countries are stronger in this area. Although the number of clothing firms has fallen substantially in recent years, the possibility of exporting certain categories of clothing under the EU's Everything But Arms initiative has to be capitalized on. The facility provided by the EU on rules of origin for textiles needs to be tapped since exports of clothing to the EU are expanding. Also, since the readymade clothing industries in SAARC are importing textiles from outside the region rather than from within the region, a shift to SAARC countries is recommended for cooperation among members, but this will happen only if products are competitive. The possibility of allowing FDI in handmade pashmina must also be explored. In terms of agriculture and agro-based industries, their FDI potential needs to be assessed. Efforts are also necessary to remove the constraints and obstacles in Nepalese agricultural exports created by complex quarantine rules imposed by India in 2001.

Nepal should take advantage of the liberalization of the Indian market, and FDI may be an appropriate avenue to pursue. Given that trade in T&C is the "glue that binds SAARC's member countries" (Tewari 2007) much attention should be given to the existing strengths of each member country for the formation of regional production networks and clustering in clothing. Nepal also needs to concentrate on producing readymade clothing, where it has an advantage. It should also participate in labor training and exchanges with other member countries, including the training of managers, quality control specialists, technical personnel, and designers. The flow of skilled workers and managerial talent in the T&C industry across the major South Asian countries needs to be supported and nurtured, along with an easing of visa rules.

Assistance should also be provided to financial companies facing difficulties, and since any instability in the banking system affects the whole economy, the Government needs to keep a watchful eye on this sector. Indeed, domestic regulations that are most significant in determining whether financial FDI can generate benefits are still not well developed. Total foreign shareholdings in financial services are limited to 67% of the issued share capital. This low share may mean fewer benefits to the country, indicating the need for a gradual increase in such shares. Effort should also be made toward establishing more financial institutions in the country, which are expected to promote other businesses. Moreover, since financial institutions with foreign investments can contribute to employment generation and gains to labor, there is a need to encourage joint-venture banks. Nepal's commitments in opening financial services to foreign investments on WTO accession also imply that the country's financial market should be more competitive in the future, thereby indicating the need for capability building.

In the area of power generation, a quantum leap in hydropower production is required as the country is facing severe power shortages at present. This implies the need for increased investment in the power sector, including that from foreign capital. Failure to obtain private investment in time might lead to further power shortages by 2012. Therefore, more consolidated efforts are required from the Government and the bureaucracy to attract FDI into hydropower. Moreover, a transparent and enabling framework, improved peace and security, and the creation of a robust and growth-oriented power market, including full and nondiscriminatory access to northern India, are necessary. The country may also want to explore FDI in biogas, wind, and solar energy.

In the automobile industry, two investments in terms of technology transfer from the PRC have been made in motorbike manufacturing. Since these companies brought new technology, provided employment, and fostered backward linkages, they should be helped and assisted. Investment in terms of both finance and technology is also required at least in motorcycles, scooters, and spare parts.

Summary and Conclusions

The main objectives of this study were to examine the FDI policy and environment in Nepal, analyze the impact of FDI on the economy, and investigate key opportunities and barriers to investment. The study also considered the importance of policies to enhance labor mobility as a complement to capital mobility.

The Government has encouraged FDI in the country since liberalization in 1990. Although its foreign investment policy is attractive, a considerable barrier is the lack of implementation. Complementary policies, such as those on labor and customs, have also hindered FDI.

FDI is represented by a wide variety of companies and countries in various areas. There is the possibility of FDI in many niche agricultural products and the potential in hydropower is huge. Current severe power shortages point to further possibilities for development. The potential in the services sector is evidenced by its increasing role in the economy, but although the country committed to opening up various services after WTO accession, there is still no consensus as to whether certain services should be liberalized. Nepal should try to achieve the full potential of intraregional investment. In manufacturing, investment in readymade clothing has been the most prominent.

Foreign investment brings economic and social benefits, improves the county's reputation, and offers access to the world market. In recent years, however, FDI has not helped much in terms of closing the foreign exchange gap.

Trade and investment are constrained by the small size of Nepal's economy, technological backwardness, remoteness, landlocked position, civil strife, and susceptibility to natural disasters. Nepal's low productivity (the weakest among countries in the region) is another obstacle, as are government and policy instability, inefficient bureaucracy, corruption, and inadequate infrastructure. To this could be added a poor work ethic, tax regulations, delays in customs and transshipment, a rigid and formal labor market, lack of labor–employer cooperation, and weak policy and institutions in taxation, investment, and trade promotion. These are the areas where improvements are most needed.

Looking specifically at important sectors in the T&C industry, the number of firms with FDI has decreased gradually since the end of MFA in January 2005, although the facility provided by the EU under its Everything But Arms initiative has resulted in the gradual expansion of exports of textiles. Specifically, pashmina shawls and other textile products offer prominent export potential. In the automobile industry, the potential for FDI is in producing spare parts.

Finally, there is a considerable potential for intraregional investment in Nepal, since much of such investment currently comes from India, suggesting the need to diversify inflows from other SAARC countries.

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CHAPTER 8

Sri Lanka Country Investment Study

Dushni Weerakoon
Jayanthi Thennakoon

Country Economic Profile

Sri Lanka's economic development has been vastly complicated by the adverse impact of long-standing tensions that erupted in armed conflict in the mid-1980s. While this conflict has resulted in significant socioeconomic costs to the country, economic growth overall has nonetheless been fairly resilient with a gross domestic product (GDP) growth rate of around 5% a year on average over the last two decades and with a corresponding per capita GDP growth rate of around 3%. However, there are increasing concerns that growth has been uneven across provinces and sectors of the country, with the Western Province accounting for over 50% of GDP. Poverty has also remained endemic in parts of the country, as reflected in a national poverty headcount of 23% and increasing evidence that income inequality has been on the rise (World Bank 2007). In response to such developments, Sri Lanka's more recent economic policy priorities have been reoriented toward addressing regional and sector inequities with a stronger emphasis on the rural economy, agriculture, and small and medium-sized enterprises (SMEs) as vehicles for realizing a vision of "growth with equity."

Overall Macroeconomic Conditions and Business Climate

The share of agriculture in GDP has been declining, accounting for 16.8% of GDP by 2006, but remains an important source of livelihood and employment, particularly for the rural poor, absorbing nearly 32.2% of total employment. In contrast, the services sector has been expanding hugely to account for 56.2% of GDP and 41.2% of total employment in 2006. Sri Lanka's industry sector growth has remained fairly stagnant and remains dominated by export-oriented clothing manufacturing, which accounted for approximately 27.0% and 26.6% of GDP and total employment in 2006, respectively.

While a GDP growth target of 8% has been set for the medium term to address issues related to poverty and to regional and sector imbalances, the ability to achieve and sustain an accelerated growth momentum remains in doubt. The economy saw a steady acceleration in output growth in 2005 and 2006 of 6.5% due to a resurgence in agricultural production resulting from improved weather conditions and sustained growth in services. Nonetheless, the sharp improvement in growth was largely due to the expansionary impact of relatively loose fiscal and monetary policies. The most visible and potentially most destabilizing manifestation of the resultant weakening in macroeconomic management has been a persistent buildup of inflationary pressure in the economy.

Significant structural weaknesses in Sri Lanka's public expenditure management remain. Current spending on wages and salaries of public employees, interest payments on government borrowing, and transfers and subsidies together exceed the total revenue available to the Government. There are fairly rigid expenditure patterns in the face of only a slow increase in fiscal revenue, constraining capital investment. Thus, the country has continued to run budget deficits in the range of 9%, necessitating a heavy borrowing requirement (Table 8.1). The weaknesses in public expenditure management are evident by a high total debt-to-GDP ratio of over 90% in recent years.

In turn, inflationary pressures caused by the fiscal deficits spilled over into monetary policy management. As Sri Lanka's rate of inflation began to accelerate from mid-2004, monetary policy response was slow, leading to an annual inflation rate of 17.5% by mid-2007. Cost-push inflationary pressures in the economy have been aggravated by the external supply-side shock from high global oil prices, but it

Table 8.1: Selected Macroeconomic Indicators, 2001–2006

National Accounts	Unit	2001	2002	2003	2004	2005	2006
GDP	$ billion	15.1	16.4	18.2	19.4	23.2	26.0
GDP Growth	%	(1.5)	4.0	6.0	5.4	6.0	7.4
Agriculture	%	(3.4)	2.5	1.6	(0.3)	1.5	4.7
Industry	%	(2.1)	1.0	5.5	5.2	8.3	7.2
Services	%	(0.5)	6.1	7.9	7.6	6.4	8.3
Investment	% of GDP	22.0	21.3	22.1	25.0	26.5	28.7
Savings	% of GDP	15.8	14.5	15.9	15.9	17.3	17.1
External Sector							
Exports	$ million	4,817	4,699	5,133	5,757	6,347	6,883
Imports	$ million	5,974	6,105	6,672	8,000	8,863	10,253
Trade Balance	% of GDP	(7.3)	(8.5)	(8.4)	(11.2)	(10.7)	(12.5)
Current Account Balance	% of GDP	(1.4)	(1.4)	(0.4)	(3.2)	(2.8)	(4.9)
FDI	% of GDP	0.5	1.1	0.9	1.1	1.0	1.7
Official Reserves	$ million	1,338	1,700	2,329	2,196	2,735	2,837
Tourist Arrivals	'000 persons	336,794	393,174	500,642	566,202	549,308	559,603
Tourist Earnings	$ million	202	250	340	408	356	410
Fiscal Variables							
Gov't. Expenditure	% of GDP	27.5	25.4	23.7	23.5	24.7	25.4
Gov't. Revenue	% of GDP	16.7	16.5	15.7	15.4	16.1	17
Fiscal Balance	% of GDP	(10.8)	(8.9)	(8.0)	(8.2)	(8.7)	(8.4)
Gov't. Debt	% of GDP	103.2	105.4	105.8	105.5	93.9	93
Prices and Money							
Inflation	%	14.2	9.6	6.3	7.6	11.6	13.7
Interest Rate[a]	%	13.74	9.91	7.24	7.65	10.37	12.96
Broad Money (M2)	% change	13.6	13.4	15.3	19.6	19.1	17.8
Exchange Rate	SLRs/$	93.2	96.7	96.7	104.6	102.1	107.7
ASPI	1985 = 100	621	815.1	1,062.10	1,506.90	1,922.20	2,722.40

() = negative, ASPI = All Share Price Index.

[a] 12-month Treasury bill rate.

Source: Central Bank of Sri Lanka, *Annual Report* (various years).

is clear that the country's inflation rates remain well above comparative global and competitor country rates. This is prima facie evidence that domestic policy bears the greater responsibility for high inflation.

The Government remains tightly constrained in its ability to raise the country's overall investment rate to a target of around 35% of GDP from the current level of 30% of GDP if it is to achieve its medium-term growth target of 8%. Already, the high interest rate regime is exerting a downward pull on GDP growth. A deterioration in the peace and order situation in the country has further weakened investor confidence.

During the first half of 2007, signs of a gradual slowdown in economic growth were visible, with the growth rate declining to 6.3% from nearly 8% in 2006.

Dependence on foreign sources of finance to raise Sri Lanka's investment rate is likely to remain high. Domestic savings remain low at around 17% of GDP. Inflows of remittances have allowed the country to raise its national savings rate to around 23% of GDP, but this remains well short of the required rate of investment to accelerate and maintain GDP growth in the region of 7%–8% over the medium term. Resorting to increased foreign currency–denominated

commercial borrowing has its inherent risks and prudent policy options have to be explored. Raising the volume of inward foreign domestic investment (FDI) remains one of the key priorities to bridge the country's domestic resource gap.

Trade Profile

Sri Lanka's trade regime underwent significant change in the late 1970s with the transition from a predominantly import-substituting strategy to that of an export-oriented regime. Since then, incremental reforms have ensured that the country follows an open, liberal economic policy with a ratio of exports and imports to GDP of around 65%. Incremental changes have been made to gradually lower the top tariff band. However, tariffs on intermediate goods have tended to decline at a much faster pace than those on final goods. Overall, the effective duty rate on total imports[1] has been declining continuously over the years to reach 4.2% by 2006. Nonetheless, in view of significant concessions granted to export-oriented industries, including duty-free access to key intermediate goods such as textiles, as well as financial incentives, the high effective protection for domestic production is not viewed as having deterred export-oriented activities.

Since the mid-1990s, policy attention vis-à-vis the external trade strategy has been primarily on pursuing preferential trade initiatives with only limited focus on rationalizing Sri Lanka's import tariff regime. Recent changes in the policy direction of trade have been introduced in line with the Government's plan to address regional and sector imbalances. For example, the priority theme of the proposed trade and investment policy in the Government's Ten-Year Plan (2006–2016) aims to strengthen export growth by promoting exports and efficient import substitution as broad policy objectives through export diversification with an emphasis on SMEs, infrastructure development, and policy support–based backward integration for high-value-added exports (Government of Sri Lanka 2007). The strategies outlined in the Ten-Year Plan recommend market penetration through securing preferential market access, upgrading competitiveness, and strengthening the trade regulatory environment.

Manufacturing exports have been the mainstay of merchandise exports since the liberalization of the economy in the late 1970s. The bulk of FDI in Sri Lanka in the 1980s was in manufacturing, predominantly concentrated in the clothing sector. In fact, many studies have suggested that FDI was more efficient than local investment in raising manufactured export growth (Kelegama 1992, Athukorala 1995). By 2006, industrial exports contributed 78% of total exports with agriculture accounting for 19%. The larger portion of agricultural exports came from tea, which had a 13% share of total export earnings. Despite the significant share of industrial exports, export earnings continue to be heavily concentrated in clothing, accounting for 57% of total manufacturing exports and 42% of total export earnings in 2006 (Table 8.2).

Some diversification of Sri Lanka's manufacturing export has transpired over time with the emergence of other labor-intensive product exports, such as leather goods, footwear, toys, plastic products, and jewelry, which cater to niche markets. In particular, export of processed food and beverages has increased sharply from a 3.6% share of total manufacturing exports in 2000 to over 6.7% by 2006. Substantial increases in manufacturing export shares were also noted for rubber products and machinery, mechanical, and electrical equipment.

Despite some degree of expansion of Sri Lanka's export trade in various product categories, destinations remain heavily dependent on markets in North America and Europe. This is primarily a reflection of the composition of Sri Lanka's exports, which is dominated by textiles and clothing (T&C). Historically, the United States (US) was the largest buyer for Sri Lanka's T&C products. However, exports to the European Union (EU) have increased progressively with the Generalized System of Preferences (GSP) Plus scheme, which has been in place since mid-2005. The EU accounted for 41% of exports from Sri Lanka in 2006 and the US 29% (Table 8.3). The rest of South Asia remains fairly marginal as an export destination, with the exception of India, with which Sri Lanka has rapidly strengthening export trade relations.

[1] Duty collection as a percentage of the cost, insurance, freight (CIF) import value.

Table 8.2: Composition of Manufacturing Exports, 1990–2006
(%)

Sector	1990	1995	2000	2006
Food, Beverages, and Tobacco	3.1	3.4	3.6	6.7
Textiles and Clothing	60.6	64.6	69.6	57.2
Chemical Products	2.5	1.0	0.7	1.5
Petroleum Products	9.6	3.0	2.3	3.5
Rubber Products	—	5.3	4.6	8.3
Ceramic Products	—	1.6	1.1	0.9
Leather, Paper and Wood	—	6.5	5.6	2.7
Plastics and Articles	—	0.8	0.9	1.1
Machinery, Mechanical, and Electrical Equipment	5.7	4.3	5.7	7.3
Jewelry	0.3	1.1	0.3	0.3
Diamonds	8.9	5.7	4.2	5.8
Other	—	2.7	1.5	4.9

— = data not available.

Note: Aggregate composition of leather, rubber, paper, wood and ceramics exports are estimated at 9.3% of total exports in 1990. Disaggregated data are unavailable.

Source: Central Bank of Sri Lanka, *Annual Report* (various years).

Table 8.3: Direction of Export Trade, 1990–2006
(%)

Country/Region	1990	1995	2000	2006
United States	24.8	35.6	39.5	29.1
European Union	25.0	31.0	35.3	40.7
Japan	5.2	5.3	4.1	2.4
ASEAN	3.9	3.7	3.1	3.4
SAARC	3.6	2.7	3.8	10.7
India	1.0	0.8	1.0	7.1
Pakistan	1.6	1.1	0.5	0.8

ASEAN = Association of Southeast Asian Nations, SAARC = South Asian Association for Regional Cooperation.

Source: Central Bank of Sri Lanka, *Annual Report* (various years).

India has emerged as Sri Lanka's single largest country supplier, overtaking Japan (Table 8.4). The East Asian region also is an important source of imports for Sri Lanka, providing intermediate inputs for its T&C industry.

Trade in export services is also an emerging area of interest. In 2006, of the combined export receipts of $8.5 billion, 81% came from merchandise goods and only 19% from services, of which two thirds were accounted for by traditional services exports such as transport and tourism (Table 8.5). It is, however, encouraging that the computer and information services segment, which includes business process outsourcing, is an expanding sector with exports reaching $98 million over the period 2004–2006.

Table 8.4: Direction of Import Trade, 1990–2006
(%)

Country/Region	1990	1995	2000	2006
United States	7.7	3.3	3.5	2.0
European Union	14.4	15.3	18.8	15.9
Japan	12.1	9.4	8.8	4.4
ASEAN	12.8	12.8	21.0	21.7
SAARC	6.9	10.2	14.0	27.2
India	4.4	8.8	8.2	21.2
Pakistan	1.9	1.0	1.0	1.4

ASEAN = Association of Southeast Asian Nations, SAARC = South Asian Association for Regional Cooperation.

Source: Central Bank of Sri Lanka, *Annual Report* (various years).

Table 8.5: Net Service Trade Flows, 1995, 2000, and 2006
($ million)

	1995		2000		2006	
Description	Credit	Debit	Credit	Debit	Credit	Debit
Transportation	336	201	406	337	751	540
Travel	226	186	252	244	410	373
Telecommunications	—	—	46	48	68	49
Computer and Information	—	—	—	—	98	—
Construction	—	—	—	—	29	6
Insurance	27	10	41	22	57	37
Other Business Services	213	240	184	234	190	329
Gov't. Expenditure	19	31	24	30	21	35
Total	821	669	953	915	1,625	1,368

— = data not available.

Source: Central Bank of Sri Lanka, *Annual Report* (various years).

Indeed, business process outsourcing–related export earnings in 2006 increased sharply by 20% from the previous year.[2] However, telecommunications infrastructure remains a constraint to further expansion owing to expensive leased lines and limited geographic coverage that services only the urbanized Western Province. English language education and training also need improvement to expand the scope of business process outsourcing.

Industry Profile

Textiles and Clothing

Economic reforms during 1977–1978 emphasized the need for manufacturing export growth, which was left largely to the liberalization of trade and payments. Although Sri Lanka combined an outward-oriented policy with some elements of

[2] Data on country breakdown of services exports are not available.

selective protection, it lacked a systematic approach to encourage infant industries to improve their technological capability and competitiveness in the global market. Nonetheless, there was growth in manufacturing, but this was concentrated in labor-intensive sectors. The policy of generalized promotion of manufacturing activities aimed at maximizing gross earnings of foreign exchange failed to allow a shift from labor-intensive to capital-intensive activities. Instead, there was an initial surge in the production of industries, such as T&C, after which the stimulus of trade liberalization petered out. Foreign investment played a major part in transferring technology and boosting Sri Lanka's manufacturing exports. This was mainly attributable to the low relative wage costs, unutilized Multi-Fiber Arrangement (MFA) quotas, and a competitive incentive regime. However, there was hardly any progress in more complex technology-intensive value-added activities.

The initial boost in industrial output came from the export-oriented clothing sector. The T&C industry emerged as a significant contributor to the economy through its contribution to industrial output growth, export growth, foreign exchange earnings, and employment generation. In 2006, the T&C industry accounted for 33% of industrial output and 45% of total merchandise exports, with gross earnings of nearly $3 billion (Central Bank of Sri Lanka 2006). The T&C industry is also a dominant source of employment generation, providing employment to over 5% of the total labor force and accounting for one third of total manufacturing labor employment.

Automobiles

Other key sectors of the economy include food and beverages, and tobacco products; and chemical, petroleum, rubber, and plastics products. These two key sectors accounted for 31% and 15% of total industrial production in 2006, respectively. Industrial activity in the automobile-related sector (i.e., fabricated metal products, machinery, and transport equipment) has been relatively limited, contributing only about 6% to industrial production in 2006. Although the Sri Lankan market is relatively small for any automobile manufacturer, growth in local demand and growing trade within the region have made it a more attractive location for automobile parts and assembling industries. As such, the Government has been trying to promote the industry by offering various incentives and concessions (e.g., a temporary reduction in the local value-addition requirement for local assemblers, and tax concessions offered by the Ministry of Industrial Development).

Overall, industry's share of GDP has remained stagnant at around 26%–27% over the last decade. Given the importance of the industry as a source of potential employment generation and driver of overall growth, policy attention has focused on attempts to formulate appropriate industrial policy strategies. However, these have had limited success, and strategies have also tended to vary through the years.

Infrastructure

The fiscal constraints under which the Sri Lankan economy has been functioning, with a heavy diversion of resources on security expenditures and consumption spending, has left limited resources for public investment in economic infrastructure. For example, public investment in transport and communications, at 1.3% of GDP in 1990, had climbed no higher by 2006. While the Government promotes private investment in infrastructure, largely on a build-own-operate or build-own-transfer basis, the lack of suitable pricing policies has often deterred private sector entry.

Inadequate infrastructure is a growing constraint to investment in the country. Results of an Investment Climate Survey for Sri Lanka undertaken by the World Bank in 2004 showed that over 40% of respondents from 458 establishments cited access to electricity as the key constraint to a less than attractive investment climate (World Bank 2005). Other concerns by both urban manufacturing and rural enterprises include low-quality infrastructure, especially in energy and transport, as well as costly and limited access to finance.

In terms of energy infrastructure, delays in the implementation of key power sector infrastructure—in particular, a proposed coal power plant—have contributed to the emergence of a significant gap between demand and supply. In addition, the heavy reliance on petroleum-generated energy has resulted in sharp cost increases in energy for household and industrial consumers. With electricity demand continuing to grow at an estimated 8% annually, in 2007 the Government initiated the establishment of

Table 8.6: Socioeconomic Indicators, 2004

Country	GDP Per Capita (PPP) ($)	Adult Literacy Rate (%)	Life Expectancy at Birth (years)	School Enrollment Ratio (%)
Korea, Rep. of	20,499	98.0	77.3	95
Malaysia	10,276	88.7	73.4	73
Thailand	8,090	92.6	70.3	74
Philippines	4,614	92.6	70.7	82
Sri Lanka	4,390	90.7	74.3	63
India	3,139	61.0	63.6	62
Pakistan	2,225	49.9	63.4	38
Bangladesh	1,870	—	63.3	57

— = data not available, PPP = purchasing power parity.

Source: United Nations Development Programme (2006).

a much-delayed coal power plant. However, this is unlikely to address both capacity shortages and the high cost of electricity (the latter a problem that has emerged over time).

Although Sri Lanka has a fairly dense road network of 1.5 kilometers per square kilometer, only 10% of paved roads are in good condition due to poor maintenance (World Bank 2004). In addition, the country has seen little investment in improving trunk roads, upgrading roads, or constructing new national highways, despite substantial expansion in traffic demand (World Bank 2004). There are also disparities in access and connectivity across the country.

Sri Lanka does, though, have several large ports and its ports in general are relatively efficient due largely to the entry of the private sector in their construction and operation. The same is true in telecommunications, where the introduction of policy reforms to promote competition has been a driving force for improved performance. However, delays in implementing interconnection rules and in providing a fiber optic network for the entire country has held back progress in strengthening the telecommunications infrastructure.

Resource Endowments

The main resource endowment is human. A commitment to provide free and universal health and education services saw the country achieving socioeconomic development levels far ahead of other comparable countries by the mid-1970s. Thus socioeconomic indicators far surpass those of its neighbors in South Asia with, for example, adult literacy, infant mortality, and life expectancy comparable to or even exceeding those of some East and Southeast Asian countries (Table 8.6).

Sri Lanka has high levels of educational attainment at primary and junior secondary levels. For the country as a whole, net primary completion is at around 95% but access to tertiary education remains restricted due to the limited number of institutions and facilities. Adult literacy overall is estimated at 91% with only a small difference between male and female rates. However, there are weaknesses in the quality of education, with mastery of English a particular problem.

Regional Trade Agreements

The external trade strategy since the mid-1990s has been heavily focused on market access and domestic export diversification through bilateral and regional preferential trade initiatives. Although Sri Lanka became a member of the Bangkok Agreement in 1975, it was a fairly loose arrangement with limited exchange of tariff preferences on selected commodities. From the early 1990s, however, the country adopted a more aggressive stance on promoting regional economic integration, proposing the setting-up of a scheme for preferential trade

within the ambit of the South Asian Association for Regional Cooperation (SAARC). Thus from the mid-1990s, the country's external trade policy orientation focused primarily on negotiating regional and bilateral trade initiatives.

For Sri Lanka, membership in regional and bilateral trade initiatives was considered as a means to access markets and diversify its export base, as well as to provide a small but crucial competitive advantage to help attract larger FDI inflows. The first of these was the SAARC Preferential Trade Agreement (SAPTA) implemented in December 1995, which provided for limited agreement with minimal liberalization on a preferential basis. This was followed by the India–Sri Lanka Free Trade Agreement (ISFTA), which was signed in December 1998 and implemented in March 2000. A similar arrangement was made with Pakistan under the Pakistan–Sri Lanka Free Trade Agreement in July 2002 and implemented in June 2005. Sri Lanka also became a signatory to the South Asian Free Trade Agreement (SAFTA) in January 2004 and implemented in July 2006. The SAFTA pact supersedes the previous SAPTA trade deal.

The dominant policy changes in the region have been those associated with unilateral across-the-board policy liberalization rather than the relatively minor preferential measures arising from the SAARC integration arrangements. The most important of Sri Lanka's negotiated trade agreements remains the bilateral free trade agreements (FTAs) with India and Pakistan, and SAFTA. All three agreements have been negotiated on a negative list basis, with the coverage remaining partial. The FTAs are subject to general rules of origin, most typically a combination of domestic value addition of 35% and a change in tariff heading at Harmonized System (HS) four-digit level.[3] Sri Lanka has been offered asymmetric treatment under both bilateral FTAs, primarily in terms of the size of the negative list and period for tariff phaseout, in view of the relative size of its economy and resource constraints vis-à-vis its negotiating partners.

Despite some drawbacks, regional trade agreements have benefited Sri Lanka. The most significant benefit has accrued from ISFTA in terms of increased export earnings as well as drawing in more FDI from India.[4] For instance, exports to India saw a significant increase in absolute terms, from $58 million in 2000 to $566 million in 2005.[5] However, there have been concerns that this substantial increase reflects expanded activities in two key products—vegetable oil and copper wire—rather than a meaningful diversification of the country's manufacturing export base to India. Nevertheless in general, growth in export earnings to India has far outstripped growth in total export earnings for Sri Lanka since 2001 and has contributed significantly to closing the trade gap between the two countries.

Sri Lanka is currently pursuing negotiations to further deepen and expand the scope of ISFTA to a Comprehensive Economic Partnership Agreement with India, under which preferential access will be extended to cover investment and services. In addition, Sri Lanka is also a signatory to the FTA by the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation signed in 2004 and due to begin implementation as soon as negotiations are completed.

FDI Policy and Environment

The origin of FDI in Sri Lanka can be traced to the country's preindependence era that was characterized by considerable foreign capital, especially in the plantation and related sectors under the colonial regime. Nevertheless, FDI began to attract policy attention only after independence in 1948, and two distinct phases can be identified: the first phase in 1948–1977 with the state as a dominant entity, and the second phase post 1977 with a private-sector-led export-oriented economy.

Short Economic History in the Context of FDI Policies

Governments maintained a fairly liberal environment for FDI until the mid-1960s, although with mixed policy response from time to time. Nonetheless,

[3] With the exception of the Pakistan–Sri Lanka Free Trade Agreement where change in tariff heading is applied at the HS six-digit level.

[4] The FTA with Pakistan is of quite recent vintage and cannot be expected to have had major impacts on trade or investment.

[5] Export earnings dropped in 2006 with the disruption to Sri Lanka's exports of vegetable oil (vanaspathi) following a trade dispute with India.

the policy environment up to then was fairly liberal, permitting multinational corporations to set up affiliates and manufacture goods for the domestic market that were previously supplied from their overseas production centers. However, with the dominant focus on import-substituting strategies at the time, there was an increasing shift toward the establishment of a dual foreign investment regime. However, this failed to make any notable headway either in attracting more FDI or in diversifying Sri Lanka's export base toward manufacturing. Several additional criteria imposed on FDI, such as use of local raw materials, use of intermediate technology, production for export, and rural establishment of manufacturing plants, also proved less than attractive to foreign investment.

The institutional framework for FDI was governed by the Foreign Investment Advisory Committee consisting of representatives from key ministries. It had the objective of centralizing, facilitating, and expediting decision making on projected foreign investment. Businesses opening under the Committee were subject to the import and exchange control regime, which provided for import duty rebates on imported inputs for the export of finished goods.

The liberalization of the economy in 1977–1978 was a significant breakthrough in the FDI policy regime. Policy reforms centered on an export-oriented market economy and the creation of a new institutional structure to promote FDI. A statutory body called the Greater Colombo Economic Commission was established in 1978 charged with attracting and supporting export-oriented foreign investment through an attractive incentive package to foreign investors and establishing and managing export processing zones (EPZs). There were no significant changes in policy toward FDI until the adoption of further liberalizing reforms in 1990 under the second phase of liberalization.

Performance of FDI

The country witnessed a sharp increase in FDI inflows in the immediate postreform period, albeit from a relatively low base. Having averaged less than $0.5 million per year in 1970–1976, net FDI inflows were estimated to have increased to $86 million in 1982 (Athukorala 2006).[6] The momentum, however, stalled with the escalation of armed conflict in the mid-1980s. While there was marginal recovery in FDI inflows from the early 1990s—driven by a return to political normalcy in most parts of the country and renewed efforts to further liberalize the economy under the second phase of reforms—overall performance has been somewhat poor, particularly in relation to the volume of FDI flowing into economies in Southeast Asia. Sri Lanka witnessed higher inflows of FDI during the mid-1990s with the implementation of a divestiture program of state-owned enterprises. Nevertheless, total FDI inflows have stagnated at an average of around 1.0%–1.5% of GDP for the most part throughout the last decade.

The initial inflows of FDI to Sri Lanka, following the opening up of the economy, were in manufacturing, particularly in the T&C industry. However, beginning in the early 1990s, total FDI inflows to Sri Lanka began to be dominated by services. Initiatives described above to jump-start the stalled privatization process as part of the second phase of reforms were a key factor. Thus, liberalization of Sri Lanka's foreign investment regime coincided with the gradual opening up of certain infrastructural services to private suppliers.

In terms of the dispersion of FDI, services-related FDI flows accounted for 61.0% of total inflows in 2006, while manufacturing and agriculture accounted for the remaining 38.9% and 0.1%, respectively (Table 8.7). Of this, the T&C industry continues to be an important destination for manufacturing FDI, accounting for nearly 40% of total manufacturing FDI during 1995–2000 and around 36% of total manufacturing FDI during 2001–2006 (Table 8.8). Nonetheless, there has been a noticeable increase in the number of foreign firms in other labor-intensive activities, such as footwear, travel goods, plastic products, gems and jewelry, rubber-based products, and ceramics. There has also been an increase in the processing of primary products, such as rubber and ceramics, which were previously exported in largely raw material form. Overall, a significant amount of FDI came in to exploit the low labor cost advantages of the country and to

[6] The relative contribution of net FDI inflows to private sector fixed capital formation increased from 0.1% during 1970–1977 to 5% during 1978–1989 (Athukorala 2006).

Table 8.7: Distribution of FDI by Sector, 1995–2006
($ million)

Year	Sector			Total
	Manufacturing	Services	Agriculture	
1995	61.3	39.5	16.7	117.5
1996	40.5	146.6	16.7	203.8
1997	72.4	189.8	1.8	264.0
1998	74.0	173.7	9.1	256.8
1999	62.9	211.9	3.6	278.5
2000	91.3	195.3	2.0	288.6
2001	43.1	17.2	4.0	64.3
2002	71.2	52.7	1.9	125.8
2003	38.4	165.6	9.5	213.5
2004	82.2	23.9	3.2	109.3
2005	135.3	151.3	0.4	287.2
2006	234.7	368.1	0.6	603.6

Source: Board of Investment of Sri Lanka.

use it as an export platform. Sri Lanka also attracted some home market-oriented industries that supply goods and services that were constrained primarily by high transport costs. This implies that investment liberalization attracted some FDI that competed with home-based firms in market segments such as soft drinks and fast food.

The country was not very successful in attracting FDI in assembly activities in high-tech industries. The share of manufacturing FDI in the fabricated metal products, machinery, and transport equipment segment, for example, accounted for only 10% of total manufacturing FDI in 1995–2000. Poor progress in this area has been attributed largely to the increase in political risk following the worsening of armed conflict in the mid-1980s (Athukorala 2006). In more recent years, however, FDI in assembly activities has increased to around 23% of total manufacturing FDI, with Sri Lanka becoming host to a limited number of small-scale firms engaged in electronic assembly activities.

As previously mentioned, FDI in services has been increasing progressively since the 1990s and surpassed that of manufacturing during the second half of the 1990s (Table 8.9). At present, 60% of total FDI in Sri Lanka is in services, notably in construction, energy, telecommunications, and port services. Inflows of FDI in telecommunications increased from just over 39% of total services-related FDI in 1995–2001 to over 50% in 2002–2006.

Although slightly more than half the 268 firms that were launched in 1978–1995 came from industrial countries, developing countries account for the larger share of FDI in terms of value of total investment. The Republic of Korea is by far the largest investor with 73 firms, accounting for 33% of total foreign investment during the period. Given the initial surge of FDI in T&C-related manufacturing, the dominance of East Asian economies as key sources of FDI in Sri Lanka is unsurprising. Other primary sources of FDI, besides the Republic of Korea, are Hong Kong, China; Japan; and Singapore. Even as T&C-related manufacturing FDI has slowed in recent years, other Southeast Asian economies such as Malaysia have emerged as significant investors, particularly in services. Malaysia for example, was the single largest source of FDI in 2004–2006, accounting for 27% of Sri Lanka's total. More than 90% of total Malaysian FDI in Sri Lanka has been in telecommunications.

More recently, India has also emerged as a growing source of FDI for Sri Lanka, increasing its share

Table 8.8: Distribution of FDI in Manufacturing, 1995–2006

Sector	1995–2000			2001			2002			2003			2004			2005			2006		
	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]
Food, Beverages, and Tobacco	80	31.1	7.7	7	0.4	0.9	3	0.2	0.3	6	1.3	3.4	7	22.7	27.6	18	29.4	21.7	28	34.1	14.5
T&C and Leather Products	180	160.0	39.8	46	24.9	57.8	60	13.5	19.0	19	8.8	22.9	22	19.7	24	36	47.3	35	64	103.0	44.0
Wood and Wood Products	12	7.2	1.8	—	—	—	3	16.9	23.7	—	—	—	3	0.2	0.2	2	0.9	0.7	5	4.3	1.8
Paper, Paper Products, Printing and Publishing	15	3.6	0.9	1	0.1	0.2	3	0.7	1.0	1	...	...	2	0.6	0.7	3	8.1	6.0	4	0.8	0.3
Chemical, Petroleum, Coal, Rubber and Plastic Products	75	40.6	10.1	10	7.9	18.3	12	1.9	2.7	9	3.7	9.6	13	15.2	18.5	22	20.1	14.9	32	43.1	18.4
Nonmetallic Mineral Products	41	35.7	8.9	3	2.3	5.3	10	8.5	11.9	4	3.4	8.9	4	2.3	2.8	15	5.9	4.4	8	5.2	2.2
Fabricated Metal Products, Machinery, and Transport Equipment	25	55.5	13.8	8	5.4	12.5	19	22.6	31.7	10	8.3	21.6	11	15.1	18.4	19	15.3	11.3	20	14.1	6.0
Other Manufactured Products	109	68.4	17.0	8	2.1	4.9	7	6.9	9.7	17	12.9	33.6	10	6.4	7.8	11	8.2	6.1	46	29.5	12.6
Total	**537**	**402.4**	**100**	**83**	**43.1**	**100**	**117**	**71.2**	**100**	**66**	**38.4**	**100**	**72**	**82.2**	**100**	**126**	**135**	**100**	**207**	**235**	**100**

... = negligible, — = data not available.

[a] $ million.
[b] Value as a share of total FDI.

Source: Board of Investment of Sri Lanka.

Table 8.9: Distribution of FDI in Services, 1995–2006

Sector	1995–2001			2002			2003			2004			2005[c]			2006[c]		
	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]
Housing Property Dev't. and Shop Office Complex	48	194.0	20.0	4	0.7	1.3	6	22.0	14	1	1.4	5.9	16	13.0	8.9	35	56.0	15.0
Container Service Warehousing and Freight Forwarding	23	13.0	1.3	6	3.7	7.0	3	0.2	0.1	1	...	...	2	0.3	0.2			
Computer S/W Dev't. and Data Entry Operations	50	15.0	1.5	11	2.3	4.4	9	4.5	2.7	7	4.0	17.0	13	2.1	1.4			
Hotels, Restaurant Service and Entertainment Complex	53	21.0	2.2	5	0.1	0.2	6	6.5	3.9	6	4.0	17.0	10	2.4	1.6	22	5.5	1.5
Hospital Service and Medical Centers	5	0.5	0.1	2	7.2	14.0	1	1.0	0.6	1	...	...						
Educational Training Institutions and Research	40	3.9	0.4	11	0.5	0.9	5	0.4	0.2	1	...	...						
Management Consultancy	2	...	...	—	—	—	—	—	—	1	...	...						
Trading Houses/ Buying Houses	20	6.0	0.6	1	0.3	0.6	3	0.4	0.2	4	1.0	4.2						
Telephone, TV, and Radio Communications Network	19	384.0	39.0	3	3.7	7.0	2	2.6	1.6	1	2.0	8.4	5	112	74.0	12	263.0	72.0
Gar. Washing/Processing Plant, Screen Printing	25	5.6	0.6	6	0.7	1.3	8	1.4	0.8	2	2.0	8.4						
Power	14	119.0	12.0	8	29.0	55.0	4	79.0	48.0	4	0.7	2.9	4	16	10.0	9	7.8	2.1
Port	—	—	—	—	—	—	—	—	—	—	—	—						
Others	33	212.0	22.0	7	4.6	8.7	9	48.0	29.0	9	8.8	37.0	19	5.7	3.8	84	36.0	9.7
Total	**332**	**974**	**100**	**64**	**53**	**100**	**56**	**166**	**100**	**38**	**24**	**100**	**69**	**151**	**100**	**162**	**368**	**100**

... = negligible, — = data not available.

[a] $ million.
[b] Value as a share of total FDI.
[c] Data are available only for major sectors.

Source: Board of Investment of Sri Lanka.

Table 8.10: Source Country Profile of FDI in Sri Lanka, 1978–1995 and 2004–2006

	1978–1995			2004			2005			2006		
Source	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]	No.	Value[a]	%[b]
Malaysia	3	0.9	0.2	3	39.9	17.0	8	99.6	34.7	9	164.7	27.3
Luxembourg	16	6.0	1.4	2	13.2	5.6	4	17.3	6.0	3	54.0	8.9
Sweden	10	9.1	2.1	3	1.8	0.8	6	10.1	3.5	10	49.9	8.3
Hong Kong, China	47	50.8	11.9	9	9.7	4.1	12	15.5	5.4	27	46.2	7.7
United Kingdom	20	5.9	1.4	20	44.1	18.8	34	26.4	9.2	11	40.4	6.7
Japan	41	49.6	11.6	6	2.6	1.1	14	4.1	1.4	28	38.6	6.4
United States	21	4.8	1.1	7	1.1	0.5	16	12.8	4.5	40	35.5	5.9
Singapore	13	27.3	6.4	9	8.2	3.5	12	30.6	10.7	20	29.6	4.9
India	10	5.2	1.2	21	17.7	7.6	19	17.9	6.2	31	27.1	4.5
United Arab Emirates	0	0.0	0.0	2	6.0	2.6	4	7.1	2.5	11	20.0	3.3
Italy	0	0.0	0.0	3	1.2	0.5	5	10.6	3.7	10	19.5	3.2
Netherlands	14	3.5	0.8	2	0.2	0.1	3	0.6	0.2	7	12.6	2.1
Korea, Rep. of	73	139.3	32.7	0	0.0	0.0	11	5.0	1.7	18	10.5	1.7
Belgium	0	0.0	0.0	2	1.6	0.7	2	8.4	2.9	3	8.1	1.3
Mauritius	0	0.0	0.0	0	0.0	0.0	2	4.1	1.4	8	7.4	1.2
Germany	30	29.8	7	4	0.5	0.2	8	2.1	0.7	16	5.1	0.8
Australia	14	63.8	15	6	3.9	1.7	6	3.3	1.1	13	4.5	0.7
PRC	6	2.2	0.5	2	0.3	0.1	2	0.9	0.3	6	4.4	0.7
Switzerland	6	3.0	0.7	3	50.4	21.5	4	1.5	0.5	12	4.3	0.7
Other	44	25.4	6	47	32.0	13.7	27	9.4	3.3	92	21.3	3.5
Total	**368**	**426.6**	**100**	**151**	**234.3**	**100**	**199**	**287.2**	**100**	**375**	**603.7**	**100**

[a] $ million.
[b] Value as a share of total FDI.

Source: 1978–1995 data from Athukorala and Shand (1997); 2004–2006 data from the Board of Investment of Sri Lanka.

from 1.2% during 1978–1995 to over 5.6% during 2004–2006 (Table 8.10). In terms of the number of firms, of the relative contribution to total foreign investment, and of total investment, India has historically been the largest investor among South Asian countries in Sri Lanka. At times, tense political relationships with India have discouraged more active Indian involvement in the economy. However, with a marked improvement in bilateral relations since the late 1990s, Indian investment has picked up sharply. This process has been assisted by improved economic links following the signing of a bilateral FTA between the two countries in 1998. Although the FTA was confined to trade in goods, improved business links and business confidence have undoubtedly had an impact on generating more FDI from India.

Current FDI Regime and FDI Promotion Policy

The Board of Investment of Sri Lanka (BOI) is responsible for the approval and facilitation of foreign investment throughout the country, other than for investments made by purchasing shares on the Colombo Stock Exchange or for investments in activities regulated by other statutory agencies.

Priority Sectors

While sector-specific incentives are made available by BOI to foreign investors, at present there are no specific sectors identified as priority areas to further encourage FDI participation. The current incentive structure of BOI consists of two schemes, one for

medium-sized investments and the other for large infrastructure projects. Incentives vary based on the industry subcategory, with specific incentives and qualifying criteria for each of the 14 subcategories.[7]

Labor Laws and Mobility

Historically, Sri Lanka has had active and politically influential labor unions and its labor legislation has likewise often been cited as a constraint on promoting more flexibility in labor mobility due to a plethora of investment-deterring labor laws. Foremost among these laws is the Termination of Employment of Workmen (Special Provisions) Act (TEWA) which provides that any company with more than 15 employees is prevented from making redundancies without obtaining approval from the Labor Commissioner. The provisions of TEWA tend to ensure that workers, once hired, are difficult to lay off, constraining employers from being able to restructure enterprises freely. This has also led to large informal sector employment, estimated at 40%–60% of total employment. Exempted from certain clauses of the labor legislation are firms operating in EPZs.

It has been recognized that some provisions of the TEWA must change to create an environment conducive for foreign investors, especially since the cost of labor accounts for a significant share of total costs. Some recommendations include withdrawal of the requirement for government approval of termination and establishment of a standard minimum notice period and severance payment formula across industry. However, labor reforms have remained a difficult political issue, as proven by failed initiatives that tried to introduce more flexibility.

Trade Policies and Nontariff Barriers

Sri Lanka maintains a fairly liberal trade policy regime although certain paratariffs, such as cesses and import duty surcharges, have been introduced more recently. At present, an import surcharge of 10% and a paratariff in the form of a ports and airports development levy, comprising 3% of the cost, insurance, freight value (CIF) of imports, is in force. In addition, a total of around 370 items at the HS six-digit level remain under import control for health, national security, environment protection, and other reasons. Nonetheless, given that foreign investors by and large qualify for the duty-free import of raw materials and capital goods, the adverse impacts on foreign investment is minimized. However, policy uncertainty related to ad hoc tariff changes can have unfavorable impacts on the ability of investors to plan in the long term and on investor outlook and confidence in the overall macroeconomic management of the country.

However, more serious constraints to enhancing trade are found in the general area of trade facilitation. Despite some notable efforts to, for example, improve customs procedures and the harmonization of standards, transaction costs in Sri Lanka, as in many South Asian countries, remain high by international standards. According to the Global Competitiveness Report 2004–2005 and 2006–2007, the country also ranked below the mean value for South Asia in terms of critical areas in trade facilitation (such as efficiency of customs procedures), overall infrastructure quality, railroad infrastructure development, air transport infrastructure quality, and irregular payments in export and import trade. According to the same reports, despite the overall poor ranking of Sri Lanka, it appears to be relatively better placed vis-à-vis other South Asian economies in many areas, particularly in terms of days taken for customs clearance and lead time for exports and imports (Porter et al. 2004, Porter et al. 2006). Nonetheless, the overall picture of trade facilitation procedures that emerges is that there is significant room for improvement in almost all respects, both across the region and in the domestic arena.

While attempts have been made to incorporate trade facilitation measures in several bilateral and regional trade initiatives undertaken by countries in South Asia, there has been little follow up by way of implementation. However, in terms of attracting FDI, these agreements appear to have had some success. In particular, Sri Lanka's experience suggests that

[7] Includes manufacturing of nontraditional goods, export-oriented services, manufacturing of industrial tools and equipment, small-scale infrastructure projects, information technology (IT) and IT-enabled services, regional operating headquarters, any industry with advanced technology, research and development, agriculture or agroprocessing, export trading houses, large-scale projects, establishment of industrial estates, textile/fabric manufacturing, and setting up of export houses for the rural sector.

there has been some boost in encouraging more FDI from related partner countries. According to BOI, for example, the goal is to target countries and regions that have conceded preferential market access to Sri Lanka. Of the preferential trade initiatives and FTAs, GSP and ISFTA appear to dominate. Thus the focus of BOI at present in attracting FDI is mainly directed at the US, EU, and India. While a common reason cited for targeting these economies is the size of their markets, concessions offered to Sri Lanka under the EU's GSP Plus scheme or ISFTA, for example, appear to play a significant role.

The T&C industry was expected to receive a boost from bilateral FTAs, particularly from ISFTA. Although Sri Lanka requested duty concession access for its T&C exports to the Indian market, the final agreement stipulated a tariff rate quota whereby preferential market access of 50% was granted for 8 million pieces of clothing a year, of which a minimum of 6 million pieces should contain fabric of Indian origin. Given that Sri Lanka's major sources of fabric have historically been the East Asian region, there has been very limited use of these preferences. In 2007, the tariff rate quota related to T&C was further relaxed, requiring a minimum of 5 million pieces to contain fabric of Indian origin.

Sri Lanka's T&C industry is also a major beneficiary of the GSP Plus scheme, and will receive preferences on around 7,200 products that are eligible to enter the EU duty free. However, the utilization rates of such schemes have been mixed, with that for T&C estimated at around 40% (Wijayasiri 2007). Sri Lanka wants the value-addition criteria brought down further since it lacks the domestic fabric base to meet the required criteria.

Screening, Admission, and Establishment Policies

In general, FDI approval is handled by BOI. While the procedure is automatic across a wide range of sectors, regardless of origin, commitments in some specified industries are either prohibited or above certain thresholds, subject to case-by-case approval. Nonetheless, Sri Lanka's list of restrictions remains fairly limited. The relatively liberal nature of its FDI regime is clearly evident from the fact that nearly 60% of FDI by value and 45% by number of projects have been made through wholly owned foreign enterprises (UNCTAD 2004).

Still, there is room for rationalizing the scope of FDI entry into the country. Restrictions on the entry, for example, of education establishments and air transportation appear to be somewhat arbitrary and there is too much discretionary power in granting approval on a case-by-case basis in some areas.

Fiscal and Financial Incentives

BOI has the authority to give a variety of incentives and concessions under legislation relating to inland revenue, customs, and exchange control. It offers an array of incentives both to local and foreign investors. In general, special BOI-specific incentives are targeted at export-oriented investments. While incentives are liable to change over time, typically they have taken three main forms: an initial tax holiday, often for 5 years, followed by a short period of a concessional income tax rate (e.g., 10% for 2 years) and a long-term concessional rate of, say, 15%–20% depending on the industry; zero dividend tax and dividend withholding tax during the tax holiday period and for 1 year thereafter; and import duty exemptions on capital equipment in some industries and zero duties on raw materials in export manufacturing. No country is given special treatment or better investment facilities than others.

The incentives offered for the category of "manufacturing of nontraditional goods" are applicable to both the T&C and automobile industries. The minimum capital that should be invested to qualify is $250,000 with a minimum 80% export requirement of output, while the incentive package includes a 3-year full tax holiday, a further concessionary tax holiday period, duty exceptions on imports of capital goods and raw materials, and exemptions from exchange control regulations.

The fiscal incentives-based system of attracting FDI has drawn its share of criticism. It discriminates against SMEs that may be unable to meet the minimum investment required. The most vocal criticism, however, has been that such incentives have created a tilted playing field where investors who are ineligible for such concessions face a far higher tax burden of 50%–100% (UNCTAD 2004). In addition, Sri Lanka's deteriorating revenue generation has partly been ascribed to the generous tax breaks that were offered without any compensatory revenue measures being instituted.

Performance Requirements

Minimum investment, export requirements, and employment levels are qualifying conditions that are applied in granting BOI approval. A minimum equity participation of $150,000 applies to all foreign investment projects. In most areas of manufacturing, firms are required to export at least 90% of their output. Sri Lanka notified the World Trade Organization (WTO) in 2000 that its investment regime does not stipulate local content requirements, trade balancing requirements, foreign exchange balancing requirements, exchange restrictions resulting in import restrictions, or domestic sales requirements involving restrictions on exports.

The Temporary Importation for Export Processing scheme allows producers who manufacture goods for export (or indirect export) to import inputs without payment of fiscal levies. Approval is granted by the Department of Customs. The amount of duty and tax exemption depends on the amount exported. Similarly, two other schemes based on export performance are enforced: one relating to imported material to build plants, machinery, and equipment to be used by an industry that exports a certain percentage of its output; and the other to capital and intermediate goods and to transport equipment to be used exclusively by an exporting industry.

Property Rights (including intellectual property rights)

Sri Lanka is party to the Convention on the Settlement of Investment Disputes and the United Nations Commission on International Trade Law. While it is not a party to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention), it was referred to in the Greater Colombo Economic Commission Law and has been enshrined in the Arbitration Act. Foreign arbitral awards are enforced in Sri Lanka.

In addition, Sri Lanka has instituted an Intellectual Property Right Law that is WTO compliant with a clearly defined process and product patents as well as copyright protection (WTO 2004). The country is also a signatory to several international conventions and treaties on intellectual property. However, based on the Index of Economic Freedom for 2007, it scored poorly on property rights[8] because its judiciary is influenced by other branches of government and the system is subject to extensive delays in litigation that often lead investors to pursue out-of-court settlements.

Institutions

BOI is the primary agency responsible for the approval and facilitation of foreign investment. A key objective in setting up BOI was to offer superior regulatory, tax, and administrative treatment to eligible investors, usually large investors. All other investors are subject to the general regime and to administration by line agencies, which has created a dual regime.

BOI's key contribution has been as a facilitator for new, large investors. It is considered to be playing a useful role. However, it has not been quite as successful as a magnet for FDI. While it is difficult to assess the true investment attraction performance of BOI as investors may be drawn by incentives rather than leads generated by BOI, the Board has come under some criticism. It is considered to be heavily overstaffed and too centralized in carrying out its functions although, to some extent, the nature of fiscal incentives offered to BOI companies has necessitated a large bureaucracy to approve and monitor size-based incentives.

Another criticism has been the concentration of activities in the Western Province with two districts alone there accounting for 70% of projects by number and 80% of investment by value (UNCTAD 2004). Thus efforts started in 2002 to decentralize the functions of BOI through Regional Economic Development Commissions that are spread throughout the country to pursue region-specific investment opportunities. However, there has been little progress since their establishment.

Export Processing Zones

To attract FDI, EPZs were set up with the intention of providing better infrastructure and less bureaucratic red tape. The first EPZ was established at Katunayake in 1978, close to the international airport. Since then, nine EPZs have been set up. EPZs offer vacant sites to exporting investors with utilities and central services (e.g., waste management). However, under current government policies, foreign investors are allowed to establish factories in almost any part of the country and

[8] www.heritage.org/research/features/index/country.cfm?id=SriLanka

still receive tax incentives. Foreign investment accounts for approximately 60% of total investment in the EPZs. However, about 80% of BOI firms are estimated to operate outside the EPZs (World Bank 2004). This is largely a reflection of the extension of EPZ privileges during the second wave of reforms during 1990–1991 to local investors who establish new export-oriented projects in the country. Thus, many local investors took advantage of locating their enterprises outside EPZs since many established EPZs were situated well away from the capital city and had limited access to international port and airport facilities and other infrastructure.

Despite the significant number of firms operating outside EPZs, such zones have come to account for a significant share of export earnings, estimated at over 30% of the total in 2000 compared to 8.7% in 1980 (UNCTAD 2004). This could be indicative of the fact that the larger and more established firms continue to operate in EPZs, particularly in Katunayake EPZ, widely regarded as the most successful EPZ.

Investment Treaties

Foreign investment is guaranteed by Article 157 of the Constitution, which ensures the commitments of bilateral investment protection agreements. Sri Lanka is currently a signatory to approximately 25 such agreements, covering essentially the principal home-country investors in the country. The agreements typically include national treatment, most-favored-nation treatment, arbitration (under the United Nations Commission on International Trade Law/International Center for Settlement of Investment Disputes), and guarantee against nationalization and expropriation.

Double taxation agreements with some 25 countries are also in place, aimed at reducing risks resulting from inconsistencies and overlaps between national and foreign income tax legislation. The agreements generally regulate the treatment of dividends, interest payments, and royalties.

FDI and the Economy: Potential, Impact, and Constraints

Despite the fairly limited inflows of FDI to Sri Lanka, evidence suggests a close association between the growth of manufactured exports and the share of foreign firms in the country during the postreform decades. More recently, services have been attracting the larger share of FDI, bringing in much-needed capital, technology, and managerial skills, as Sri Lanka embarked on a gradual program of opening certain infrastructure services to private operators. Employment generation directly related to FDI has been quite significant, particularly in manufacturing.

While much of Sri Lanka's FDI has originated outside South Asia in the past, some data suggest that intraregional FDI is on the rise in a range of sectors and activities. The expansion in the size of the domestic and regional market that can be serviced—as economic growth accelerates and barriers to regional trade fall—can be expected to provide additional momentum to enhance intraregional foreign investment and FDI from third countries.

Analytical Framework and Rationale

The analysis in the following sections attempts to draw on available secondary sources, primary data, and stakeholder interviews. Country- and sector-specific analysis in relation to the role of intraregional FDI is used to determine volumes and trends of intraregional FDI, particularly in the manufacturing sectors of T&C and automobiles. Interviews with key investors from South Asia operating in the T&C and automobile industries were undertaken to supplement the discussion.

The analytical framework also focuses on a stakeholder perception survey of 25 foreign investors from all sectors carried out by the Institute of Policy Studies in late 2006 with respect to Sri Lanka's trade and investment environment and relevant issues of concern to foreign investors. Existing literature, such as business climate surveys, and governance and corruption indexes, were also used in examining country reputation and linkages with FDI.

FDI Potential

The liberal nature of Sri Lanka's FDI regime and the many other comparative advantages it holds—a relatively more educated labor force and higher per capita income than other South Asian countries—should have made the country an attractive destination for most forms of FDI. However, it

Table 8.11: Trends in FDI Inflows to Sri Lanka from South Asia, 1978–1995 and 2004–2006

Country	1978–1995			2004			2005			2006		
	No. of Projects	Value[a]	%[b]	No. of Projects	Value[a]	%[b]	No. of Projects	Value[a]	%[b]	No. of Projects	Value[a]	%[b]
India	10	5.2	1.2	21	14.8	6.3	19	17.9	6.3	31	27.1	4.5
Maldives	1	0.2	…	2	0.6	0.3	2	1.0	0.4	3	1.8	0.3
Pakistan	8	3.6	0.8	1	0.4	0.2	1	0.2	0.1	5	1.1	0.2
Bangladesh	—	—	—	1	…		—	—	—	2	0.2	…
From SAARC Countries	**19**	**9.0**	**2.1**	**25**	**15.7**	**6.7**	**22**	**19.0**	**6.7**	**41**	**30.2**	**5.0**
Total	**368**	**426.6**		**151**	**234.3**		**199**	**284.2**		**375**	**603.7**	

… = negligible, — = data not available, SAARC = South Asian Association for Regional Cooperation.

[a] $ million.
[b] Percentage share of total FDI in Sri Lanka.

Sources: 1978–1995 data from Athukorala and Shand (1997); 2004–2006 data from the Board of Investment of Sri Lanka.

seems that the worsening security situation from the mid-1980s prevented a more positive response. Nonetheless, even with a moderate inflow of FDI, there have been some significant developments in both manufacturing and services.

Intraregional FDI has tended to play only a small part in the economy in the past. Total FDI from South Asian countries lagged significantly, at only 2.1% of cumulative investment received by Sri Lanka during 1978–1995, of which FDI from India alone accounted for more than half (Table 8.11). However, despite the fact that extraregional FDI has been far more important than intraregional investments, there are signs that the latter are increasing, as seen in a substantial increase in FDI from South Asia primarily India, in recent years. Part of the reason for the increase from India undoubtedly lies with the increased shift to closer economic linkages, primarily through various bilateral and regional preferential trade initiatives. While there is evidence to suggest that firms from other South Asian countries are also increasingly undertaking FDI in Sri Lanka in a range of sectors and activities, in volume terms their FDI remains negligible. Available data for 2004–2006 indicate that the share of FDI from South Asia in the total rose to an average of 5.8%.

Within South Asia, India and Pakistan are growing sources of cumulative FDI inflows.[9] Sri Lanka appears to be the preferred country within South Asia for Indian investors, with more than half India's joint ventures in South Asia estimated to be located in Sri Lanka. BOI expects that India will become the second-largest source of FDI within the next couple of years in view of investments due to be realized.

The recent surge of Indian FDI in Sri Lanka can largely be attributed to the marked improvement in bilateral relations between the two countries since the late 1990s. Relatively lower operational costs and ability to reexport to India while enjoying duty concessions on raw materials have also become major attractions for Indian companies to set up operations in Sri Lanka.

The scale of expansion of Indian investment from the mid-1990s is clear (Table 8.12). Indian investors were involved in 18 projects in 1999. By 2006, the number had risen to 83, with the most significant expansion seen in services. In fact, as of 2006, over 71% of total Indian FDI in Sri Lanka was in services-related activities. Indian FDI in manufacturing has been mainly in steel, cement, rubber products, T&C, food products, automobile components, electrical equipment, chemicals, and printing. While investment in food and beverages accounted for nearly 77% of total Indian FDI in manufacturing in the late 1990s, this share dropped to 42% by 2006. A key area of Indian manufacturing FDI more recently has been in the fabricated metal products, machinery, and transport

[9] FDI from other South Asian countries is negligible in terms of value and contribution to the Sri Lankan economy. Thus the discussion focuses on India and Pakistan.

Table 8.12: Estimated Investment from India in Sri Lanka, 1999 and 2006

Sector	End-1999 No. of Projects	End-1999 Investment (SLRs million)[a]	End-1999 %[b]	End-2006 No. of Projects	End-2006 Investment (SLRs million)[a]	End-2006 %[b]
Food, Beverages, and Tobacco	2	621.3	67.8	6	2,654.1	12.0
Textiles and Clothing, and Leather Products	2	24.9	2.7	4	545.3	2.5
Wood and Wood Products	1	1.6	0.2	3	99.1	0.4
Paper and Paper Products	1	7.4	0.8	1	32.0	0.1
Chemical, Petroleum, Rubber and Plastic Products	4	134.1	14.6	9	427.4	1.9
Nonmetallic Mineral Products	1	10.0	1.1	7	432.2	2.0
Fabricated Metal Products, Machinery and Transport Equipment				17	1,567.8	7.1
Manufactured Products, n.e.s.				6	621.9	2.8
Services	7	116.7	12.7	30	15,675.9	71.1
Total	**18**	**916**		**83**	**22,055.7**	

n.e.s. = not elsewhere specified.

[a] Data made available from the Board of Investment of Sri Lanka is cumulative in nature and does not permit conversion to dollars on an annual basis.

[b] Sector share of total FDI from India.

Sources: 1999 data from Jayasuriya and Weerakoon (2001) based on information from the Board of Investment of Sri Lanka; 2006 data from the Board of Investment of Sri Lanka.

equipment segment, where the share has increased to 25%. In services, the principal areas of activity are tourism, computer software, advertising, and financial and nonfinancial services.

According to Kelegama and Mukherji (2007), Indian manufacturing projects are currently operating in Sri Lanka as a result of investment driven by the bilateral FTA. During the post-ISFTA period, there has been a sharp upturn in trade, particularly in exports from Sri Lanka to India. Much of the increase in exports has originated from a handful of export items, notably vegetable oil and copper-related products. Since ISFTA granted to Sri Lanka significant duty concessions on such items, it provided an impetus for Indian companies to establish their business enterprises in Sri Lanka, to exploit the benefits of preferential entry of products made there and exported to India.

Textiles and Clothing

Indian FDI in the T&C industry has seen fairly limited expansion. From 3% of all manufacturing FDI by the late 1990s, FDI in T&C crept up to just over 8% of total manufacturing FDI by 2006. The number of establishments operating in the industry increased from only two to four over the same period. Thus there has been only limited interest on the part of Indian business partners to invest in the T&C industry in Sri Lanka despite preferential access granted to T&C exports from Sri Lanka under ISFTA.

However, potential for expanding intraregional links in the T&C industry is clearly present. Sri Lanka (or Bangladesh) does not have adequate domestic textile production capacity to meet the rapid increase in demand for textiles for clothing production. In contrast, India and Pakistan are both large producers of textiles. The growth of clothing exports from the region and the existence of established fabric production industries in India and Pakistan not only provide avenues for potential increases in intraregional trade, they also present new investment opportunities for both domestic and foreign investors. Closer intraregional trade links, facilitated by any further preferential treatment for regional suppliers of fabrics or other reductions in intraregional trade costs,

have considerable potential for expansion in the context of the textiles–clothing industry nexus. In addition, "artificial" fostering of backward linkages by nurturing an inefficient protected fabric industry can be detrimental to the general growth of the dynamic clothing sector.

Automobiles

The machinery and transport equipment sector has seen far more Indian involvement than T&C in recent years. The automobile industry in Sri Lanka has been confined to producing automobile components for motor vehicles given the limited domestic capacity in manufacturing finished motor vehicles with high-tech manufacturing requirements. The industry consists of several import-oriented automobile part industries and distributors while only a few local companies with external collaboration are currently operating in the market in manufacturing and assembly of automobiles. Sri Lanka, a net exporter of natural rubber, has been seeking greater access to the protected but growing Indian market, but with little success. On the other hand, increased penetration of the transport equipment market by India has seen a large influx of Indian-made vehicles, such as the "three wheelers" dominated by Bajaj vehicles, creating opportunities for firms to supply rubber products, such as tires.

To the extent that further liberalization or preferential measures may ease Sri Lanka's access to Indian rubber and rubber goods markets, there is clearly a developing opportunity for export-oriented investments in Sri Lanka that can target the Indian market. ISFTA has also given a boost by creating investment opportunities for Indian automobile manufacturer to set up plants in Sri Lanka to produce intermediate automobile parts for the fast-growing Indian automobile industry. The availability of relatively cheap labor and raw materials—in particular, high-quality natural rubber supplies—is one of the main factors that have accelerated the motivation of Indian automobile investors to set up plants in Sri Lanka.

Table 8.13 shows the distribution of concessions granted by the respective countries for the T&C and automobile-

Table 8.13: Restrictions and Concessions Granted for T&C and Transport Equipment under Trade Initiatives

		ISFTA		PSFTA		SAFTA		
Concession	**Sector**	**India**	**Sri Lanka**	**Pakistan**	**Sri Lanka**	**India**	**Pakistan**	**Sri Lanka**
Negative List	Textiles and Clothing[a]	60	20	190	16	302	293	20
	Transport Equipment[b]	n.a.	42	27	40	4	73	37
	Total[c]	**199[d]**	**1,220**	**540**	**697**	**886**	**1,184**	**1,066**
Zero Duty	Textiles and Clothing	n.a.	n.a.	48	2	n.a.	n.a.	n.a.
	Transport Equipment	134	n.a.	4	5	n.a.	n.a.	n.a.
	Total	**4,233**	**1,225**	**206**	**102**			
TRQ and MOP	Textiles and Clothing	788	n.a.	21	n.a.	n.a.	n.a.	n.a.

ISFTA = India–Sri Lanka Free Trade Agreement, MOP = margin of preference, n.a. = no applicable information, PSFTA = Pakistan–Sri Lanka Free Trade Agreement, SAFTA = South Asian Free Trade Area, TRQ = tariff rate quota.

[a] Including all tariff lines at six-digit HS level under chapters 50–63.
[b] Including all tariff lines at six-digit HS level under chapters 86–89.
[c] Revised negative list of items since implementation.
[d] Excluding 50% margin of preference concessions.

Sources: Respective agreements.

related sectors under different trade agreements to which Sri Lanka is a party at present. It is clear that ISFTA, more so than the Pakistan–Sri Lanka Free Trade Agreement and the SAFTA, has been relatively more open to Sri Lanka in terms of concessions on T&C and the automobile industries. The number of items restricted under the negative list of India is smaller in the bilateral FTA than that in the regional SAFTA treaty. Conversely, the tariff restrictions of Sri Lanka on the T&C and automobile industries are consistent in the three agreements in terms of the number of tariff lines placed under the respective negative list.

According to a detailed analysis of Sri Lanka's traded exports under ISFTA, T&C exports to India under tariff rate quotas and margins of preference recorded a notable increase from $3.5 million in 2000 to $18.4 million in 2006. However, despite the growth in export earnings of items offered a margin of preference, there has also been an increase in exports of T&C items subject to the negative list treatment as well. In absolute terms, the total value of T&C exports on the negative list increased from $0.4 million in 2002 to $0.9 million in 2006. As a share of the total value of exports of items on the negative list, it increased from 1% in 2002 to 5.6% in 2006, indicating the significance of the sector. Thus the trend in overall T&C exports to India suggests rising trade that is spurred to a large extent by preferential treatment.

In the automobile industry, no tariff line related to automobile components is subject to India's negative list. As a share of the total value of the zero-duty list of items, Sri Lanka's exports of transport equipment enjoying zero-duty concessions from India increased from 0.5% in 2001 to 1.6% in 2006. The bulk of this export growth came from Indian ventures established in Sri Lanka producing intermediate automobile parts for the fast-growing Indian automobile industry.

Sri Lanka's tariff liberalization commitments are yet to be completed and the full impact of these commitments will be experienced only after the complete implementation of ISFTA in 2008. Subsequent to that, India's export presence in the country is expected to improve significantly and thereby heighten competition from cheaper Indian imports in the Sri Lankan market.

Economic and Social Benefits

As in many other developing countries, the economic and social impacts of FDI in Sri Lanka are mainly visible through the channels of, for example, export expansion, foreign exchange earnings, and technological spillover. Even though the most effective method of assessing the economic benefits should be carried out using a conventional cost-benefit analysis, given the lack of data, the present analysis is mostly confined to existing literature.

Technology Spillovers

There is little technology transfer associated with FDI inflows into the clothing sector, although there is the possibility of some degree of managerial skills transfer. FDI inflows into more skill-intensive industries, such as the manufacture of automobiles and consumer goods, can bring in new technology. If such foreign firms are more capital intensive, employment levels may fall in the short term, but in the longer term technology-driven productivity enhancement may confer wider benefits on the host economy. The somewhat higher share of FDI flows more recently to technology-intensive sectors, such as basic engineering and chemicals and pharmaceuticals, can be expected to generate some positive spillovers.

Although rigorous quantitative assessments have not been done on the subject, available evidence suggests that there may be important technological spillovers related to FDI in Sri Lanka. Foreign market information and exposure to international markets gained through joint ventures may have inevitably contributed to the export success of local firms. Supporting evidence of such trends is provided by Lall and Wignaraja (1992),[10] based on case studies of management practices of selected foreign firms in the clothing industry where significant externalities arising from on-the-job training of local middle-level management were found. Anecdotal evidence from firms in the porcelain and cement industries also suggests that multinational companies with FDI, such as Unilever, have had positive managerial spillovers in the country and appear to have contributed to the transfer of marketing technologies (UNCTAD 2004). In the services sector, the participation of Indian health

[10] Cited in Athukorala and Rajapatirana (2000).

care providers, such as the Apollo Group of Hospitals operating in Sri Lanka, may also have led to substantial health care technology transfer in the industry.

Nevertheless, it has been argued that export-oriented foreign firms have failed to develop significant backward linkages with domestic industries. This is largely due to high-quality export requirements faced by these companies in the international markets, which are not necessarily found in Sri Lanka. Moreover, parent companies preserve their technologies from international mobility by not opening certain high-skilled sectors of an industry to domestic personnel. In addition, FDI in Sri Lanka is mostly found in labor-intensive industries where technology requirements are not high. More particularly in the case of clothing, many of the companies apply universally available technologies. Even in the electronics industry where FDI operates, the assembly activities transferred to Sri Lanka are in labor-intensive processes (Athukorala and Rajapatirana 2000).

Interviews with staff of automobile parts companies that have Indian investment reveal that managerial, design, technology, and marketing capacities appear to be under the control of the parent company and are sourced from India, while high-tech skilled sectors are occupied by foreign professionals. A key reason for such practices appears to be primarily the lack of such capacity in Sri Lanka. Nonetheless, it is clear that technological spillovers are almost nonexistent, though some backward linkages with domestic industries are found in the case of the automobile industry.

Trade and Investment Effects

As previously mentioned, the initial inflow of FDI to Sri Lanka came into manufacturing, dominated heavily by a concentration in the T&C industry. While such FDI was driven in part by the fact that the country had access to major quota-restricted markets under the MFA, the shift to a more liberal economic policy environment also played a key role. This is substantiated by the fact that prior to the liberalization of the economy, there was only very limited FDI in the T&C industry despite the fact that the country had unused quotas for T&C exports. Abundance of low-cost labor was another key ingredient in attracting FDI into T&C. Thus "quota-hopping" foreign investors, particularly from East Asian economies, were attracted to Sri Lanka to set up FDI ventures. This is clearly evident from the predominance of foreign firms in the T&C industry from economies such as Hong Kong, China in the early years.

In turn, there was a significant structural transformation in the export basket, as the economy moved from predominantly agriculture-based exports to manufacturing. The share of exports of industry, which accounted for just 15% of total export earnings in 1978, contributed more than 75% of total exports by the mid-1990s. T&C exports alone accounted for more than half Sri Lanka's export earnings by the mid-1990s from a negligible share of under 4% at the beginning of the liberalization episode in 1977–1978.

The initial stimulus from foreign investors was important in attracting subsequent foreign investment as well as in providing an environment where domestic firms could become involved in the T&C industry. In particular, its potential became highlighted, international buying groups were attracted to the country, and domestic firms found that they could also obtain market access through these buying groups. There is evidence that foreign firms generated considerable positive spillover effects on domestic firms (Athukorala 1995).

The development of the T&C industry highlights some of the dynamics of trade and investment in the context of trade and investment liberalization. The initial stimulus for growth in countries such as Sri Lanka came from foreign investors outside South Asia who were attracted by the more open trade and investment policies that allowed them to combine their firm-specific advantages, such as technology, experience, and market links, with the countries' cheap labor. They also considered the privileged access to lucrative developed-country markets. Initially, the industry had few backward linkages, either within the country or the region. This was in some ways an advantage since it meant that the industry could expand output and exports (and employment) massively without being constrained by domestic supply bottlenecks (Athukorala 1995). Subsequently, the industry has attracted domestic investors, who have profited from the entry of buyer groups and skill formation.

Country Reputation and Linkages

It is argued that the rapid expansion of FDI into Sri Lanka's fledgling T&C industry in the immediate postreform period enabled local firms to successfully expand exports of clothing as a direct benefit of the market links established through their dealings with foreign firms (Athukorala 2006). The rapid expansion of East Asian clothing exporters operating in Sri Lanka with already established foreign markets was a key contributor in this regard. Thereafter, it had a knock-on effect in attracting FDI into the T&C industry from other regions, such as investment from the United Kingdom into subsidiary companies. Thus the presence of foreign firms generated significant spillover effects on the export success of local exporting firms.

A direct result of such developments was also that the Sri Lankan economy became more closely integrated with East Asian economies as an important source of FDI and imports, particularly of intermediate inputs into the local T&C industry, while it became interlinked with markets in North America and Europe as export destinations for the bulk of the country's merchandise goods. Nonetheless, the benefits of enhancing the country's reputation as an emerging economy with potential for rapid economic development via an export-led (and FDI-led) phenomenon have remained limited. Sri Lanka was largely unable to capitalize on its early performance in generating a rapid increase in FDI following the onset of strife in the country in the mid-1980s. The net outcome is that FDI inflows have stagnated due to the prolonged political uncertainty. So, where economic prospects are perceived to have dimmed because of political factors, as in Sri Lanka, a country's attractiveness as an investment destination falls, despite a favorable policy regime.

Foreign Exchange Gap

Despite the recognized need to raise Sri Lanka's investment rate from the current level of 28%–30% of GDP to around 35% of GDP in the medium term, domestic financial constraints have been a key limiting factor preventing a higher rate of investment. In view of relatively low levels of domestic savings, efforts to encourage more FDI into the country have been recognized as one means of bridging the resource shortfall. On the external front, Sri Lanka's balance of payments has also tended to come under persistent pressure. While a growing trade imbalance has been offset by higher inflows of migrant remittances, the country has witnessed a sharp deterioration in its current account.

Private and worker remittances are an important source of foreign exchange earnings for Sri Lanka. They became the second-largest source of export earnings from the early 1990s (after gross earnings from clothing), overtaking tea as a key source of export earnings. Remittance inflows accounted for nearly 8.6% of GDP in 2006 ($2.3 billion), far above that of average FDI inflows of 1.0%–1.5% of GDP. In comparison to remittances therefore, the role of FDI in bridging the foreign exchange gap has been limited. The volume of FDI into the country has been relatively small, averaging around $200 million–$250 million a year. This is in sharp contrast to the country's high dependence on inflows of migrant remittances. Nonetheless, FDI has generated indirect foreign exchange support via the country's earnings from exports of merchandise trade in goods and services.

Employment Generation

While it is increasingly recognized that trade and investment liberalization complement each other, there is also concern about the economic role of FDI in developing countries. While FDI may contribute to growth there, such benefits may not always be equally distributed. The distribution of gains from FDI is also linked to some degree to the sectors in which FDI is directed. In the case of Sri Lanka, vertical FDI dominated manufacturing in taking advantage of abundant and relatively cheap labor. The leading sector for FDI has been T&C, typically employing unskilled female labor. The T&C industry was a dominant source of employment generation, providing employment to over 5% of the total labor force, and one third of total manufacturing labor employment. Of this, 87% of employment in clothing is female. Thus the clothing industry, driven by inward FDI, was a significant source of new employment opportunities for young female labor.

Risks and Negative Effects

Conversely, liberalization had a severe impact on the domestic textile sector with a significant corresponding loss of employment. Prior to liberalization, the sector was estimated to employ

150,000 people, falling to 25,000 by the end of the 1980s (Ministry of Handloom and Textiles 1991). So, while new employment opportunities were created, they were accompanied by significant displacement of employment in import-competing industries.

If FDI inflows represent additional investment, they should provide employment. However, FDI inflows are increasingly for mergers and acquisitions, attracted by the trend toward privatization of public utilities and other state-owned enterprises. Such FDI inflows may not necessarily increase employment.

In addition, such FDI inflows can lead to increased market concentration in some sectors. In the case of Sri Lanka, the privatization process of state-owned enterprises has seen monopoly status conferred on multinationals for an agreed period of time as an inducement to attract such investors. For instance, a large multinational was granted a monopoly for 5 years with the privatization of Sri Lanka's state-owned gas company. Such deals have often been driven by the need to attract greater inflows of FDI for domestic fiscal purposes rather than imperatives associated with improving efficiency. Lack of transparency in such negotiations has perpetuated a degree of unease and contributed toward instilling a negative perception of multinational-driven FDI in some quarters of Sri Lankan society, reinforcing historical hostility to foreign investment.

Constraints

Despite better economic performance in some aspects with regard to the cost of doing business and generous fiscal incentives offered under its liberal FDI regime, Sri Lanka has not been entirely successful in attracting FDI. Foreign investors take into account a much broader set of factors that affect the growth of their operations, such as market size, production and labor costs, financial and economic stability, tax regime, transparency, infrastructure, political and social stability, and highly educated workforce, before taking investment decisions. Sri Lanka performs poorly on some of these factors, including political stability, continuity of policy regimes, economic certainty, quality of infrastructure, and labor regulations. For example, results of a stakeholder perception survey of 25 foreign investors showed that an overwhelming majority (80% of respondents) claimed that government efforts to reduce trade policy uncertainty and to increase trade policy predictability need improvement (Jayawardhana 2007).

Efforts to reduce the compliance costs of customs, regulatory and administrative procedures at the border were likewise identified as further areas where reforms are needed. Even though the majority of firms interviewed in the T&C industry maintained that existing government policies did not place any barriers to investing in Sri Lanka, investors in services felt that existing policies could be improved. Other factors specifically mentioned by investors as hurting the investment climate included policy inconsistency, especially with regard to trade policies, as well as inefficiency in institutional arrangements, particularly those related to BOI procedures.

In addition, the country continues to suffer from constraints, such as in the provision of trade facilitation measures and infrastructure services. Sri Lanka ranked number 89 in the world and 4 in the region behind Maldives, Pakistan, and Bangladesh in 2006, in that order, in terms of the ease of doing business (World Bank 2006). According to the report, Sri Lanka performs comparatively well in business start-up and closing, dealing with licenses, and trading across borders among South Asian economies, but lags far behind fast-growing economies in the rest of Asia. It stands at a better position among South Asian countries on number of procedures and cost of enforcement, while the respective performances are also comparable with Organisation for Economic Co-operation and Development averages as well.

Sri Lanka is at a relatively better position among South Asian countries and other countries with similar income levels in terms of its level of governance, where it outperforms other countries in the region on almost all six composite indexes,[11] except for political stability (World Bank 2005). The country has managed to reduce bureaucratic obstacles by a significant margin. Corruption is not perceived as a major investment constraint, although it does exist to a certain extent.

[11] Includes control of corruption, rule of law, regulatory quality, government effectiveness, political stability, and voice accountability.

In terms of business infrastructure, Sri Lanka's ports and procedures are more efficient and competitive than those of its competitors, such as India and other South Asian countries (World Bank 2005). This is largely the result of reforms introduced in the 1990s that allowed the private sector to operate a new terminal at Colombo port and enhance competition. Efficient port and customs are particularly important for the Sri Lankan clothing sector given its heavy dependence on imported inputs. However, there is scope for improvement, especially in import clearance and procedural matters, where standards are behind those in India.

Improvements to existing infrastructure and the maintenance of transport, telecommunications, and power generation infrastructure are other key areas requiring attention. According to the World Bank (2005), poor infrastructure and limited investment-related services pose as investment obstacles. In particular, access to regular and cost-effective electricity supply has been identified as the most serious impediment to investment and doing business in Sri Lanka.

Policy Recommendations

Although trade and investment links in the South Asian region are still rather limited, they indicate both the potential and the manner in which future developments will occur in a more liberal trading and investment environment in the region. The following are policy recommendations for achieving the full potential of intraregional investment.

Based on the review of the data on emerging trends of intraregional investment, policy recommendations can be geared to addressing constraints and risks specific to the country as well as those that are specific to particular sectors of importance (i.e., the T&C and automobile industries).

General

The degree to which FDI is attracted to Sri Lanka has been primarily affected by overall liberalization policies, in particular, the degree to which trade liberalization has been accompanied by domestic market reforms, the liberalization of FDI regulations, and the development of a more FDI-friendly policy stance, as well as the growth dynamics of the country overall. The more liberal policies have attracted export-oriented industries that exploit comparative advantage in labor and specific natural resources. The primary obstacle to encouraging more FDI is tied to the country's economic prospects, which have dimmed for political reasons. Consequently, settlement of the country's internal conflict must remain a priority.

Although the FDI regime is liberal, there is room for improvement in the approval and implementation process. Despite the "automatic" approval process in most areas of activity, investors face delays in implementation resulting from bottlenecks in land acquisition, and delays in the legal process, etc. Such bureaucratic red tape can often be a disincentive for foreign investors.

Sector Specific

Prospects for encouraging FDI in several services sectors also remain constrained by regulatory requirements. The development of sectors such as education where India, for example, is becoming an increasingly important "exporter" to regional markets is a phenomenon still in its infancy. Lifting exchange rate restrictions and allowing the participation of private education suppliers has encouraged expansion of such linkages. This has the potential to gather greater momentum, although the degree to which this will occur will depend greatly on domestic educational policies. Sri Lanka's current regulatory policy on FDI in educational services, for example, restricts direct FDI participation in the provision of institutions awarding degrees. Attention needs to be paid to a systematic evaluation of existing regulatory restrictions on FDI.

Overall infrastructure services provided for investors constitute a critical constraint. In particular, inadequacies in energy have been highlighted repeatedly as a major bottleneck. Lack of road access is another area of concern. While investment in infrastructure is receiving government attention as a priority issue, fiscal constraints have ensured that such investment remains fairly limited. Improving domestic infrastructure services has to remain a top priority in the medium to long term.

Sri Lanka has been less successful in attracting FDI into assembly activities in high-tech industries. This is despite a clear comparative advantage that the country has in

its skilled labor force. Vertical FDI of this nature will be encouraged wherever there are scale economies and different country-specific locational advantages in the production of different segments of the value chain. The major constraining factor has been heightened political risk as a result of the armed conflict. This type of investment will typically require that there is no disruption in the production chain, making it sensitive to potentially risky investment destinations. Sri Lanka has been successful only in integrating ancillary production activities, as illustrated by its tire manufacturing. Clearly, ensuring some degree of political stability will be critical for the country to attract investors with a long-term horizon into assembly-related FDI activities.

Nonetheless, current patterns of investment do indicate significant potential for the country to integrate with the rapidly growing automobile manufacturing industry in South Asia. There is anecdotal evidence from the firm level that suggests that trade agreements granting preferential market access have played a key role in stimulating intraregional investment.

In the case of T&C, while the industry appears to be well placed to face the quota-free trading environment, competition for market access is expected to intensify. The accession of Viet Nam to WTO in November 2006 and the removal of quotas imposed by the US on T&C exports from Viet Nam was one such factor. A more critical development, and one likely to impose tougher competition for smaller garment-producing countries such as Sri Lanka, was the 2008 removal of restrictions by the EU and US on the exports of the People's Republic of China. These restrictions have so far acted as a buffer against the full impact of the phase out of quotas and that country's ability to dominate as a result.

Toward meeting the challenges of the quota-free environment, Sri Lanka's clothing industry has already undertaken several initiatives, including setting up fabric mills and manufacturing accessories to improve the industry's backward linkages and embarking on a branding campaign under the slogan of "Garments without Guilt" to highlight the relatively good labor conditions in the country. The Government has also extended various fiscal incentives as a means of helping the industry withstand competition in international markets. With Sri Lanka's GSP Plus arrangement up for review in 2008, efforts to ensure compliance with international labor standards remain a key priority. Preferential access in such a highly competitive sector can grant countries some degree of advantage over their competitors.

Improving turnaround time and accessing new markets for its T&C industry are other means of ensuring the continued growth of clothing exports. In this respect, bilateral and regional trade initiatives can be used to support the growth of the industry.

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CHAPTER 9

Country and Regional Policies and Initiatives For Greater Intraregional Trade and Investment

This chapter summarizes the various recommendations in the industry study on textiles and clothing, and in the country investment studies of Bangladesh, India, Nepal, and Sri Lanka. The analysis points to the need for reforms at both the country and regional levels. Indeed, efforts are required in several key areas, such as infrastructure, trade facilitation (including reduction of trade barriers and harmonization), governance and effective implementation, and confidence building. The South Asian Free Trade Area (SAFTA) should also be broadened to include investment and services. All these measures are expected to contribute to strengthening intraregional trade and investment, as well as economic ties in the region.

Summary of Country and Regionwide Recommendations

The South Asian Association for Regional Cooperation (SAARC) adopted a preferential trade agreement (SAARC Preferential Trading Arrangement) in 1993 and a free trade agreement (SAFTA) in 2004, which became operative in 2006. However, even as reforms and agreements toward freer and preferential trade have been initiated, advances and impacts have been much too feeble. One reason for this may be the members' long negative lists, which include the region's major trading goods. The lists override any preferential and free trade agreement, making them powerless to increase regional trade. Thus intraregional trade and investment flows among SAARC countries continue to be meager. The lack of adequate infrastructure, physical, financial and institutional, is another major roadblock.

To address the constraints, SAARC has identified the needs and endeavors in the following areas:

- to study and make recommendations on the early and eventual realization of a South Asian Economic Union and the concept of a South Asian Development Bank;
- to develop regional and subregional energy resources, particularly hydropower, grid connectivity, and gas pipelines;
- to implement the proposals of the SAARC Regional Multimodal Transport Study toward an efficient multimodal transport system in the region;
- to address the major barriers hindering effective trade liberalization, in particular, the revision of sensitive lists by the SAFTA Ministerial Council and improvement of trade facilitation in terms of mutual recognition of standards, adoption of common tariff nomenclatures, harmonization of custom procedures;
- to develop communication and transport infrastructure and transit facilities, especially for landlocked countries;
- to negotiate the Framework Agreement on Trade in Services under SAFTA; and

- to finalize the agreement on investment promotion and protection.

The pinnacle of an economically integrated South Asia with the fruition of mutual interests and cooperation is still a long way ahead, but SAARC has laid the groundwork for its realization to be possible, and for obstacles to be overcome.

Table 9.1 summarizes the recommendations to be implemented by each country, by all countries, or by the region collectively.

Table 9.1: Summary of Country and Regionwide Recommendations

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
Textiles and Clothing Industry					
i. The years of conflict within the region, the high costs of regional trade with myriad tariffs and NTB costs, and local production inefficiencies make the dynamics of regional cooperation unworkable. Thus, despite the clear differences in specialization among South Asian countries, there is very little intraregional trade. The complementarity of production structures—with India and Pakistan specializing more on textiles and fabrics, and Bangladesh and Sri Lanka mainly exporting clothing—is not being taken advantage of by these four countries.	a. To secure intraregional FDI from countries like India and Pakistan, Bangladesh should target high-end products of the T&C market, such as high-value textiles and accessories, where it has shown strong capacity and comparative advantage. b. Bangladesh has a unique potential in exporting jute products. Foreign investors, especially from India and Pakistan, with experience in jute manufacturing should set up jute mills and export to both regional and other markets.	a. India should lower tariffs and prioritize cross-border investment in T&C.	a. Nepal should concentrate on clothing production, where it has an advantage, and should work to improve the quality of goods, minimize costs of production, and enhance productivity. b. Clothing exporters from Nepal can capitalize on the EU's Everything But Arms initiative.	a. With the removal of quotas by the US and EU on PRC T&C exports and with Sri Lanka's GSP Plus arrangement up for review in 2008, compliance with international labor standards should be prioritized. Bilateral and regional trade initiatives should also be explored to access new markets and support the T&C industry.	a. SAARC member countries should remove T&C from their negative lists. b. It is crucial for South Asian governments to make major improvements in trade facilitation, to lower and simplify tariffs, and to upgrade transport and energy infrastructure in its bid to lower production and trading costs. c. T&C can be the core export for South Asia. Coordination and integration among South Asian countries should help promote T&C exports. One avenue of cooperation that should be explored is jute, since 70% of world supply is from South Asia. d. Key turning points, such as the expiration of the US and EU safeguards on the PRC in 2008, which could potentially create demand for pan-South Asian collaboration in the T&C industry, should be identified and acted on.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
Textiles and Clothing Industry					
					e. Public and private investments should prioritize the creation and modernization of more efficient T&C marketing and distribution networks, as well as quick and cost-effective transport of locally made fabric and accessories. f. Interstate collaborative ties among the next generation of professional entrepreneurs in T&C in South Asia should be nurtured.
ii. Firms have not adequately invested in capacity expansion and new technologies. As a result, South Asia's production networks are fragmented and on a small scale with very little product diversity in the region's fiber range. There is also a virtual absence of competitively priced man-made fiber and materials.	c. Bangladesh should develop its backward linkages in T&C for it to remain competitive.	b. India should expand the manufacturing and marketing bases of its clothing sector. Through R&D and tapping new markets, innovation and export growth should be achieved. c. India and Pakistan should review their tax laws on man-made fiber.	c. The possibility of allowing FDI and technical collaboration in handmade pashmina should be seriously studied and considered by the Nepalese Government considering the need for quality improvements and market linkages for this product.		g. Since Bangladesh, India, Nepal, Pakistan, and Sri Lanka have comparative advantages in the manufacture and export of yarn, textiles, fabrics, and woven products, they should specialize in parts of the value chain where they are exhibiting their strongest advantage in terms of resource and skill endowments. Such specialization could create vertically linked regional production chains, helped by geographic proximity and a free trade environment.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
Textiles and Clothing Industry					
					Specialization will also facilitate clustering and agglomeration economies. h. Product diversification should be encouraged in part by restructuring incentives and tax structures. Textile line agencies may need to mount a serious program on product diversification and upgrading. India's Textile Technology Upgrade Fund may be developed for this purpose.
iii. Production capacities are constrained by tightness in the supply of skilled workers.		d. Deepening of skills of managers, technical personnel, and designers has to be encouraged. Labor standards should be improved and codes of conduct should be complied with.	d. Nepal can participate in the training of managers, quality control specialists, technical personnel, and designers.		i. Early multilateral investment should support regionwide training institutions, and training programs would be important. j. With the nascent development of cross-border manufacturing services and interpenetrated labor markets, the problem of interstate mobility (especially visa problems) should be immediately addressed by national governments.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
Automobile and Automobile Components Industry					
Considering the significant growth and further potential of the industry in India and Pakistan, given the absence of any productive capacity in other SAARC countries, there is significant opportunity for mutual cooperation in the automobile industry in South Asia. Since the industry is a booster of economic growth, cooperation will have cascading effects.	a. FDI does not show much promise. With the unavailability of steel, manufacturers are unlikely to set up plants in Bangladesh. The narrow manufacturing base is even experiencing declining profitability and reduced production.	a. India can make significant investments in the automobile and automobile components sector in Sri Lanka and Pakistan, especially in the area of smaller and cheaper cars. Joint ventures in automobiles between Pakistanis and Indians should be promoted.	a. High taxes and duties are factors investors will have to contend with.		a. The region should strive for uniform standards in the industry by, for example, establishing common testing facilities.
Other FDI Potential Sectors: Manufacturing, Services, and Agriculture	a. Bangladesh should promote the leather industry as a potential investment site for neighboring countries. With the availability of low-cost labor, the sector's small gas requirement and with raw materials being sourced from domestic and Indian markets, the sector holds much potential for growth.	a. Given India's considerable advances in software development, its companies can be encouraged to invest in IT-related industries in Bangladesh, Nepal, and Sri Lanka, and in joint ventures with Pakistan.	a. For the time being, Nepal may mainly have to piggyback on India's software export industry. b. To promote FDI in services, continued peace and stability, a stable supply of electricity, and good labor–management relations are needed.		a. Since services play an integral part in South Asian economies, SAARC member countries should actively pursue the broadening of SAFTA to include trade in services. This will open up more avenues through which more FDI can enter.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
			c. Efforts should be made to remove the complex quarantine rules in agriculture imposed by India. Increasing demand for flowers, tea, and coffee would require FDI and market linkages. A direct air link to northern Europe, the traditional market for flowers, would help this sector.		
Infrastructure: Energy, Roads and Transport, and Telecommunications	a. Development of infrastructure, especially gas exploration, coal mine development, and coal power generation, is paramount. The Government should make an all-out effort to develop the power and gas sectors by enhancing private and public sector investment, including FDI. It should approve the country's coal policy without delay. Bangladesh should also consider investing in India in the area of gas power distribution from Bangladesh into India.	a. India should consider making significant investments in hydropower in Nepal.	a. With the immense hydropower resources of Nepal, the Government should consider further effort to attract FDI in this sector, especially from India. Hydropower matters should be dealt with professionally and efficiently. There should be a transparent and enabling framework, improved peace and security, and non-discriminatory access to India. FDI in biogas, windwind, and solar energy should also be considered.	a. Improving domestic infrastructure, especially energy and road networks, has to remain a top priority in the medium to long term.	a. Infrastructure needs are most immediate in energy generation and distribution. Regional cooperation for the improvement and expansion of energy generation, transmission, and distribution should be explored.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
	b. Investment in Bangladesh is constrained by the lack of infrastructure. Policies that actively promote and encourage FDI are no match to the constraining effects of these inadequacies, thus FDI remains low. Public investment in infrastructure is insufficient, and this should also be addressed.	b. A comprehensive policy to address the infrastructure and transport problems in India, with a special focus on intraregional connectivity, is needed. Improved port–hinterland connectivity is required. At present, railways are closed to FDI; and telecommunications, airports, and airlines have caps. These restrictions may have to be reviewed. Sector caps in telecommunications should be removed.	b. Infrastructure has been identified as one of the top five constraints to doing business in Nepal, and should be addressed. Difficult topography makes infrastructure development difficult and expensive. Inadequate transport infrastructure constrains FDI.		b. The problem of inadequate and poor quality infrastructure in South Asia, with a focus on intraregional connectivity, should be immediately addressed by their respective governments. Infrastructure needs are most immediate in the transport (i.e., road and rail networks, and ports) and telecommunications sectors. There should be more direct links by air, land, and sea. An efficient and integrated transport system for the whole of South Asia is essential for the effective implementation of SAFTA. More land routes should be opened up between SAARC countries, especially India and Pakistan, and with effective infrastructure support at border points.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
					c. The telecommunications tariff between South Asian countries is very high and should be reduced. Improvement and expansion of telecommunications infrastructure for improved connectivity, to support the needs of industry and commerce, should be a regional priority.
Trade and Investment Issues: Tariffs, NTBs, Long Negative List, Bilateral and Regional Agreements, and FDI Regime					
i. **Reduced Tariffs and NTBs:** Gains from bilateral and regional free trade agreements would be limited in the presence of NTBs: negative lists; standards, testing, labeling and certification requirements; antidumping and countervailing measures; export subsidies and domestic support; and government procurement policies. Local taxes, domestic infrastructure, complex and lengthy procedures, and compliance with international standards make life difficult for exporters.	a. Many of the most important tradable items have remained in the negative list of partner countries, and this list should be curtailed. Duty-free imports of raw materials and other incentives that are currently provided to export-oriented firms need to be continued to encourage inward investment.	a. All NTBs should be reduced or eliminated.	a. Nepal trades mainly with India, but faces numerous NTBs in the areas of sanitary and phytosanitary requirements, quarantine rules, and customs procedures. Nepal also suffers from uneven implementation and interpretation of trade treaty measures by state governments in India. Trade facilitation and improvement in customs clearance procedures (to be consistent with WTO rules) are needed to reduce trade costs. Nepal has to address its significant domestic and border regulatory constraints.		a. **Reduction of tariffs and NTBs**: Tariff rates should be reduced as these are still high relative to rates in other regions. This move should be in tandem with the reduction in high and specific duties, particularly on T&C products. Tariff structures should also be simplified and transparent. Curtailment of long negative lists and the removal of important trading items in those lists need to be pushed through.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
ii. In the absence of a harmonized trade regime in South Asia, investors are not encouraged to invest in the region.					b. South Asian countries should adopt a consistent trade policy, particularly on transport, transit, and customs. Trade documents and procedures should be transparent and simplified to facilitate trade and to stem corruption. SAARC can further collectively develop and establish common testing facilities; work toward the harmonization and promotion of common standards; harmonize cross-border procedures and requirements; upgrade infrastructure and improve efficiency in customs and ports; and create industry-related forums on dealing with international organizations, such as the WTO or other trading groups. Harmonization of standards is most important for products with high trade potential.
					c. A Regional Standards Organization should be set up to develop and enforce standards for South Asian goods.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
Trade and Investment Issues: Tariffs, NTBs, Long Negative List, Bilateral and Regional Agreements, and FDI Regime					
iii. **Fair distribution of benefit of regional integration**: Distributional consequences of regional integration, such as displacement and intensified import competition, seem to be orthogonal to the demands of the local industry. The concern is more so for smaller countries that may be overwhelmed by India's market size, potential investments, as well as control over resources and local markets (once they open their borders to fuller trade and investment from India).		b. India should be encouraged to open up its market to its South Asian neighbors for the region's benefit and for its own. c. India should simplify its rules of origin, improve product prices, and diversify its product range in such a way that will be mutually beneficial and relevant to itself and its neighbors.	b. To minimize possible negative effect of FDI, some form of selective intervention may be needed, such as requiring provision for training programs and R&D activities, balancing inflows and outflows of foreign exchange by FDI firms, and restrictions on domestic borrowing, etc.		d. SAFTA's provision of compensating least developed countries for custom's revenue losses promises to be constructive mechanism. The accrual of benefits of economic integration to all member countries should be ensured. There is then a need to create awareness about the benefits that cooperation can provide.
iv. **FDI regime**		d. Private investment in rural areas needs to be promoted to make rural areas centers of growth. This may create additional demand for goods and services and investment.	c. FDI liberalization in Nepal should be guided by proper sequencing and pacing, and by ensuring that an appropriate regulatory framework is in place.	a. Existing regulatory restrictions on FDI should be reviewed and evaluated, such as the restriction on FDI in educational institutions awarding degrees.	e. SAFTA's scope should be broadened to encompass investment and services. A transparent investment protocol with simplified cross-border investment rules for South Asia should be established.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
		e. Opening up retail trade and higher education to FDI has to be considered.	d. SEZs should start operating to draw FDI firms. Strategies should be developed to diversify inflows and attract investment from other SAARC countries, since a large share of Nepal's inward FDI from South Asia is from India.		SAARC member countries should create conditions for industry actors and officials to address common problems and priorities, such as the issue of seeking intellectual property protection (via geographic indication) of some weaves, designs, and processes in the T&C sector, which are a common heritage of the region and which are being copied by competitor countries. By building on areas of common and overlapping interest, and generating linkages and spillovers, the supposed trade-offs between countries may instead be positive-sum outcomes, strategies, and sequences. f. Priorities would include efforts at brokering a viable risk-underwriting regional investment accord (investment protocol), that would work through problems of repatriation and ownership of assets created by non-natives, as well as creating institutions of conflict resolution.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
Human Resources Development, Labor Issues, and Travel Restrictions					
Human Resources Development	a. The Government should take a more proactive role in developing the country's human resource base.	a. The situation has moved from many people chasing a few jobs to many jobs available for trained and skilled workers, who are relatively few in number. The need remains for better training and development of skills.			
Labor Issues			a. Nepal's Labor Act should be relaxed since it is putting a significant burden on firms. The cost of retrenchment is so high that firms limit the number of permanent workers, which is a disincentive to productivity. b. There were some instances when Indian FDI in Nepal left due to hostile labor relations in the country. This should be addressed.	a. Some provisions of Termination of Employment of Workmen should be modified to give employers more freedom to restructure their firms. The requirement for government approval for termination should be withdrawn, and a standard minimum notice period and severance payment formula across the country should be established.	

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
Travel Restrictions			c. The import of labor is regulated by the Immigration Department which makes it very difficult to bring in skilled and experienced specialists. The flow of workers and managerial talent should be nurtured and supported.		a. Governments should extend SAARC visa exemptions to bona fide business people. Travel and visa restrictions across SAARC countries should be eased.
General Business Environment-Governance, State of Commerce and Financing Services, Product Diversification, and Macroeconomic Stability					
Ease of Conducting Business, Governance, Macroeconomic Stability, and Protection Indian firms prefer to establish businesses in Western Europe and North America because of the ease of conducting business in those regions and in view of enhancing their global profile. With regional concerns and issues relating to security, political instability, and investment protection,	a. The rate of implementation of FDI projects from South Asia is much lower than in other countries due to the more stringent scrutiny such projects undergo. Such policy and practice should be reviewed.		a. Government and policy instability, inefficient bureaucracy, corruption, tax regulations and administration, and delays in customs and transshipment aggravate the already high productivity and trading costs. These should be addressed.	a. The highly unstable and uncertain macroeconomic environment, which includes trade policies, is a constraint to FDI. Bureaucratic red tape and high costs of compliance also pose as obstacles to investing in Sri Lanka. The approval of FDI projects, while "automatic," still results in delays in the legal and implementation processes. These problems have to be addressed.	a. The governments of the region should address the absence of an adequate and enabling policy framework that will facilitate and assist intraregional trade and investment.

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Table 9.1: Summary of Country and Regionwide Recommendations *(continued)*

Sector/Issue	Bangladesh	India	Nepal	Sri Lanka	Regionwide
the policy framework to enable and assist intraregional trade and investment is inadequate.					
	b. High and rising inflation should be contained.				b. To create a secure environment for high-technology FDI, laws on the protection of intellectual property rights need to be enforced by each country government.
Finance and Banking	c. It is important to reduce the lending rate of banks to keep the cost of doing business to a minimum.	b. Information gaps, inadequate finance and credit facilities, lack of standardization of letters of credit, and lack of investment guarantees have constrained outward FDI.	b. Assistance should be provided to financial companies, as stability in the financial sector is important to business. The 67% cap on foreign equity in financial services should be reviewed. As growth in this sector promotes business in general, Nepal should pursue efforts to establish more foreign investment, and to improve the sector's competitiveness.	b. Steps should be taken to address underdeveloped capital markets, given high borrowing costs and limited investment-related services.	

BOI = Board of Investment, EPZA = Export Processing Zone Authority, EU = European Union, FDI = foreign direct investment, GSP = Generalized System of Preferences. IT = information technology, NTB = nontariff barriers, PRC = People's Republic of China, R&D = research and development, SAARC = South Asian Association for Regional Cooperation, SAFTA = South Asian Free Trade Area, SEZ = special economic zone, SME = small and medium-sized enterprise, US = United States, T&C = textiles and clothing, WTO = World Trade Organization.

Study on Intraregional Trade and Investment in South Asia

This study broadens and deepens intraregional cooperation and integration in trade and investment among South Asian countries. It showcases the benefits of regional integration and presents an array of policy recommendations to maximize and realize such gains. Three parallel initiatives are needed: first, reduce nontariff barriers to deepen the South Asian Free Trade Area (SAFTA); second, expand SAFTA's scope to include investments and services; and third, focus on key industries to succinctly demonstrate the process and benefits of reforms. These translate into six component studies:

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