RIS Policy Briefs

No. 2 May 2003

Initiative for Closer Economic Cooperation with Neighbouring Countries in South Asia

Relevance of the Prosper-Thy-Neighbour Policies

India with its large and expanding market, technological and entrepreneurial resources, has the potential to play an important role in expediting the industrial and economic development in the neighbouring countries especially Nepal, Bhutan, Bangladesh, Myanmar, Sri Lanka and Maldives. A case in point is Bhutan where India has played a critical role in economic development of the country by investing in hydro electrical projects and buying back the output. This led to rapid growth in Bhutan, which has since grown richer in terms of per capita income even compared to India. It is argued that the 'Prosper-Thy-Neighbour' policies bring rich rewards in the form of not only expanded markets for Indian exports but may also solve the problems of migration of refugees, insurgencies in border areas and terrorism.

Over the past five decades, India has contributed to the development of the neighbouring countries under different programmes of assistance such as under ITEC programme, programme of assistance to neighbouring countries, with grants, technical assistance and trade preferences, etc. Since 1995, India has exchanged trade preferences with South Asian countries under four rounds of SAPTA negotiations. India has also exchanged tariff preferences with Bangladesh and Sri Lanka under the Bangkok Agreement, and trade with Bhutan, Nepal and Sri Lanka is conducted on free trade basis. The facilities for clearance and payments of mutual trade exist through memberships of most of the countries in the Asian Clearing Union. Some cooperation is also taking place in the context of sub-regional initiatives such as BIMST-EC and BBIN-GQ. India has also proposed a Framework Trade and Investment Agreement with ASEAN which covers Myanmar. These initiatives have helped to improve the share of South Asian countries in India's exports from 3.5 per cent to 5.1 per cent over the 1990s. However, share of South Asian countries in India's imports remains marginal at 0.9 per cent at the end of 1990s even with an improvement over the proportion of 0.5 per cent at the beginning of the decade. The expansion of India's exports faster than her imports from the region has led the balance of trade being perpetually in her favour (except with Bhutan and Myanmar). With consistent and rising trade surplus, India's perception in the region is generally of a big brother that is not concerned with the development of her smaller and less developed neighbours. This perception can be changed with gradual approach of removing obstacles to exports of neighbouring countries and a special facilitation and creation of supply capabilities (a la Bhutan) for exporting back to India.

This Policy Brief explores some strategies to strengthen the India's economic linkages with a view to expediting the industrial and economic development in the South Asian countries.

Proposals for Trade and Investment Liberalization and Facilitation

FTAs with Bangladesh and Myanmar

Despite the initiatives made by India at the unilateral, bilateral as well as at the regional levels (e.g. SAPTA and Bangkok Agreement), the intra-regional trade especially the share of South Asia in India's imports remains rather marginal at less than a percent. Preliminary analysis conducted by RIS shows that bilateral FTAs with Bangladesh and Myanmar and possibly Maldives would be useful in expanding the trade with these countries. India is proposing a Framework Trade and Investment Agreement with ASEAN. In addition, an FTA for BIMSTEC has been proposed. Therefore, in due course trade with most of these countries will be conducted

RIS Policy Briefs are prepared to communicate results of RIS research on specific policy issues to the policy makers.

This Policy Brief is based on a Concept Paper prepared by RIS. It is being issued in the interest of further discussion.

on free trade basis. However, in the meanwhile we may propose bilateral FTAs which could be concluded expeditiously. The experiences with FTAs with Nepal and Sri Lanka have been favourable, though the full potential of industrial restructuring remains to be exploited. The approach to FTAs should be based on negative list basis with a fast track for important products of mutual interest. The SAPTA's experience suggests that positive list approach is too time consuming. However, until the FTA partners agree to have a common external tariff regime, rules of origin will have to be put in place to prevent third countries exploiting the preferential trade regime offered by India for their advantage. As both Bangladesh and Myanmar are least developed countries, these rules of origin imposed could be generous than normally imposed.

Fostering Industrialization in South Asian Countries: Exploiting the Potential of Efficiency-seeking Industrial Restructuring

The formation of FTA with liberalization of investment regime and other facilitating measures can help in exploitation of the potential of efficiency-seeking restructuring of industry within the region. This includes rationalization of industry on the basis of overall efficiency taking into account the special advantages of different locations across the region in terms of availability and relative cost of labour and skills, natural resources, and other factors. This may lead to migration of forest-based and energy intensive industries to countries such as Myanmar and Bangladesh and in that process generating value added and intra-regional exports. The conclusion of Indo-Sri Lanka FTA has unleashed a trend of such efficiency-seeking restructuring where Indian companies are making export-oriented investments in rubber and plantation industries in Sri Lanka. According to recent reports, Indian investments in Sri Lanka following the implementation of FTA has totalled US$ 650 million of which $ 400 million being committed in 2001 alone. Several Indian companies have set up plants for production of fast moving consumer goods (FMCG) in Nepal for serving the Indian market. For instance, both Colgate India and Hindustan Lever have set up plants for serving the north Indian market for their toothpaste brands in Nepal following the 1996 Free Trade Treaty. Dabur India manufactures "Real" fruit juices in Nepal for exporting to India. Following these relocations of production the FMCG's exported by these companies have emerged among the most important items of Nepal's exports to India. For such restructuring of industry to be facilitated, the FTA should be complemented by liberalization of intra-regional investment flows. The FTA partners could also consider signing a Investment Promotion and Protection Agreement and a Double Taxation Avoidance Agreement, if they do not exist.

Mobilization of Extra-regional Sources of FDI

Liberalization of intra-regional trade will increase the attractiveness of the region's economies especially the poorer and smaller ones towards extra-regional FDI inflows by extending the effective market size. Therefore, region's least developed economies like Bangladesh and Myanmar may be able to attract greater interest and attention of western MNCs as destinations for investments given their preferred access to a large market of the size of US$ 550 billion. This would help in convergence between the levels of development among the member countries.

The Indo-Bangla Revolving Fund for Joint Projects

The persistent and rising trade surplus with Bangladesh has become a sensitive issue for the bilateral relations. It has by itself become a limiting barrier to further expansion of bilateral trade. To a large part the widening trade surplus arises because of growing imports by Bangladesh from India of the intermediate goods that feed her expanding garment export industry. In other words, imports from India are enabling Bangladesh to earn trade surplus in other markets. Other reasons of the widening surplus include limited supply capabilities and political constraints to export natural gas to India.

It is proposed to recycle a part of India's trade surplus to fund Indian investments in Bangladesh that will add to the supply capacity and promote growth of the economy and overtime contribute to more balanced trade.

India may consider putting 20 per cent of the amount of trade surplus in India-Bangladesh trade for the next five years in a revolving fund. This way a Fund with a substantial corpus of about a billion US dollars will be created within five years keeping in mind the current patterns of bilateral trade. The Fund could be managed by a joint venture of say IDBI or EXIM Bank in India and its Bangla counterpart. This Fund could lend on an *exclusive* basis to Indian companies that want to invest in Bangladesh in joint ventures or sole ventures on concessional terms to make it more attractive. This may prompt Indian companies to exploit the investment opportunities in Bangladesh to mutual advantage. The Fund could give a preference to investment proposals that seek to locate production in Bangladesh that would lead to exports to India (such as gas based industries) or will contribute to infrastructure development especially the transport and transit facilities that may facilitate bilateral trade.

Given the fact that the Fund will be built up by recycling the trade surplus of India, it may help create a perception that a part of the surplus in being retained in Bangladesh for facilitating her industrial development. By lending exclusively for investment projects set up in Bangladesh, the Fund could be instrumental in pulling a lot of FDI from

Indian companies in Bangladesh and help expedite the industrialization and supply capabilities. It would also help Indian companies to establish a foothold in the Bangladesh market of an enduring nature and lead to a growing interdependence between their economies.

Project Development Facility of the Revolving Fund

The Revolving Fund could be accompanied by another mechanism for industrial development of Bangladesh. The interest proceeds received by the Fund will be put into another Window that would operate as a Project Development Facility for Joint Projects. This facility would promote in infrastructure and industrial development of the two countries by funding the preparation of project reports/ feasibility studies of infrastructure or industrial projects involving the two countries. Once the financial viability of these projects is established, the funding could be obtained from various sources by entrepreneurs including from the Revolving Fund.

Harmonization of Customs Procedures and Documentation

Substantial proportion of India's trade with the South Asian countries like Bangladesh is conducted unofficially thus losing revenue on the both sides. While high tariff rates and NTBs do affect formal trade adversely, high transaction cost of formal trade may also be responsible for making unofficial trade more attractive. Studies have shown that transaction costs of intra-regional trade increase significantly because of tedious documentation and custom procedures in practice. The attempts to harmonize customs procedures under the SAARC framework have not borne fruits as yet. An expeditious approach may be considered at a bilateral level.

Removal of State Government Imposed Taxes on Bangladesh Exports

It has been reported in some studies conducted for the Asian Development Bank that the State governments of West Bengal and Assam have been imposing a luxury tax of 25 per cent on consumer goods imported from Bangladesh in addition to custom duties imposed by the Central government. Such levies obviously affect the international competitiveness of Bangladesh exports to India. They also create the perception of giving discriminatory treatment to exports from a particular country. This needs to be examined and addressed.

Transport and Transit Facilities and Infrastructure Development

A major barrier to expanding India's trade with the partner countries in the region is lack of adequate transport and transit facilities. These problems need to be addressed on an immediate basis. The development of transport infrastructure such as road and rail links, bridges, creation of warehouses facilities can be undertaken in the form of regional projects. These regional projects will itself facilitate some economic activity in the neighboring countries as well as in the Northeastern States of India and hence spur their development and will also earn goodwill besides boosting trade. They may also generate some contracts for Indian construction companies and employment for people of the concerned countries. Hence, India may consider creating a *Projects Group* within the Government to identify possible infrastructure projects and find ways and means to implementing them expeditiously on a bilateral or sub-regional basis. This Group may also coordinate with the initiatives taken as a part of the BBIN-GQ or BIMSTEC due to overlapping coverage. The Revolving Fund suggested above may also fund the feasibility studies and lend towards financing of these projects. The Projects Group may also look into the economics of laying pipelines from Myanmar via Bangladesh to India to bring gas from gas fields in Myanmar (and also in Bangladesh, should it agree to sell it to India). Even if Bangladesh does not export gas to India, it could earn revenues of transit fees.

Clearance and Payment Arrangements and Local Currency Trading

Four member countries of BIMSTEC, viz. India, Bangladesh, Myanmar, Sri Lanka, Nepal and Bhutan (besides Pakistan and Iran) are members of the Asian Clearing Union (ACU) and hence are able to conduct their trade through the clearance facilities provided by ACU. ACU mechanism has worked very well over the past 26 years of its operations without any default in the history. The currencies of Nepal and Bhutan are tied to Indian rupee and hence they are able to conduct their trade with India in local currencies.

While clearance and payment facilities or local currency trading facilities do facilitate mutual trade, it works only in the situation when the trade is broadly balanced. In the cases of perpetual and widening trade imbalances such as in the case of Indo-Bangladesh trade, these facilities may not be of much relevance. Therefore, the emphasis for the time being should be on creation of supply capabilities in Bangladesh for a more balanced pattern of bilateral trade before exploration of local currency trading facilities.

Increasing Value Addition in Traditional Export Commodities and Joint Marketing

As is typical of poorer countries, a number of traditional export commodities of the South Asian countries are exported in bulk. Owing to lack of marketing power and other constraints, it has not been possible to increase the value added realization over time. Tea offers a typical example. Sri Lanka and India are two major exporters of tea in the world, accounting for over 37 per cent of the world market. However, since South Asian tea is still exported in bulk, value addition takes place mainly in other countries in terms of blending, packaging and branding. Sri Lankan steps to increase the extent of value addition in the industry have met with limited success so far. Indo-Sri Lanka joint ventures in tea blending and marketing could be set up to facilitate the value addition. Integration of some tea estates in Sri Lanka with Tata Tea-Tetley combine may facilitate such process. Similarly, joint ventures of regional commodity exporters could undertake their packaging and marketing on behalf of joint venture partners. This approach could be fruitful for coffee, jute, cardamom, rice, etc. which are currently exported in bulk and are subject to low unit value realization.

Dealing with the Emerging SPS Measures and TBTs

Regional cooperation can also be fruitful for dealing with emerging environment and health related non-tariff barriers in developed countries, such as sanitary and phyto-sanitary (SPS) measures and technical barriers to trade that are potentially very damaging for South Asian exports. India and Bangladesh, for instance, face similar problems with respect to export of textiles, leather goods and marine products. The cooperation could involve exchange of information and experiences and expertise and even sharing infrastructure for compliance with these requirements. They could consider launching a joint eco-label for common export commodities to get greater visibility and acceptance than individual labels besides conserving resources on its promotion.

Concluding Remarks

In this policy brief, some proposals have been made that may help in expediting the process of industrialization of the neighbouring countries besides making the pattern of bilateral trade more balanced. In particular, the formation of an Indo-Bangla Revolving Fund, along with the bilateral FTAs with Bangladesh and Myanmar, trade and investment facilitation through harmonization of custom procedures, bilateral investment agreements, and development of transport infrastructure could play an important role.

Some Recent Publications of RIS

Books

- ✰ *Globalization and Non-Aligned Movement: An Economic Agenda for Action*, 2003 (Available on CD-ROM)
- ✰ *India-ASEAN Partnership in An Era of Globalization: Reflections by Eminent Persons*, RIS, New Delhi, 2002.
- ✰ *South Asia Development & Cooperation Report 2001/02*, 2002.
- ✰ *Globalization and the Quality of Foreign Direct Investment* by Nagesh Kumar, Oxford University Press, New Delhi, 2002.

Occasional Papers

#65. *Status of Biotechnology in Singapore* by Sachin Chaturvedi, 2002.

#66. *Capital Inflows and Effects of Market-Driven Investments: A Focus on Southeast Asian Crisis* by Biswajit Dhar and Murali Kallummal, 2002.

Discussion Papers

#50 *ASEAN's Contribution to the Building of an Asian Economic Community* by K. Kesavapany, May 2003.

#51 *India and the Asian Economic Community* by Mukul G. Asher and Sadhna Srivastava, May 2003.

#52 *Performance Requirements as Tools of Development Policy: Lessons from Experiences of Developed and Developing Countries for the WTO Agenda on Trade and Investment* by Nagesh Kumar, June 2003.

#53 *Economic Cooperation between India and Central Asian Republics with Special Reference to Uzbekistan* by Abdurahim Okhunov Abduraxmonovich, 2003

#54 *Nepal-India Bilateral Trade Relations: Problems and Prospects* by Gyanu Raja Shrestha, 2003.

#55 *Economic Cooperation between India and Egypt* by Abdel Hamid Saba Elregal, 2003.

Recent Issues of RIS Journals:

- ✰ *South Asia Economic Journal*, Vol. 4, No.1, January-June 2003: Special Issue on WTO, South Asian Agriculture and IPRs.
- ✰ *Asian Biotechnology and Development Review*, Volume 5 No. 2, March 2003.
- ✰ *RIS Diary*, January 2003 and April 2003.

RIS Discussion Papers, Policy Briefs and RIS Diary are available at RIS Website: www.ris.org.in

Research and Information System for the Non-Aligned and Other Developing Countries (RIS)
Core IV-B, Fourth Floor, India Habitat Centre
Lodhi Road, New Delhi-110 003, India.
Ph. 91-11-24682177-80 Fax: 91-11-24682173-74
Email: dgoffice@ris.org.in
Website: http://www.ris.org.in