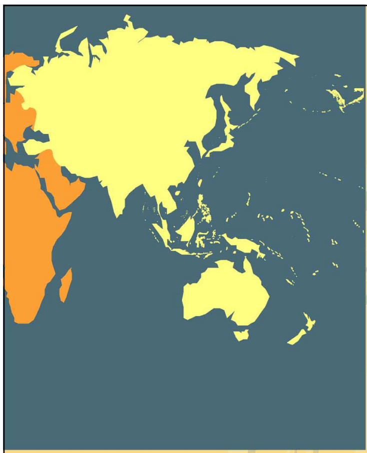

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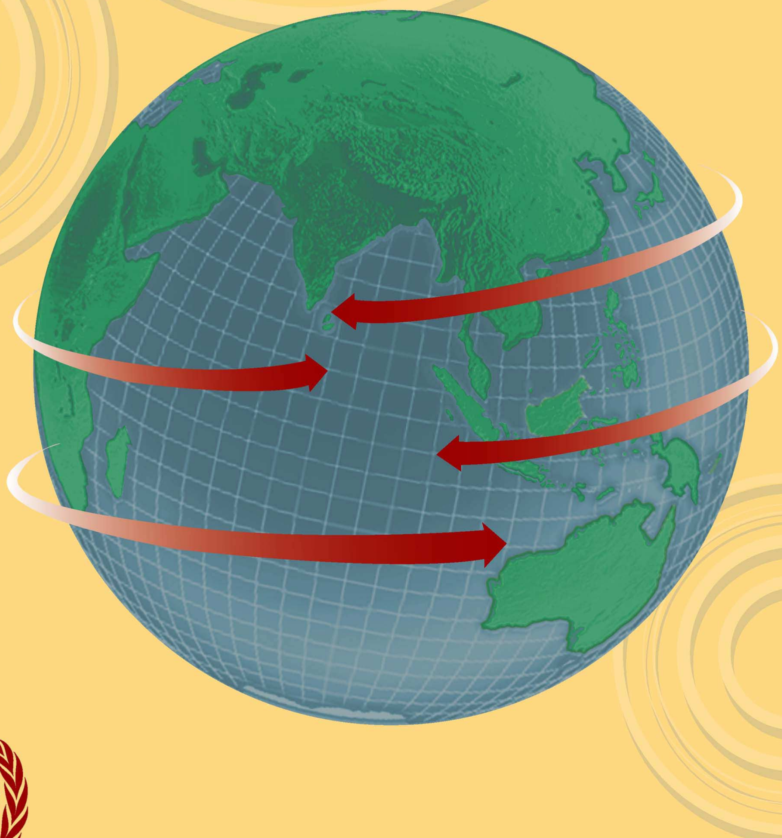

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AIMS AND SCOPE

The *Asia-Pacific Trade and Investment Review* is a biannual, peer-reviewed journal for the dissemination of timely information and research analysis on the new, emerging issues of trade, investment and enterprise development in Asia and the Pacific. Primarily aimed at government policymakers, researchers and representatives of the private sector, the *Review* imparts information on the latest trends in trade and investment policy issues facing the region. The Review emphasizes implications for policy relevance and operational research rather than academic research on theoretical and methodological issues. Articles will be drawn from research work conducted by outside researchers as well as the staff of the Trade and Investment Division of UNESCAP and its consultants.

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FOREWORD

This inaugural issue of the *Asia-Pacific Trade and Investment Review* features policy-oriented research papers and articles presenting new, innovative and insightful views and information on national best practices and regional comparative analyses on pertinent trade and investment policy issues for the Asian and Pacific region.

One of the thematic priority areas for the United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) is managing globalization. Policymakers in the region are keenly interested in the emerging issues in trade and investment. In the rapidly globalizing economy, policymakers in the developing economies are in great need of timely, insightful information for policymaking and implementation to realize positive results for their economy. Hence, this first issue of the *Review* covers such salient trade and investment policy issues as regional cooperation for the rehabilitation of tsunami-stricken countries; the phasing out of the Multifibre Arrangement in January 2005 at the country and regional levels, the socio-economic impact and adjustment costs of accession to the WTO by the least developed countries of the region, foreign direct investment policy issues and the internationalization of production networks and their implications for outsourcing activities. It also includes policy briefs and executive summaries of the recent monograph study series undertaken by the Trade and Investment Division of UNESCAP with a view to providing brief analysis and timely information on topics of great relevance and importance to the region.

I sincerely hope that the *Review* will provide useful and timely information for researchers and policymakers in the developing and the marginalized economies of the region and that it will help them to maximize benefits and minimize unnecessary costs associated with the process of managing globalization. I also wish to extend my appreciation to the contributors to the *Review* and commend all the staff members involved in the design and production of this newly launched flagship publication of the Trade and Investment Division of UNESCAP.

Kim Hak-Su
Executive Secretary

ASIA-PACIFIC TRADE AND INVESTMENT REVIEW

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Research Articles

Foreign Direct Investment and the Internationalization of Production in the Asia-Pacific Region: Issues and Policy Conundrums

*Ramkishen S. Rajan**

ABSTRACT

This paper draws on the relevant academic literature to examine selected policy issues relating to foreign direct investment (FDI) and its links to international production, trade and technological development.

In particular, the paper stresses the importance of "production fragmentation", broadly defined as the decoupling of a product into its constituent parts, the production of which are spread across countries according to the basis of comparative advantage. This cross-border multi-staged production process in turn has been facilitated immensely by major improvements in transportation, coordination and communication technologies. While production fragmentation has been used extensively in commodity trade (such consumer goods as garments, footwear, toys and handicrafts) for decades, it is now being applied more intensively to trade in airliners, computers, semiconductors, automobiles and many other products.

Production-sharing is not limited to trade in goods as transnational corporations (TNCs) have fragmented and dispersed various services functions worldwide to take advantage of marginal differences in costs, resources, logistics and markets. Many companies – especially western ones – have come to

(Continued on page 4)

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(Continued from page 3)

appreciate the fact that, if they do not outsource to reduce costs, while their competitors continue to do so aggressively, they stand to lose global and local market share to their foreign rivals.

The current global environment is characterized by an intense "global race" for FDI. No doubt, FDI is drawn to different countries for different reasons – resource seeking (natural or human resources), market seeking, efficiency seeking or strategic-asset seeking. Nonetheless, at a general level, in order for a country to be more attractive to investors (both local and foreign), there is a need to put in place measures to ensure the existence of an enabling environment, i.e., one that is conducive to doing business. The paper focuses on investment promotion activities and the potential effectiveness (or lack thereof) of fiscal and financial incentives.

The paper emphasizes that FDI policy intervention ought not to be sectorally biased. Instead, intervention ought to focus on improving the host country's general capability to benefit from FDI by improving the quality of the labour force and infrastructure in a country, develop local skills, technology and local learning, and ensure a stable and conducive overall macroeconomic and regulatory environment.

The paper ends with a brief discussion of the proliferation of regional trade agreements (RTAs) in the Asia-Pacific region and their consequent implications for regional trade, investment and development.

1. INTRODUCTION

The common refrain nowadays is that economic openness is an important ingredient of an effective poverty reduction strategy. But what exactly is the nexus between economic openness and poverty reduction? In order to answer this question effectively, it is important to keep in mind that economic openness consists of at least three distinct strands, viz. financial and capital flows, labour flows and internationalization of production and trade flows ("real sector openness").

There is limited evidence to suggest that openness to financial and capital flows (other than FDI) has had any discernible positive impact on growth in developing countries (see Eichengreen, 2002 and references cited within), let alone poverty reduction. Indeed, all that can be said with certainty is that, if international financial liberalization *does not* take place in a well-sequenced and timed manner, it could lead to episodes of severe financial instability and distress (Bird and Rajan, 2001 and Cobham, 2001).

While greater cross-border labour mobility – particularly if it involves unskilled labour – is a definite way of helping alleviate poverty, social and political compulsions and biases prevent many developed countries from taking a more *laissez-faire* attitude towards such cross-border flows (Bauer and Zimmermann, 2000, and Simon and Lynch, 1999). Consequently, the global market for unskilled labour remains extremely fragmented. This said, there is an intense competition between countries for skilled personnel ("global talent"). The economic implications of this "brain drain" – loosely defined as the outmigration of human capital from developing to developed countries – for developing countries are not altogether apparent. Why?

On the one hand, developing countries from which the emigrants originate stand to gain through (a) remittances (which in turn add to the country's gross national product); (b) the establishment of diasporic business and trade networks; (c) stimulating greater private investment in education (given the prospects of higher private returns abroad); and (d) other externalities and technology/knowledge transfers from return migrants. Counter-balancing this is the fact that the emigration of skilled workers denies poor source countries the opportunity to recoup the costs of subsidizing higher education and prevents them from attracting more knowledge-intensive industries and building high quality public institutions.[1] It is in this context that many have advocated the imposition of a "brain drain tax" (for instance, see Desai et al., 2001).

This leaves us with real sector openness. This type of economic openness itself consists of three interrelated aspects, viz. FDI, internationalization of production, and international trade. This paper draws on some recent theoretical and empirical literature to examine selected policy issues relating to FDI and its links to trade, technological development and growth. FDI has been found to be the most stable source of external finance for developing countries in the Asian and Pacific region, and it has been highlighted in the Monterrey Consensus as a critical source of financing for development (FfD) (see Rajan, 2004b and Nunnenkamp, 2004).

The paper is organized as follows. Section 2 discusses the links between FDI and trade by stressing the importance of "production fragmentation", broadly defined as the splintering of a product (or service) into its constituent parts, the production of which is spread among several countries on the basis of comparative advantage. Section 3 examines the nexus between FDI and growth, paying particular attention to its role in enhancing the technological capacity of the host country. Section 4 discusses steps to boost FDI inflows. The focus is on reducing transaction costs, investment promotion and the offering of fiscal and financial incentives. The final section offers a few concluding remarks on the developmental impact of regional trade agreements that have proliferated in Asia and the Pacific.

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[1] Beine et al. (2001) offers a useful formalization of the trade-off between the two effects of migration of skilled labour, viz. the incentive for higher human capital investments, on the one hand, and loss of skilled migrants, on the other. Given these trade-offs, a case can be made that the greatest gains to developing (as well as developed) economies might be reaped from the temporary – as opposed to permanent – movement of natural persons. Asia-Pacific countries such as India stand to reap significant gains from the greater temporary movement of service providers.

2. INTERNATIONALIZATION OF PRODUCTION AND TRADE

Table 1 summarizes the available data on the direction of exports in the various subregions of the developing Asia-Pacific region (using the standard ADB definition of subregions) between 1985 and 2001. As is apparent, the extent of intraregional trade remained stable at about 25 per cent of total exports between the two periods, having peaked in the mid-1990s prior to the East Asian crisis of 1997-1998. Averages hide significant variations. For instance, while intraregional exports by Central Asia and the Pacific averaged only between 10 and 13 per cent, about one third of South-East Asia's exports were destined to the rest of the region (largely intra-East Asian). About one third of East Asian trade was with the rest of the developing Asia-Pacific region, this proportion rising marginally in the last decade largely because of the escalating trade prowess of China. South Asia's trade with the rest of the Asia-Pacific region rose from 13 per cent in 1990 to about 21 per cent in 2001, largely a consequence of India's trade and economic liberalization programme, initiated in 1991-1992 (Rajan and Sen, 2002, 2003).

(a) Production fragmentation

The openness of the East Asian subregion and increasingly India is characterized mainly by "production fragmentation" (Ng and Yeats, 1999 and Athukorala, 2003), defined as the decoupling of previously integrated goods into their sub-component parts, components and accessories (PCAs), which in turn are distributed among several countries on the basis of comparative advantage. This cross-border multi-staged production process in turn has been facilitated immensely by major improvements in transportation, coordination and communication technologies.

Lemoine and Ünal-Kesenci (2002) offer a useful description of the phenomenon of production fragmentation:

> "As production processes have become internationally fragmented, firms located in different countries take part in the production of a commodity but at different stages of the value-added chain. The value-added chain is split up across different countries and firms, and international trade involves ever more flows of goods belonging to a single industry but at different stages of production. The international segmentation is fostered by the search for cost minimization and economies of scale which arise through expanding markets…As manufactured products are becoming more and more technologically sophisticated, the number of stages of production increases and the productivity at the different stages changes rapidly; in this context a country tends to specialize only in individual segments… Firms... have localized the production of components in different countries, with the aim of a better utilization of different countries comparative advantages… This splitting up of value added chain allows for an ever more in-depth specialization." (pp. 10-11).

Table 1. Direction of exports of the developing Asia-Pacific region, 1985-2001

(Percentage of total)

To	*Developing member countries*				*Japan*				*USA*				*EU*				*Others*			
From	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*
East Asia	n.a.	33.9	n.a.	35.7	n.a.	12.5	n.a.	12.0	n.a.	20.9	n.a.	21.2	n.a.	14.8	n.a.	14.5	n.a.	17.9	n.a.	16.6
Hong Kong, China	35.6	35.5	46.0	45.6	4.2	5.7	6.5	5.9	30.8	24.1	21.2	22.3	11.8	18.5	15.8	14.5	17.6	14.7	10.5	16.4
Republic of Korea	12.9	14.8	38.4	31.7	15.0	18.6	12.3	11.0	35.6	28.6	16.8	20.9	10.4	14.8	13.3	13.1	26.0	23.1	19.2	23.2
Taiwan Province of China	15.6	n.a.	n.a.	n.a.	11.3	n.a.	n.a.	n.a.	15.5	n.a.	n.a.	n.a.	5.5	n.a.	n.a.	n.a.	52.1	n.a.	n.a.	n.a.
China	38.2	52.2	36.6	30.9	22.3	14.7	20.4	16.9	8.5	8.5	17.7	20.4	7.8	10.0	15.0	15.4	23.3	14.7	10.3	16.4
Mongolia	3.1	14.0	38.5	48.8	11.2	17.6	21.5	2.1	5.5	2.0	8.0	30.5	20.5	20.5	n.a.	8.0	59.6	45.9	32.0	10.6
Central Asia	n.a.	n.a.	n.a.	14.9	n.a.	n.a.	n.a.	0.4	n.a.	n.a.	n.a.	1.8	n.a.	n.a.	n.a.	29.6	n.a.	n.a.	n.a.	53.3
Azerbaijan	n.a.	n.a.	n.a.	1.9	n.a.	n.a.	n.a.	0.0	n.a.	n.a.	n.a.	0.6	n.a.	n.a.	n.a.	69.5	n.a.	n.a.	n.a.	28.1
Kazakhstan	n.a.	n.a.	15.1	13.5	n.a.	n.a.	1.4	0.2	n.a.	n.a.	n.a.	1.8	n.a.	n.a.	n.a.	23.3	n.a.	n.a.	n.a.	68.7
Kyrgyzstan	n.a.	n.a.	53.8	25.5	n.a.	n.a.	0.2	0.1	n.a.	n.a.	n.a.	1.5	n.a.	n.a.	n.a.	24.7	n.a.	n.a.	n.a.	52.3
Tajikistan	n.a.	n.a.	n.a.	17.6	n.a.	n.a.	n.a.	0.0	n.a.	n.a.	n.a.	0.2	n.a.	n.a.	n.a.	32.8	n.a.	n.a.	n.a.	49.4
Turkmenistan	n.a.	n.a.	n.a.	27.9	n.a.	n.a.	n.a.	0.0	n.a.	n.a.	n.a.	4.0	n.a.	n.a.	n.a.	11.3	n.a.	n.a.	n.a.	56.8
Uzbekistan	n.a.	n.a.	15.8	24.8	n.a.	n.a.	2.1	2.4	n.a.	n.a.	n.a.	2.5	n.a.	n.a.	n.a.	21.2	n.a.	n.a.	n.a.	49.4
South-East Asia	n.a.	31.0	n.a.	38.6	n.a.	18.3	n.a.	13.4	n.a.	19.6	n.a.	18.2	n.a.	15.8	n.a.	15.0	n.a.	15.3	n.a.	14.9
Cambodia	67.9	83.3	52.1	7.6	7.0	7.6	1.8	1.0	n.a.	0.0	1.2	64.2	13.2	5.0	14.0	24.8	11.9	4.1	30.9	2.3
Indonesia	17.2	21.6	31.5	32.1	46.2	42.5	28.8	20.9	21.7	13.1	16.5	15.3	6.0	12.0	18.3	13.8	8.8	10.6	4.9	15.7
Lao People's Democratic Republic	71.9	78.1	64.9	46.6	6.6	7.1	6.6	1.5	2.7	0.1	4.8	0.9	0.5	9.4	27.0	25.6	18.2	5.3	−3.0	25.4
Malaysia	38.1	42.1	45.9	39.4	24.6	15.3	13.4	13.3	12.8	16.9	18.2	20.2	13.6	15.4	14.8	13.6	11.0	10.3	7.7	13.0
Myanmar	47.1	57.1	54.1	52.8	8.4	6.9	7.4	3.4	0.8	2.3	8.3	16.6	8.4	6.9	6.3	14.5	35.4	26.8	23.9	12.7
Philippines	19.5	15.0	25.1	26.5	19.0	19.8	17.1	15.7	35.9	37.9	32.6	28.0	13.8	18.5	18.6	19.3	11.8	8.9	6.6	10.6
Singapore	36.7	36.2	48.4	47.8	9.4	8.8	8.2	7.7	21.2	21.3	18.4	15.4	10.1	15.0	13.4	13.4	22.5	18.7	11.6	15.8
Thailand	27.1	20.5	34.0	32.2	13.4	17.2	16.8	15.3	19.7	22.7	18.0	20.3	17.8	22.7	15.7	16.1	22.0	17.0	15.5	15.9
Viet Nam	50.4	25.6	24.6	26.8	17.4	13.5	26.4	17.5	n.a.	0.0	4.5	7.6	6.2	6.8	25.0	26.8	26.0	54.1	19.5	21.3

(Continued on next page)

Table 1 *(Continued)*

To	*Developing member countries*				*Japan*				*USA*				*EU*				*Others*			
From	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*	*1985*	*1990*	*1996*	*2001*
South Asia	n.a.	12.7	n.a.	20.2	n.a.	8.4	n.a.	3.8	n.a.	16.3	n.a.	23.8	n.a.	29.9	n.a.	26.1	n.a.	32.8	n.a.	26.1
Afghanistan	n.a.	14.7	n.a.	49.1	n.a.	1.5	n.a.	0.2	n.a.	3.4	n.a.	0.8	n.a.	61.7	n.a.	26.9	n.a.	18.7	n.a.	23.4
Bangladesh	14.5	10.1	7.6	5.1	7.2	3.9	3.1	1.1	18.1	30.5	31.0	29.6	13.0	31.5	45.0	41.3	47.3	24.0	13.3	22.9
Bhutan	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
India	8.9	11.4	24.1	23.5	11.1	9.3	7.4	4.5	18.9	15.1	17.3	21.0	16.7	27.7	29.4	24.0	44.4	36.5	21.8	27.1
Maldives	50.8	38.5	41.9	25.0	10.1	8.5	7.0	2.8	24.3	24.2	8.5	54.4	4.0	26.2	38.0	11.6	10.9	2.6	4.6	6.2
Nepal	41.4	13.9	12.4	37.9	0.7	0.8	0.6	1.8	35.3	23.4	34.4	34.8	20.3	53.3	52.0	19.6	46.8	8.6	0.6	5.8
Pakistan	16.0	18.4	21.4	19.1	11.3	8.2	6.5	2.0	10.0	12.4	16.7	24.3	20.9	36.0	30.1	27.1	41.7	25.0	25.3	27.5
Sri Lanka	11.2	9.3	8.1	7.7	5.1	5.4	6.2	3.9	22.3	25.9	34.1	40.8	17.9	26.3	34.4	26.7	43.6	33.2	17.2	20.9
Pacific	n.a.	13.6	n.a.	16.0	n.a.	21.6	n.a.	10.4	n.a.	4.2	n.a.	6.8	n.a.	23.4	n.a.	9.6	n.a.	37.3	n.a.	57.2
Cook Islands	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Timor-Leste	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Fiji	22.5	4.6	4.9	15.3	3.0	5.9	8.4	5.0	4.9	8.4	10.6	28.8	31.0	23.3	21.3	13.5	38.6	58.3	54.8	37.4
Kiribati	7.2	1.0	n.a.	43.6	4.3	12.2	n.a.	49.2	n.a.	8.9	n.a.	3.0	44.5	72.3	n.a.	1.8	44.0	5.7	100.0	2.4
Marshall Islands	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Micronesia, Federated States of	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Nauru	n.a.	11.5	n.a.	31.7	n.a.	0.0	n.a.	6.9	n.a.	2.0	n.a.	0.0	n.a.	0.5	n.a.	1.4	n.a.	86.1	n.a.	60.0
Papua New Guinea	9.9	17.2	19.0	13.8	22.1	27.8	21.5	10.6	4.0	2.4	0.4	1.5	46.5	24.1	21.0	8.9	17.6	28.6	38.1	65.1
Samoa	0.3	6.8	2.7	12.4	0.9	0.9	0.3	1.4	59.4	6.9	1.7	11.2	5.8	20.5	1.6	2.0	33.6	64.9	93.7	72.9
Solomon Islands	11.1	19.4	n.a.	61.6	52.1	43.1	n.a.	21.9	2.4	3.9	n.a.	3.4	26.3	22.6	13.5	5.3	8.2	10.9	86.5	7.8
Tonga	5.9	1.7	n.a.	3.1	0.2	30.0	n.a.	51.3	3.2	26.0	n.a.	34.4	0.5	1.6	5.5	3.0	90.2	40.7	94.5	8.2
Tuvalu	n.a.	0.1	n.a.	14.3	n.a.	0.0	n.a.	0.0	n.a.	0.0	n.a.	0.0	n.a.	12.6	n.a.	79.0	n.a.	87.3	n.a.	6.8
Vanuatu	1.4	3.3	n.a.	54.6	6.7	20.6	n.a.	12.4	n.a.	3.7	n.a.	1.0	25.4	54.3	42.9	19.7	66.6	18.1	57.1	12.3
Developing member countries	25.6	31.1	39.2	35.5	16.5	14.4	12.9	11.8	26.3	20.0	16.4	19.9	10.7	16.3	15.8	15.6	20.9	18.1	15.1	17.2

Source: ADB, *Asian Development Outlook*, various years.

While production fragmentation has been used extensively in commodity trade (such consumer goods as garments, footwear, toys and handicrafts) for decades (for instance, see Gereffi, 1999, 2001), it is now being applied more intensively to trade in airliners, computers, semiconductors, automobiles and many other products. This said, there are some important distinctions between the "old" and "new" types of production fragmentation. These are highlighted in table 2.[2]

There is an essential difference between cross-border production fragmentation involving consumer goods industries, such as garments and footwear, on the one hand, and semiconductors and automobiles, on the other. To be sure, the former set of goods tend to be "buyer-driven" while the latter tend to "producer-driven". The main characteristics of the two are summarized below.

Table 2. Main characteristics of producer-driven versus buyer-driven production fragmentation

	Producer-driven production fragmentation	**Buyer-driven production fragmentation**
Drivers	Industrial capital	Commercial capital
Core competencies	R&D, production	Design, marketing
Barriers to entry	Economies of scale	Economies of scope
Economic sectors	Consumer durables, intermediate goods, capital good	Consumer non-durables
Typical industries	Automobiles, computers, aircraft, semiconductors	Apparel, footwear, toys
Ownership of manufacturing firms	Transnational corporations (TNCs)	Local firms, predominantly in developing countries
Main network lines	Investments-based	Trade-based
Predominant structure	Vertical	Horizontal

Source: Based on Gereffi (2001).

2 In line with the increasing significance of production fragmentation, there is a growing body of analytical literature on the subject. Arndt (2001, 2003) uses the term "intra-product specialization" or "super-specialization" to describe this phenomenon. Other descriptive terms sometimes used in the international economics literature include "production sharing" (Ng and Yeats, 1999), "disintegration of production" (Feenstra, 1998), "Heckscher-Ohlin (HO) plus production fragmentation" (Knetter and Slaughter, 2000), "slicing the value chain" (Krugman, 1995), "vertical specialization" (Hummels et al., 2001) and "delocalization" (Leamer, 1996). The international business literature prefers using such terms as "global commodity chains" or "fragmentation of value chains" to describe this phenomenon (for instance, see Gereffi, 1999, 2001).

Table 3 reveals that the growth of PCA trade involving developing countries has outpaced growth in manufactured trade in general and aggregate trade as well. Thus, PCA exports involving developing countries rose from 13 of total exports in 1981-1990 to over 18 per cent in 1990-2000. The share of developing countries in global PCA exports increased from a mere 4 per cent in 1981 to 21 per cent in 2000. As noted by the World Bank (2003, chapter 2), developing countries' involvement in global production networks has offered them the opportunity to raise their share of the world's fastest-growing export products (transistors and semiconductors, computers, and computer and office machine parts) from 2-3 per cent in 1980 (about the same as the share of those products in global exports) to over 16 per cent by 1998 (almost 7 percentage points higher than the share of such products in global exports).

Table 3. Growth of exports of parts, components and accessories involving developing countries, 1981-2000

(average annual percentage change in United States dollars)

Type of export	*1981-1990*	*1990-2000*
Manufactured exports	10.6	7.2
PCA exports	12.1	9.6
Share of PCA in total exports	13.2	18.5

Source: World Bank (2003, chapter 2).

Nonetheless, the trade in PCAs involving developing countries is highly concentrated, far more than total trade or manufactured goods trade in general. In this respect, almost all of the top 10 developing countries are from East Asia (Brazil being the sole exception). South Asia, sub-Saharan Africa, the Middle East and North Africa together account for only 2 per cent of developing countries' PCA exports (and two thirds of that involves India and South Africa), compared with 11 per cent of developing countries' total manufactured exports (World Bank, 2003, chapter 2). To a large extent, this concentration of PCA trade is not altogether surprising, as it is a reflection of the concentration of export-oriented FDI in core countries. After all, production fragmentation has been facilitated greatly by the expansion of the global operations of transnational corporations (TNCs) and consequent FDI. According to UNCTAD (2002, chapter 5), global markets increasingly involve competition between production systems that are organized by TNCs. As it notes:

> "While retaining their core competencies, TNCs are setting up international production systems on the basis of corporate strategies that seek to obtain the optimal configuration of their production process by spreading production to locations that offer significant advantages in production costs and access to third markets (p. 141)".[3]

The significance of production fragmentation is that, by reducing the cost of production, it makes the entire set of countries that are part of the integrated production system more attractive export markets and investment destinations – a win-win arrangement for all participants. Lower-income developing countries are not only able to gain a comparative advantage in lower-end light industries but also in the lower-end production stage of higher-tier industries, while middle- and higher-income developing countries are able to graduate to higher ends of the value-added chain, i.e., more advanced stages of original equipment manufacturing (OEM) and eventually original design manufacturing (ODM). Countries could also move horizontally, e.g. improve product quality and serve higher value-added market segments. This so-called original brand manufacturing (OBM) essentially involves moving from selling under a foreign label to developing and selling under their own label, hence allowing them to capture brand-name rents. Hong Kong, China, has done this effectively in the case of apparels, with many labels being produced by brands from Hong Kong, China. Other economies in the Asia-Pacific region are developing their own "brand names" in computers and electronics.

(b) Offshoring of service activities

Production-sharing is not limited to trade in goods as TNCs have fragmented and dispersed various services functions worldwide to take advantage of marginal differences in costs, resources, logistics and markets. Many companies – especially western ones – have come to appreciate the fact that, if they do not outsource to reduce costs, while their competitors continue to do so aggressively, they stand to lose global and local market share to their foreign rivals. This will lead to stagnant corporate profits, which will limit the creation of new capital and reinvestment in domestic technology. This has led to a rapid increase in the offshore outsourcing of and trade in many service activities that might have been considered non-tradable in the recent past. Service activities outsourced to developing countries include call centre support and back-end business process operations (BPOs), such as data entry and handling, payroll management, accounting and bookkeeping, processing of tax returns and insurance

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[3] This is not to suggest that cross-border production fragmentation always requires TNCs. In cases where there are no obvious benefits from "internationalization", outsourcing could also be conducted at "arm's length" between independent actors, i.e. separation of ownership. TNCs play a major role in production fragmentation involving semiconductors, automobiles and the like, while arm's length transactions are more common in the case of textiles and footwear and related products (see table 2). Markusen (1997) refers to TNCs as carriers of such "producer services" as management, engineering, design, marketing and financial services.

claims, ticketing, coding and organizing of documents for major litigation cases, transcription (medical and legal), as well as IT-related services, such as web hosting, network and server management, PC and application maintenance and support and development.

India has become the leading destination for outsourcing of BPO and IT services for a number of reasons, including the widespread use of English, relatively low wages, a large pool of science and engineering graduates, and the presence of strong indigenous service sector enterprises. However, other countries, among them China, Hungary, Israel, South Africa, the Philippines, Poland and the Russian Federation, are also emerging as important players (see table 4). Outsourcing to India in particular has not only involved low- to mid-skill areas, such as call centres and routine data-crunching tasks, but also more sophisticated and skills-based services, including software development, research and development (R&D), financial portfolio analysis, patent writing and product design and development, these also being niche areas for higher-income economies in the Asia-Pacific region, such as Singapore.

Table 4. Leading destinations of offshore outsourcing

Today's leader (1st Tier)		***Up and comers (3rd Tier)***	
		Belarus	Lithuania
India		Brazil	New Zealand
		Caribbean	Singapore
		Egypt	Ukraine
		Estonia	Venezuela
		Latvia	
Challengers (2nd Tier)		***Beginners (4th Tier)***	
Canada	Mexico	Bangladesh	Nepal
China	Northern Ireland	Cuba	Senegal
Czech Republic	Philippines	Ghana	Sri Lanka
Hungary	Poland	Rep. of Korea	Taiwan Province of China
Ireland	Russian Federation	Malaysia	
Israel	South Africa	Mauritius	Thailand
			Viet Nam

Source: Gartner Research Inc. (2003).

3. FOREIGN DIRECT INVESTMENT, TECHNOLOGICAL DEVELOPMENT AND GOVERNMENT POLICY

While the splitting of goods and services into finer sub-parts which are then outsourced is a means of including more countries in the production network (i.e., multiplication of supplier networks), there are well-founded concerns that small variations in costs could lead to large shifts in comparative advantage, thus necessitating large and sudden domestic adjustments.[4] Bhagwati (1997) refers to this phenomenon as "kaleidoscope" or "knife-edge" comparative advantage (i.e., TNC activities are increasingly footloose). Countries need to be ever aware of these potential cost shifts and ensure constant industrial upgrading so as to remain important cogs in the larger regional or global production system.

Notwithstanding the elasticity of the locational choices for FDI, concerted efforts need to be made to raise FDI levels as the working assumption nowadays is that, in a *relatively non-distorted* domestic policy environment, FDI fosters growth. TNC-induced FDI flows in particular are expected to bring in capital, technical know-how (elaborated below), organizational, managerial and marketing practices and global production networks, helping to accelerate the process of economic development in host countries (Lall, 2000 and OECD, 2002, chapters 1 and 3).

UNCTAD (1999) notes that TNCs can complement local development efforts by: (a) increasing financial resources for development; (b) boosting export competitiveness; (c) generating employment and strengthening the skills base; (d) protecting the environment and promoting social responsibility; and (e) enhancing technological capabilities (transfer, diffusion and generation of technology).

Technology transfer operates via four related channels: (a) vertical (backward and forward) linkages with suppliers or purchasers in the host countries; (b) horizontal linkages with competing or complementary companies in the same industry; (c) migration of skilled labour; and (d) the internationalization of R&D (OECD, 2002, chapter 1). While the transfer of technology from FDI to the domestic economy could be potentially significant, it is certainly not automatic. Indeed, the links between technological development and FDI are mixed at best (see Te Velde, 2001, Blomström and Kokko, 2003 and OECD, 2002, chapter 5).

It is sometimes argued that the absence of proactive government policies engenders the risk that TNCs will actually inhibit technological development in a host country with few vertical linkages (i.e., so-called "screw-driver" operations with minimal value-added and minimal procurement from local suppliers or interaction with local

[4] After all, the whole basis of production fragmentation – at least as discussed above – has been to exploit factor price differentials.

businesses) and crowd out domestic investment.[5] However, one has to pause before recommending a proactive industrial strategy for *all* developing countries. In cases where administrative capacity is weak (i.e., government failure is pervasive) and resources are scarce, it may be advisable for countries to eschew selective policy intervention. As Lall (2002) notes:

> "FDI strategy is an art not a science…If administrative capabilities are not appropriate to the skill, information, negotiation and implementation abilities needed, it may be best to minimize interventions with the market: to simply reduce obstacles in the way of FDI, minimize business costs and leave resource allocation to the market…(T)here is no ideal universal strategy on FDI. Strategy has to suit the particular conditions of the country at the particular times, and evolve as its needs change and its competitive position in the world alters" (pp. 20 & 21).

In relation to this, Te Velde (2001) notes:

> "(W)hilst richer countries with more financial resources and local capabilities can afford a risky and costly proactive stance towards FDI…, and can use FDI... strategically... many poorer countries are left behind with relatively fewer local capabilities. This is particularly worrying since local capabilities play the dual role of attracting FDI and enhancing positive spillovers associated with FDI" (p. 50).

This conclusion is probably too pessimistic. A more careful examination of the empirical studies linking FDI and technological development suggests that FDI is more likely to be a significant catalyst to overall industrial development the higher the income of the host country. This in turn is often interpreted as signifying that the host country must be capable of absorbing the new technology manifested in FDI (e.g., see Blomström et al., 1994). In a similar vein, another common finding is that the greatest technological spillovers from FDI occur when the technological gap between local and foreign enterprises is not very large, and crowding in of FDI and technology transfer is more likely the higher the level of human capital (Borensztein, et al., 1998, Xu, 2000 and OECD, 2002, chapters 5 and 6).

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[5] While the oft-cited study by Borensztein, et al. (1998) reveals that FDI has a net crowding-in effect on domestic private and public investment, thus advancing overall economic growth, the finding is not unambiguous. For instance, Lipsey (2000) notes that "past FDI inflows are not a significant positive influence on the current period's investment ratio" (p.76). However, in a more nuanced study, Agosin and Mayer (2000) find that the crowding-in effects of FDI vary with regions, with strong evidence of *crowding-in* in Asia but net *crowding-out* effects in Latin America. While many papers have explored the links between FDI and domestic investment, Rajan (2004b) discusses the nexus between FDI and other sources of external finance.

More generally, while there are studies that find a positive link between FDI and economic growth, FDI appears less positive in least developed countries, suggesting the existence of a "threshold level of development" (Blomström and Kokko, 2003 and Blomström et al., 1994; see also Nunnenkamp, 2004). As OECD (2002, chapter 3) concludes:

> "Apparently, developing countries need to have reached a certain level of educational, technological and infrastructure development before being able to benefit from a foreign presence in their markets. An additional factor that may prevent a country from reaping the full benefits of FDI is imperfect and underdeveloped financial markets" (p. 69).

Thus, possibly the best type of policy intervention would involve general steps to enhance a country's overall domestic human capital and technical capabilities on a non-discriminatory basis, rather than attempting technology transfer domestically or selective intervention to maximize the linkages between local firms and the local subsidiaries of TNCs. In any event, policies involving domestic content or performance requirements, joint ventures, technology licensing requirements and the like have generally had mixed results at best (for instance, see OECD, 2002, chapter 10). In fact, "artificial" attempts to indigenize TNC activities may make the TNC affiliate's operations less integrated with the production network of the parent, to the detriment of the host country.[6] To maximize spillover benefits from FDI on a sustained basis, host country characteristics (in terms of human capital, technological capacity, infrastructural development, etc.) must be improved. Any other policy is likely to be ineffective and short-lived at best, or distortionary and detrimental at worst.

4. STEPS TO BOOST FOREIGN DIRECT INVESTMENT INFLOWS

While the foregoing has discussed steps to maximize the growth benefits of FDI, the current global environment is characterized by an intense "global race" for foreign investment. No doubt, FDI is drawn to different countries for different reasons – resource seeking (natural or human resources), market seeking, efficiency seeking or strategic-asset seeking (OECD 2002, chapter 2). Nonetheless, at a general level, in order for a country to be more attractive to investors (both local and foreign), there is a need to put in place measures to ensure the existence of an enabling environment, i.e., one that is conducive to doing business. At a general level, openness to international trade and access to international markets, ensuring a stable, a transparent and predictable

[6] In addition, there are acute risks in restricting FDI inflows or activities so as to promote the development of local enterprises (conventional "infant industry" argument). For instance, it is often quite difficult in reality to distinguish between crowding out and legitimate competition.

macroeconomic and regulatory environment, and lowering the costs of doing business (transaction costs) are obvious but not always easily implementable measures needed to attract FDI.[7]

(a) Investment promotion

Over and above the general steps for attracting FDI mentioned above, it may be important for a potential host country to actively undertake investment-promotion policies to fill in information or correct perception gaps that may hinder FDI inflows. Wells and Wint (2000) define investment promotion as "activities that disseminate information about, or attempt to create an image of the investment site and provide investment services for the prospective investors."

Table 5 summarizes the annual budgets for investment promotion of selected Asian countries as well as non-Asian ones. As is apparent, on a per capita basis, Singapore – a major success story as far as FDI-led development is considered (Rajan, 2003) – massively outspent the other countries on a per capita basis. Any investment

Table 5. Annual FDI promotion budget of selected countries, 1999

Country	*Annual FDI promotion budget (Millions of US dollars)*	*Per capita budget (US dollars)*
Asian countries		
Indonesia (BKPM)	2.8	0.01
Malaysia (MIDA)	15	0.66
Philippines (BOI)	3	0.04
Singapore (EDB)	45	14.06
Thailand (BOI)	10	1.49
Non-Asian countries		
Dominican Republic (IPC)	8.8	1.05
Mauritius (MEDIA)[a]	3.1	2.58
Ireland (IDA)[b]	41	11.16
Costa Rica (CINDE)	11	3.14

Source: Te Velde (2001).

[a] Data from 1996.
[b] Excluding grants.

[7] Space limitations preclude a detailed discussion of all steps to attract FDI. See Brooks et al. (2004), Lim (2001) and OECD (2002), chapter 1. Administrative barriers can significantly raise the costs of establishing a business and doing business. Using a new database involving 32 developing countries, the empirical analysis by Morisset and Neso (2002) indicates that, for every decrease of 10 percentage points in administrative costs, the FDI to GDP ratio increases by 1.2 percentage points.

promotion strategy must be geared towards the following: (a) image-building activities promoting the country and its regions and states as favourable locations for investment; (b) investment-generating activities involving the direct targeting of firms by promoting specific sectors and industries, as well as personal selling and the establishment of direct contacts with prospective investors; (c) investment-service activities tailored to prospective and current investors' needs; and (d) raising the realization ratio (i.e., the percentage of FDI approvals translated into actual flows).

A case might be made for establishing a one-stop investment promotion agency (IPA) to assist in the entry and operation of FDI. The logic of an IPA and the need for it appear to have been embraced by a number of countries, as there are about 160 national IPAs and over 250 subnational ones (UNCTAD, 2001). While a one-stop investment promotion agency could facilitate FDI by lowering administrative delays and costs, Lall (2000) correctly notes that,

> "unless the agencies have the authority needed to negotiate the regulatory system, and unless the rules themselves are simplified, this may not help. On the contrary, there is a very real risk that a one stop shop becomes one more stop". (p. 10)

The foregoing conclusion finds justification in a recent empirical analysis of IPAs in 58 countries conducted between February and May 2002 by Morisset (2003). In particular, while there is some evidence that IPAs have a positive impact on FDI, this is more likely to be the case in circumstances where IPAs: (a) have a high degree of political visibility (for instance, by being linked to the highest government official such as the prime minister); (b) have active private sector involvement via, for instance, representation on the IPA's board; and (c) operate in a country with a good overall investment environment. Morisset (2003) further finds that the types of functions that IPAs undertake have a bearing on their effectiveness, with "policy advocacy" – defined as steps to improve the overall investment climate and to identify the views of the private sector – appearing to be the most effective function. This is followed by investment facilitation or servicing (i.e., the roles conventionally attributed to a one-stop shop) and image building. IPAs seem *least effective* in actually generating investments, principally when aimed at specific sectors.

This further emphasizes that growth-enhancing FDI policy intervention probably ought not to be sectorally biased. Instead, intervention should focus on improving the host country's general capability to benefit from FDI by improving the quality of the labour force and infrastructure in a country, developing local skills and technology and local learning, and ensuring a stable and conducive overall macroeconomic and regulatory environment.[8] Indeed, even the Government of Singapore – renowned for its

[8] Nonetheless, UNCTAD (2002, chapter 3) argues that a policy of targeted promotion potentially has high payoffs, though it acknowledges that it can be risky as well.

interventionist stance with regard to industrial policy – appears to have gained an appreciation of this point. As Tharman Shanmugaratnam, Senior Minister of State in the Ministry of Trade and Industry and currently Minister of Education, recently noted:

> "Within manufacturing and services, we will have to leave it to the market to spot future winners. Some broad clusters of growth activity are clear enough in global markets – within manufacturing, these include electronics – notwithstanding its cyclical gyrations – chemicals and the biomedical sciences. But we cannot tell what proportions of Singapore manufacturing each of these clusters will occupy in future, or which firms and which specific industries within these clusters will remain winners. Nor can we tell if other new clusters will emerge as major growth potentials for Singapore. We should therefore leave room for more 'white space' in our economic structure. The Government can support market players where they decide it is worth basing their operations in Singapore. But we should aim to make our tax system and other incentives less targeted and more broad-based, so as to accommodate a greater degree of market experimentation, whether in manufacturing or services" (Shanmugaratnam, 2002).

(b) Fiscal and financial incentives

The recognition of the importance of FDI for overall economic growth has implied that countries will increasingly compete with each other to attract FDI by offering a number of incentives and other concessionary measures. As the World Bank (2003, chapter 3) notes, apart from *fiscal incentives*, i.e., "policies that are designed to reduce the tax burden of a firm (including loss write-offs and accelerated depreciation)", countries could impose *financial incentives*, i.e., "direct contributions to the firm from the Government (including direct capital subsidies or subsidized loans)". While developed countries tend to prefer using financial incentives, fiscal or tax incentives seem to be favoured by developing countries, though this may not always be the case (as noted below).[9]

Many East Asian economies have made extensive use of preferential tax treatments and other implicit and explicit subsidies to attract TNCs. The econometric investigation performed by Chen et al. (1997) provides some empirical confirmation of the potential tax competition between certain East Asian economies (viz. Hong Kong,

[9] Of course, different types of fiscal or financial incentives can have varying impacts on TNCs. For instance, tax holidays tend to encourage short-term or footloose investments, as generous benefits to investors tend to accrue only for the first few years. In contrast, low corporate taxes generally offer lower initial benefits, but tend to be higher in present value terms the longer the duration of the investment. More work is needed on the comparative impacts of alternative incentives (for instance, see McClure, 1999).

China; Malaysia; Singapore; and Taiwan Province of China) for FDI from the major industrialized countries (viz. Germany, Japan, the United Kingdom of Great Britain and Northern Ireland and the United States of America) between 1972 and 1980. In fact, Chia and Whalley (1995) suggest the existence of a sort of Stackelberg competition among South-East Asian countries, with the rest of the countries emulating or responding to the tax incentives provided by Singapore. States with strong fiscal positions can use a combination of low tax rates and aggressive fiscal incentive policies as a competitive strategy against fiscally weak States.

Tax incentives form only a part of the overall picture. The negotiation of financial incentives with particular tax officials is not uncommon in some East – especially South-East Asian countries. So, even though formal tax incentives may not be available, taxpayers may still enjoy significant monetary benefits. For instance, Singapore provides subsidies for investors that go well beyond traditional tax measures, involving training, expenditure, land and utility pricing and even rather large equity stakes in selected ventures.[10] As with the formal incentives, financial incentives are likely to benefit large companies, both domestic and foreign, disproportionately. Transparency in fiscal and financial incentive regimes has been rather low in South-East Asia (Asher and Rajan, 2001, 2003).

Despite concerns regarding the use of such incentives and the fiscal costs of such "bidding contests", the unilateral withdrawal of incentives as policy instruments by any single country would be potentially costly to it. Most of the higher and middle income South-East Asian countries in particular have operated on the basis that, in a globalized world, those able to locate a particular activity or a plant in their jurisdiction will be in a better position to grow. Thus, it is the insecurities of globalization that have been driving formal tax incentives in these countries. It is for this reason that they have not been able to agree on rules to govern competition for investments; there remains a genuine risk of a fiscal and financial bidding war (Asher and Rajan, 2001, 2003 and Nicholas et al., 1999).[11]

While the theoretical literature on fiscal and financial incentives and FDI is burgeoning (see the review by Devereux, 1990), the empirical literature is rather lagging. However, the available empirical evidence to date suggests that such fiscal incentives may be important at the margin in influencing investment decisions (see Chen et al., 1997, for a succinct review of the empirical studies). Such incentives are particularly useful when used essentially as signalling devices about the Government's/

[10] An example is the Local Industrial Upgrading Program (LIUP) of the Economic Development Board (EDB) of Singapore. The aim of this scheme is for TNCs to help raise the efficiency of local suppliers in stages. A large part of the success of this scheme has been due to the financial incentives offered by EDB in the form of subsidies for training programmes (OECD, 2002, chapter 10). UNCTAD (2001) offers a useful overview of the general features that a successful upgrading programme ought, in its view, to have.

[11] TNCs can always minimize tax burdens by using transfer-pricing devices.

country's general (welcoming) attitude towards foreign investment and the overall business environment.[12] Tanzi and Shome (1992) draw this conclusion with regard to fiscal incentives in East Asia. Conversely, tax incentives will be least effective when used as substitutes for necessary investment-conducive policies, such as overall macro-economic policies, including a "fairly valued" exchange rate (i.e., a rate consistent with underlying macro fundamentals) and infrastructural and supporting facilities. This was also the main conclusion of a study surveying Japanese TNCs in Thailand. Policy variables, such as tax incentives, were considered secondary to such factors as market size, social and political stability and labour costs (Nicholas et al., 1999).

In the final analysis, countries looking to attract FDI – particularly lower income, peripheral countries – ought to eschew ad hoc, discretionary regimes (which could give rise to rent-seeking activities) and instead focus on deploying a simple tax system with low rates for all investors (with no preference between domestic and foreign investors), with corporate tax rates that are comparable to those prevailing in capital-exporting countries (Moran, 1998).[13] However, it is worth repeating that, beyond a signaling role, such incentives do not make up for deficiencies in the overall investment environment.

5. CONCLUDING REMARKS

Notwithstanding some important caveats, it is almost universally acknowledged that FDI has a potentially important role to play in a country's growth and development. The working assumption nowadays is that, in a *relatively non-distorted* domestic policy environment, FDI fosters growth by promoting greater competition (both in terms of price/market structure as well as via "X-efficiency") and trade and facilitates a country's overall integration with the global marketplace.

The growing significance of production fragmentation emphasizes the need for Governments seeking export-oriented FDI "to go beyond trade and FDI policies and assess their locational advantages in the international production system context" (UNCTAD, 2002). Accordingly, apart from issues relating to financial and fiscal incentives and investment promotion, regional integration efforts that lower the costs of cross-border transactions are increasingly viewed as an attractive tool for promoting trade, FDI and technological progress. While regional trade agreements (RTAs) have flourished recently in the Asia-Pacific region (Rajan, 2004c), they are clearly second-best solutions, multilateral trade liberalization being first-best. As RTAs are second best, neither theory nor empirics are able to offer any definitive insight into the likelihood of

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12 See Bond and Samuelson (1986) for a formalization of the signalling role of tax holidays.

13 Indeed, the close nexus between host and source country tax policies is a rather under-appreciated but significant factor in determining the effectiveness of tax incentives (for instance, see Asher and Rajan, 2001, 2003).

net benefits from participation in one. Nonetheless, it is almost certain that a country that is *not* a participant in any of the new RTAs will be adversely impacted owing to trade and investment diversion and a reduction in their terms of trade.

While all RTAs appear, in principle, to be open to new members, the terms of accession for new members are unclear. In many cases, it is likely that the new or potential member must be prepared to join the existing RTAs on the prevailing terms, implying a de facto loss of policy autonomy at best, complete inaccessibility at worst. Consequently, there is a strong case for joining RTAs for "defensive reasons" (Whalley, 1996).[14] It is therefore imperative that developing countries that are hitherto not part of the new regionalism look to consciously establish such linkages with other high-income countries while simultaneously focusing on multilateral trade liberalization. For such liberalizing economies, "open" RTAs with higher-income, liberal trade partners may strengthen the hand of exporters and other pro-trade forces and thus the political support for further liberalization.

At the very least, the new RTAs should be – and, in fact, have been – geared towards trade facilitation measures, such as streamlining and standardizing customs procedures and providing timely and relevant information on cross-border trade and investment opportunities. Trade facilitation has been among the more significant areas of economic cooperation pursued by the Asia Pacific Economic Cooperation (APEC) Forum (Wilson et al., 2002). It is important that non-APEC members of UNESCAP, particularly those in South and Central Asia, pay equal attention to such trade facilitation measures, as do the members of other subregional alliances (for example, the parties to the Bangkok Agreement). From the perspective of promoting real sector openness and development in the Asia-Pacific region, there is a strong case for encouraging APEC to open up its membership to other countries in Asia, at least those that have shown a genuine willingness to enhance their degree of integration with the global economy in a market-consistent manner.

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[14] The following quote in Crawford and Laird (2001) is apt: "RTAs are like street gangs: you may not like them, but if they are in your neighbourhood, it is safer to be in one" (p. 201).

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Economic Impact and Social Adjustment Costs of Accession to the World Trade Organization: Cambodia and Nepal

*Pierre Sauvé**

ABSTRACT

This paper focuses on the strengths and weaknesses of the WTO accession process in light of the experiences of Cambodia and Nepal, the first two least developed countries (LDCs) to accede to the multilateral trade organization. An analysis of Cambodia's and Nepal's terms of accession confirms the general trend of exacting significant, "WTO+", concessions from acceding countries. Both cases follow the trend, despite good intentions and calls for policy compassion embedded in the WTO accession guidelines of December 2002. Such guidelines do not appear to have yielded readily identifiable, tangible results for the two acceding countries, nor do they appear to have specifically strengthened the countries' negotiating positions. The paper devotes particular attention to a number of structural shortcomings that current accession negotiations reveal when assessed from a development perspective and offers a number of ideas on how best to overcome the development deficit of current accession procedures, particularly as regards LDCs. The paper argues that greater

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joint efforts need to be made by the trade and development communities in helping acceding countries to comprehensively assess and properly anticipate potential accession-related costs and the distributional downsides of market opening. Doing so would enable acceding countries to strengthen their negotiating position when they argue that commitments and rules should take account of their level of development, as recommended in the recent accession guidelines. It would also help acceding countries to better identify commitments that are most useful for their development strategy, especially where they need to decide whether accepting costs up-front would be wise from a longer-term development perspective. Joint efforts between the trade and donor communities are also needed to butress the supply capacity of acceding countries so as to help them generate the gains implicit in WTO membership.

1. INTRODUCTION

Cambodia and Nepal recently became the 147th and 148th members of the World Trade Organization (WTO) and were the first least developed countries (LDCs) to join this organization through full Working Party negotiations. The fact that, since the WTO was established in 1994, no LDCs had been able to accede had raised some doubts about the resolve of developed member countries to see LDCs share in the benefits of globalization. In addition, there were some controversial accession experiences, such as that of Vanuatu, which contributed to perceptions of WTO accession as a power-based, development-unfriendly exercise (Grynberg and Joy, 2000).

In 2002, the WTO's General Council agreed on guidelines to facilitate the process of accession by LDCs. The impact of such guidelines is difficult to assess when examining the commitments undertaken by Cambodia and Nepal. There is little tangible evidence of any specific effect of the guidelines on the results of the accession process, as reflected in the accession documents of the two countries.

No standard procedure has been agreed upon for acceding to the WTO (Bosworth and Duncan, 2002). Accession negotiations are approached on a case-by-case basis, with some guidance from prior accession practices. This paper reflects on the strengths and weaknesses of the accession process in light of the experiences of both countries and analyses the accession process in terms of its compatibility with general development objectives that are supposed to underpin the accession of LDCs to the WTO.

There are several reasons why this is a difficult exercise, even under the best of circumstances. First, the tangible benefits of accession are more likely to accrue at a future date, while the costs, including any shortfall in tariff revenue (for which some meaningful projections are possible), tend to be borne much earlier. Second, the precise price tag of these costs, whether these relate to implementation or to related domestic regulatory reform efforts, depends on many variables, including the degree of ambition in the implementation process, which can range from merely drafting a new law to taking the complex institutional and administrative steps required for its efficient and effective application. Third, when a broader development perspective is taken, the relative costs and benefits of WTO accession are actually a subset of the costs and benefits of trade liberalization and structural reform.

In recent years, views on the issue of liberalization and structural reform have tended to diverge more widely (Ben-David and Winters, 2000; Rodrik, 2001). Assessment of the costs and benefits of joining WTO assumes greater complexity when faith in a linear, causal, relationship between trade liberalization and increased trade, growth and development starts to waver. Development and poverty reduction are the top priorities for LDCs, and the impact of trade liberalization on these two fundamental economic and social priorities would require an integrated approach that assesses the implications of international trade in a number of policy areas, such as food security, education, the environment, the provision of social services and employment conditions (including those of women) in affected industries, among others.

Despite the above-mentioned challenges, it is still possible to make some observations based on a review of Cambodia's and Nepal's accession experiences that might deliver some insights for countries that are in the accession process in the absence of defined benchmarks for acceding to the WTO. However, such considerations must be made with the understanding that each accession is a distinct case.

Some general trends that have been common to most recent accessions can also be found in the accession protocols of both Cambodia and Nepal. Tariff concessions appear to be ambitious in the case of Cambodia, and, to a lesser extent, in the case of Nepal. In general, however, almost all of the implementation commitments covering market access for trade in goods are found to a larger extent in the two countries' plans for legislative implementation than in their schedules of tariff concessions. In both cases, such plans set ambitious targets, which would substantially alter national regulatory frameworks upon implementation.

With regard to services, both countries have agreed to far-reaching commitments. This is the area where perhaps the greatest number of concessions have been made and where significant post-accession implications might be expected, given the critical importance of services for macroeconomic performance and thus national development (World Bank, 2004). Assessing potential benefits and costs in the service trade is largely a question of how the commitments reflected in the schedules of accession would lead to sustained improvements in the domestic legislative framework that regulates various services sectors and in the enforcement capacity of national regulatory agencies.

The immediate preoccupation for Cambodia and Nepal after accession is trade-related technical assistance and capacity-building. Both are intended to ensure that the implementation of commitments would be sustained. Drafting, approving and implementing legislation can be daunting tasks for any Government. When countries also experience significant political uncertainty at the ratification stage, such challenges should not be further compounded by technical constraints in such areas as customs legislation, technical standards, intellectual property or banking regulations. Such constraints could have potentially serious adverse effects on trade and investment, in particular where domestic enterprises are involved.

In this context, the link between foreign direct investment (FDI) and ongoing improvements in host countries' investment climates deserves particular emphasis. A major rationale behind the importance and the legitimacy of liberalization and efforts at regulatory reform is the promise of additional, accession-induced, FDI. However, this link is not generally realized during the actual negotiations, despite political statements to the contrary. One major reason is that investment rules per se do not feature directly on the menu of accession negotiations beyond the GATS and the TRIMs Agreement.

In the next few years, it will be possible to assess whether the commitments by Cambodia and Nepal are proving to be sustainable and are starting to generate broader development gains. At the present time, quantifying the costs and benefits of WTO accession can only be speculative. However, this paper outlines some specific points and structural issues that negotiators from other acceding countries might consider in conducting their own accession talks.

2. A LOOK AT THE ACCESSION NEGOTIATIONS: THE EXPERIENCES OF CAMBODIA AND NEPAL

An analysis of Cambodia's and Nepal's terms of accession confirms the general trend of exacting significant "WTO+" concessions from acceding countries. Both cases follow the trend, despite good intentions and calls for policy compassion embedded in the WTO accession guidelines of December 2002.[1] Such guidelines do not appear to have yielded readily identifiable, tangible results for the two acceding countries, nor do they appear to have specifically strengthened those countries' negotiating positions. Selective evidence of this outcome can be given in order to set the stage for a tentative assessment of the likely implementation costs and development implications of the accession processes of Cambodia and Nepal.

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1 Note that the level of accession commitments may not always reflect negotiating asymmetries. The commitments may be dictated by domestic political and developmental choices, which is apparently the case for the ambitious service commitments (especially mode 3 commitments) by Cambodia.

(a) Trade in goods

(i) Tariffs and market access commitments

Both Nepal and Cambodia made important liberalization commitments involving trade in goods. According to the report of the WTO Working Party on Nepal's accession, the prevailing applied customs tariff rates ranged from 5 to 130 per cent (with intermediate tariffs from 10, 15, 25, 40 and 80 per cent; WTO, 2003). The unweighted average customs duty rate for imports had been approximately 11 per cent since 1996/1997. The maximum tariff rate of 130 per cent, applied to cars and jeeps, would be reduced and specified in the goods schedule. In addition, Nepal applied a significant amount of other duties and charges on imports, ranging from 2.5 to 11.5 per cent on industrial goods and from 2.5 to 14.5 per cent on agricultural products.

According to one recent report (Bhandari, 2004), the average bound tariff rate of Nepal was higher than its average applied tariff rate. The average applied tariff rate of Nepal for both agricultural products and industrial goods was about 11 per cent. The average bound rate for agricultural products was 51 per cent, scheduled to go down to 42 per cent after three years. Similarly, the average bound tariff rate for industrial products was 39 per cent at the date of accession, a level that would be lowered to 24 per cent in three years. Nepal has also made a commitment to eliminate other significant duties and charges, as mentioned above, over a period ranging from 2 to 10 years.

Estimates based on available data are shown in table 1, which provides some details on the potential impact of Nepal's market access commitments. Assuming that applied rates before accession would continue to be applied and that other duties and charges would be completely eliminated, a potential revenue loss of about US$ 55 million could be expected.[2] This implies that about one fourth of Nepal's total customs revenues (US$ 200 million) might be foregone if applied rates (or the lower bound rates) were immediately implemented in 2004.

The sectoral incidence of tariff cuts and foregone revenue shows that the biggest losses would result from the elimination of duties and charges on imports of rice (an estimated loss of US$ 5.5 million) and from the lowering of the tariffs on motor vehicles from the currently applied 130 per cent to the bound rate of 40 per cent (a decrease of about US$ 15 million). Other losses would be incurred from lowering the applied rates to bound rate levels for machines and mechanical appliances (about US$ 3 million), computers (about US$ 800,000) and telephones (about US$ 1 million).

Estimates of overall trade creation for Nepal resulting from the total elimination of other duties and charges and the application of the final bound rates to sectors where bound rates are lower than previously applied rates would be equivalent to US$ 89 million. Such effects mainly accrue in the same sectors where customs revenue losses would be highest.

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[2] In 2001, total official development assistance (ODA) to Nepal was US$ 388.1 million (UNDP, 2003, p. 293).

Table 1. Nepal: simulation of trade effects for all imported products, in base year 2002

HS section description	*Tariff rates (percentage)*					*Import values (US$ thousand)*			*Simulation results (US$ thousand)*		
	MFN applied	*Other duties and charges (ODC)*	*MFN applied and ODC*	*Bound 2004*	*Bound final*	*From world*	*Duty revenue*	*Final offered rate (%)*	*Trade creation*	*Revenue change*	*Welfare change*
Live animals and products	14.9	5.4	20.3	49.9	48.0	8 481	1 718	14.9	412	−396	12
Vegetable products	10.1	10.5	20.6	53.4	47.2	79 522	16 407	10.1	6 409	−7 683	423
Fats and oils	7.0	4.5	11.5	53.4	47.0	41 230	4 727	7.0	1 793	−1 693	40
Prepared food, etc.	24.2	5.0	29.2	73.2	70.2	28 199	8 135	24.2	952	−998	28
Mineral products	2.8	3.9	6.7	33.6	19.6	31 204	1 350	2.8	545	−428	10
Chemical and products	8.8	3.6	12.5	33.5	21.5	144 104	17 956	8.8	7 243	−4 476	140
Plastics and rubber	17.0	4.4	21.3	39.4	22.7	39 796	8 480	16.9	2 508	−1 303	56
Hides and skins	15.0	4.5	19.5	50.1	30.0	860	168	15.0	65	−29	1
Wood and articles	13.6	4.3	17.9	34.1	26.3	411	74	13.6	26	−14	1
Pulp, paper, etc.	8.5	3.8	12.3	35.0	19.5	14 169	1 748	8.5	673	−482	14
Textile and articles	8.2	3.2	11.3	45.0	23.6	196 370	22 286	8.2	6 792	−5 540	119
Footwear, headgear	29.9	4.5	34.4	49.0	36.2	3 146	1 082	29.9	211	−80	5
Articles of stone	14.5	4.4	18.9	40.8	29.5	6 352	1 199	14.5	376	−224	8
Precious stones, etc	5.0	2.5	7.5	35.0	20.0	118 051	8 877	5.0	174	−161	2
Base metals and products	11.8	3.4	15.1	37.3	23.4	76 922	11 637	11.8	2 468	−1 886	45
Machinery	9.6	3.6	13.2	27.0	13.1	174 311	23 017	5.9	14 717	−10 867	941
Transport equipment	80.1	6.6	86.7	83.6	38.4	87 018	71 720	37.2	42 159	−17 897	14 868
Precision instruments	8.5	3.5	11.9	28.1	14.2	18 245	2 178	7.5	1 223	−707	40
Arms and ammunition	80.0	..	..	..	..	781	625	80.0	0	0	0
Miscellaneous manufactures	16.6	4.4	21.0	40.7	26.3	7 555	1 587	14.9	673	−339	28
Works of art, etc.	25.0	4.5	29.5	50.0	30.0	11	3	25.0	0	0	0
Special uses	..	..	..	..	..	0	0	..	0	0	0
Weighted averages and totals	15.2	4.1	19.3	42.9	26.3	1 076 738	204 975	11.1	89 417	−55 203	16 782

Source: Applied tariffs from TRAINS, bound rates from WTO web site, trade flows from Comtrade and imports for 2002 from the World Bank. Estimates of tariff revenue foregone and trade creation are elaborated with WITS.

Table 2 shows calculations based on available data for Cambodia. The weighted bound tariff rate for Cambodia is about 20.4 per cent, higher than the applied rate of 13.4 per cent. However, when these figures are matched with actual trade flows, some interesting findings emerge. Calculations show a revenue loss of about US$ 23 million, representing 11 per cent of total revenues (estimated at US$ 253 million).[3] Most of these losses could be traced to tariff reductions on imports of intermediate materials used by garment factories, where the applied rate of 35 per cent would be reduced to levels between 10 and 17.5 per cent in most cases. Other areas where significant losses of customs revenue may occur are imports of automobiles and spirits. Expected trade creation would be equivalent to US$ 34.1 million and would likely be generated in sectors where accession-induced bound rates are lower than previously applied rates and where trade flows have been recorded.

Cambodia does not apply any other duties or charges to earn revenue from trade. Efforts are being made to replace the expected revenue losses by introducing a value added tax (VAT) system and by increasing excise taxes. Motor vehicles (and spare parts) and motorcycles are singled out for exceptional treatment, however. Motor vehicles face excise duties ranging from 25 to 110 per cent while motorcycles face such duties in the range of 5 to 45 per cent (WTO, 2003).

(ii) Customs and trade remedy legislation

One of the most challenging tasks concerning customs regulations for both Cambodia and Nepal will be the adoption of the WTO Customs Valuation Agreement. Each country would have a *de facto* transition period since the harmonization of non-preferential rules of origin has not yet been carried out. The transition period for Cambodia lasts until the end of 2008 and until January 2007 for Nepal. These transition periods are subject to a detailed schedule of progressive implementation.

The issue of reference prices has received particular attention. In the case of Cambodia, minimum values have been used for a number of products, such as cars, computers, air-conditioning equipment and some agricultural products. Such minimum values will continue to be applied subject to progressive phasing out according to a specific action plan, which is part of Cambodia's accession commitments (WTO, 2003).

Nepal also faces major challenges related to the use of reference prices. Such prices would have to be phased out during the first year that the Customs Valuation Agreement is implemented as reflected in the action plan agreed as part of the accession commitments (WTO, 2003a). In the cases of both Cambodia and Nepal, substantial technical assistance would be expected from international organizations, such as the World Bank and the World Customs Organization (WCO).

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[3] In 2001, total official development assistance to Cambodia was US$ 408.7 million (UNDP, 2003, p. 293).

Table 2. Cambodia: simulation of trade effects for all imported products, in base year 2001

HS section description	*Tariff rates (percentage)*			*Import values (US$ thousand)*		*Final offered rate (%)*	*Simulation results (US$ thousand)*		
	MFN applied	*Bound 2004*	*Bound final*	*From world*	*Duty revenue*		*Trade creation*	*Revenue change*	*Welfare change*
Live animals and products	29.8	35.2	35.2	17 808	5 299	29.8	0	0	0
Vegetable products	10.9	30.5	30.4	16 181	1 761	9.0	244	–263	24
Fats and oils	7.0	32.3	32.3	10 735	751	7.0	0	0	0
Prepared food, etc.	16.2	36.5	36.5	242 298	39 193	15.5	1 166	–1 123	58
Mineral products	14.6	30.4	30.4	193 560	28 330	14.6	22	–16	0
Chemicals and products	7.9	12.0	12.0	130 110	10 304	7.6	543	–318	26
Plastics and rubber	21.6	23.0	23.0	58 042	12 513	20.4	859	–344	64
Hides and skins	33.5	33.5	33.5	17 175	5 750	33.2	58	–31	6
Wood and articles	34.8	34.8	34.8	2 389	831	34.8	0	0	0
Pulp, paper, etc.	7.0	20.0	20.0	44 629	3 136	7.0	0	0	0
Textile and articles	11.7	10.4	10.4	616 985	71 891	8.0	24 348	–17 999	2 634
Footwear, headgear	13.8	24.6	24.6	16 343	2 255	13.8	0	0	0
Articles of stone	8.4	20.7	20.7	28 874	2 428	8.4	7	–4	0
Precious stones, etc.	49.9	35.0	35.0	9 845	4 912	34.9	1 929	–797	145
Base metals and products	13.2	19.3	19.3	84 621	11 156	12.5	674	–427	23
Machinery	16.8	19.4	18.0	180 562	30 283	15.0	3 300	–1 970	245
Transport equipment	13.8	25.3	25.3	112 265	15 507	13.8	37	–15	2
Precision instruments	11.1	19.8	17.0	14 341	1 587	10.1	179	–131	12
Arms and ammunition	50.0	35.0	35.0	9	5	35.0	1	–1	0
Miscellaneous manufactures	15.1	21.9	21.9	35 944	5 441	13.5	785	–318	59
Works of art, etc.	0.0	15.0	15.0	65	0	0.0	0	0	0
Special uses	..	..	..	0	0	..	0	0	0
Weighted averages and totals	13.8	20.4	20.3	1 832 781	253 335	12.1	34 152	–23 758	3 300

Source: Applied tariffs from TRAINS, bound rates from WTO website, trade flows from Comtrade and imports for 2001 from the World Bank. Estimates of tariff revenue foregone and trade creation are elaborated with WITS.

With regard to implications for the government budget, sustaining tariff reductions in the case of Cambodia and eliminating other duties and charges in the case of Nepal would depend to a large extent on the ability of customs administrations and fiscal authorities to administer the Customs Valuation Code and excise taxes in an effective way. Cambodia also needs to introduce a system of value-added taxes expeditiously.

With regard to trade remedies, neither Cambodia nor Nepal has contingency protection laws, such as anti-dumping, countervailing duties or safeguards. Both countries affirmed their commitment to making legislation in these areas WTO-consistent should such laws be enacted in the future. Each country has legislative plans that include drafting such laws. However, other more pressing accession commitments may need to be given priority attention.

In the case of Nepal, and to a lesser extent Cambodia, the gap between bound and applied rates should provide a sufficient margin of flexibility to ensure that any sudden increase in imports can be dealt with through an increase in applied duties, without the need for contingency protection measures. Furthermore, regulation involving anti-dumping and countervailing duties is becoming increasingly more complicated and costly to administer. Recent disputes brought against developing countries from both developed and other developing countries show the risks associated with the use of trade remedy legislation that is technically complex.

(iii) Technical barriers to trade and sanitary and phytosanitary measures

Commitments in the areas of technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures can be considered from both the import and export sides, with associated costs and benefits varying according to one's vantage point. When considering the composition of Cambodian exports, the SPS agreement is of direct interest with regard to exports of shrimp and tuna to Japan, which have a value of about US$ 10 million annually. However, garments are Cambodia's main exports, accounting for more than 90 per cent of total exports, which suggests that the TBT agreement might be of greater importance.

The export composition is slightly less concentrated in the case of Nepal, although garment and textile exports remain significant. Exports of butter and dried lentils together account for 10 per cent of total Nepalese exports (valued at about US$ 52 million annually) and have a potential to be covered by SPS measures in the Indian market, which is the main destination for such agricultural products.

On the import side, implementation of both the TBT and SPS agreements is relevant for a number of WTO members that currently export to Cambodia and Nepal. This explains why significant attention was given to the implementation of these agreements during the accession negotiations. The Working Party reports for both countries stress the need to fully apply the TBT and SPS agreements, establish enquiry points, apply existing regulations on a non-discriminatory basis and give notification of existing and future legislative changes.

It is clear that new institutions will have to be created and existing ones strengthened in order for both countries to meet many of the commitments related to the TBT and SPS agreements. In view of the complex and technical nature of the issues, significant demands on the government budget might not be fully met by technical assistance grants alone.[4]

(iv) Subsidies

The view from a development perspective is that developing countries should be given a certain amount of autonomy and policy space in order to use subsidies as a major policy instrument. Such a proposition tends to be analysed and debated chiefly with regard to developing countries in the middle- or higher-income categories. However, the situation for LDCs, such as Cambodia and Nepal, suggests that they have a limited ability to use subsidies owing to budget constraints.

Both Cambodia and Nepal have provided subsidies through exemptions of various types, rather than direct financial contributions to industries or enterprises. In the case of Cambodia, the Working Party report refers to Article 14 of the 1994 Law on Investment, which gives a duty exemption of 100 per cent on construction materials, means of production, equipment, intermediate goods, raw materials and spare parts used by any export-oriented project when at least 80 per cent of production is intended for export. The report indicates that many WTO members considered this provision a subsidy contingent on export performance and therefore actionable. The report points out that a WTO-compatible duty-drawback scheme could actually serve the same purpose. However, duty drawback laws can be extremely complex and require significant technical capacity to administer. The currently limited capacity of the customs administration in Cambodia would make adoption of a duty-drawback scheme quite challenging.

In the case of Nepal, subsidies take the form of exemptions from income tax, sales tax, excise duty and customs duties for qualifying industries. WTO members held the view that all such incentive schemes should be eliminated as they were prohibited under Article 3 of the Agreement on Subsidies and Countervailing Measures (ASCM). Some of these schemes would be eliminated and full notification would be made, as required under Article 25 of the ASCM.

(b) Trade in services, TRIMs, TRIPs and competition policy

(i) Services

The accession packages for Cambodia and Nepal in the area of services as well as in investment generally have a clear tendency towards liberalization. Both countries follow a pattern similar to most recent accessions characterized by wide-ranging commitments involving trade in services. Their commitments span all four modes of

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4 A recent country study on Cambodia has indicated that trade-related technical assistance has been in the form of loans from the World Bank and the Asian Development Bank. See Cambodian Legal Resources Development Centre, 2004.

supply subject to the disciplines of the General Agreement on Trade in Services (GATS). This is particularly true concerning mode 3 (commercial presence), as can be seen in table 3.

Table 3. Commitments and conditions by Cambodia and Nepal under mode 3 of GATS

Type of mode 3 commitment	*Cambodia*	*Nepal*
Horizontal	Limits on land ownership, subsidiesand incentives related to training performance requirements.	Limits involve subsidies and incentive and a prior approval requirement subject to compliance with environmental standards.
Market access	Exemptions for postal, audiovisual and real estate services. Full market access to most sectors, except telecommunications, travel agencies, maritime and pipeline transport services. Some prudential measures applied in finance, health and tourism services.	Important exemptions for postal and audiovisual subsectors and for wholesale distribution (which is unbound). Some limitations in all subsectors. Wide use of ownership and control limitations covering almost all of 21 scheduled subsectors. Foreign equity ceilings from 51 to 80 per cent (average 66.7 per cent, thus allowing majority foreign control). All commitments require local incorporation.
National treatment	Apart from the horizontal restrictions noted above, the schedule is solely for maritime transport services.	Apart from the horizontal restrictions noted above, no further restrictions included and scheduled simply “none”, except for: • Unbound distribution services; • Telecommunications sector subject to joint venture requirements with foreign equity ceiling of 80 per cent and majority of board of directors should be Nepalese nationals.
MFN exemptions	Relate to bilateral and multilateral agreements on co-production in audiovisual services as well as land, maritime and internal waterway transport.	Relate to bilateral and multilateral co-production agreements in audiovisual services.

Source: WTO (2003; 2003a).

The GATS schedules of Cambodia and Nepal show an unmistakably investor-friendly orientation. Only narrow limitations have been included in order to guide foreign direct investment (FDI) into priority sectors and activities that are expected to have strong development effects, given their impact on macroeconomic performance, such as infrastructure-related services.

Except for a few strategic sectors (transport and telecommunications), Cambodia has eliminated all quantitative restrictions on market access. However, in some important sectors, such as finance, health and tourism, a number of regulatory requirements are maintained so as to ensure that market penetration or concentration will not jeopardize specific public policy goals, such as environmental and consumer protection, while not reducing or restricting market opportunities for foreign investors.

National treatment exemptions are mostly scheduled horizontally, with a strong emphasis on the transfer of technology and skills. Subsidies are restricted to nationals in order to provide some scope for industrial policy measures in services. However, the policy space for discrimination in order to pursue other policy objectives is quite narrow. There is generally little scope for policies that differentiate between domestic and foreign entities in terms of development goals.

Nepal's commitments in services seem designed to protect incumbents by favouring the entry of foreign companies only through the establishment of new businesses (favouring greenfield investment over mergers and acquisitions) in practically all service sectors. The conditions set for such investment include the participation of Nepalese nationals and domestic businesses. Foreign control is allowed, but care has been taken to ensure that Nepalese citizens benefit from new technologies introduced by foreign investors.

A quick glance at the schedules of commitments made by Cambodia and Nepal seems to indicate that the sequence of liberalization through pre-commitments to the future opening of markets was given little attention. The issue is not whether to allow FDI, but how best to promote positive interactions with foreign investors in the host country. Along these lines and in light of Nepal's unique and fragile ecology, it is significant that environmental protection has been introduced as an important part of the investment screening process. The general investment environment in Nepal is otherwise far from restrictive. Only distribution and telecommunications services remain subject to significant protection, while restrictions in the financial sector aim primarily at ensuring quality, soundness and prudential standards among operators.

(ii) TRIMs

Both Nepal and Cambodia committed themselves to fully implementing the Agreement on Trade-Related Investment Measures (TRIMs), waiving the seven-year transition period allowed for LDCs under it. In choosing such a policy course, the two countries have decided to forego allowable policy space in an issue area where the debate about post-Uruguay Round implementation has been prominent. The decision of both countries would appear to be motivated by the absence of any current measures deemed inconsistent with the TRIMs Agreement.

(iii) Competition policy

Competition policy and pro-competitive regulatory regimes need to be developed and properly harnessed in both Cambodia and Nepal. This would contribute to the success of the liberalization strategies chosen, particularly in service industries, and ensure that the benefits of FDI accrue to the local economies (World Bank, 2002). Building a culture of competition and deploying institutions and their embedded knowledge are daunting and costly tasks, especially in countries where administrations are weak and face resource constraints. Cambodia and Nepal could both benefit from a significant amount of post-accession technical assistance in these areas.

(iv) TRIPs

Both countries have also embarked on major law-making efforts in the area of intellectual property in order to comply with requirements of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). Experience has shown that commitments in the area of intellectual property entail significant costs, as provisions of the Agreement need to be reflected directly in domestic legislation. Accordingly, technical assistance and additional resources from donors would be required in order to encourage compliance in this area during the transition phase. Cambodia has undertaken to enter into compliance with the TRIPs Agreement no later than 1 January 2007, with a measure of protection provided in the interim period. Nepal agreed to adopt the required legislation by December 2005.

3. A TENTATIVE ASSESSMENT OF IMPLEMENTATION COSTS AND DEVELOPMENT IMPACT FOR CAMBODIA AND NEPAL

(a) Implementation costs

Assessment of the costs of implementing commitments undertaken by WTO-acceding countries has not been given much analytical attention to date (Finger and Schuler, 2000). One useful distinction has been made between (a) the costs of aligning trade policy instruments with WTO requirements (e.g., transforming quotas into tariffs) and (b) the costs linked to the institutional changes necessary to ensure the application of the new WTO-induced disciplines (drafting new laws, devoting resources to administering the law, establishing enquiry points, etc.). Cambodia and Nepal cannot avoid such costs over the medium to long term.

One proxy measurement of the implementation costs could be the assessment of technical assistance needs, although such estimates are often influenced by a number of additional factors (donor preferences, budget cycles of ODA, relative strengths of domestic stakeholders, etc.). In the case of Cambodia, for example, an evaluation of this kind has been carried out. As an example, the estimated costs of technical assistance to help the country in the implementation of the WTO Customs Valuation Agreement are shown in table 4.

Table 4. Summary of estimated technical assistance costs involved in implementing the WTO Customs Valuation Agreement in Cambodia

Description	*Amount in US$*	*Time period*
TCAP (co-financed by Japan, the Netherlands, ADB, DFID, UNDP, IMF)	906 000	2004-2009
Existing TA funded (EC Project)	294 000	2003-2005
Customs Automation (WB)	2 500 000	2003-2004
Drafting legislation: rules of origin	150 000	2004-2005
WTO Customs Valuation (NZ)	115 000	2003-2004
Streamlining Trade Facilitation (WB)	90 000	2003-2004
Total	**4 055 000**	**2003-2009**

Source: UNESCAP, 2004, *Perspectives from the ESCAP Region after the Fifth WTO Ministerial Meeting: Ideas and Actions Following Cancún* (ST/ESCAP/2338), chap. II, sect. B (United Nations publication, sales No. E.04.II.F.44).

It is important to consider whether technical assistance would be comprehensive, effective and coordinated since various projects are funded by a multiplicity of donors. There might still be a wide gap in knowledge and capacity at the end of any specific project activity in view of the limits on capacity- and institution-building activities contained in many technical assistance projects. Moreover, some World Bank and ADB capacity-building projects might be in the form of loans, the repayment of which further constrains government budgets.

Beyond the difficulties associated with estimating the assuredly high implementation costs of the vast array of WTO rules, it is important to keep in mind the more traditional calculation of customs revenue foregone, which may be a particularly important issue for LDCs, which often have limited sources of revenue.

A fuller appreciation of accession costs should take into account multiple and disparate factors that might make the calculation of accession costs more speculative, including: (a) revenue foregone due to the implementation of bound duties that may be lower than applied duties; (b) revenue foregone when the transaction value is introduced in place of the minimum price system, according to the WTO Customs Valuation Agreement; (c) revenue raised owing to the termination of rebates and duty exemptions in order to comply with the WTO Subsidies Agreement; (d) government budget expenditures for creating or strengthening regulatory agencies and ministries responsible for regulatory oversight and compliance with international commitments; and (e) government budget expenditures to repay technical assistance loans from international financial institutions.

Other factors could be added when considering commitments on trade in services and intellectual property. A broader and more complete account of potential costs would assess the inevitable economic and social impact that arises from structural adjustments engendered by further trade and investment liberalization. Various economic sectors can expand or contract, different categories of workers can prosper or suffer for a number of reasons depending on differing skill levels and capacities for intersectoral and interregional mobility. For instance, women in poor rural areas or in the urban informal sector generally have fewer assets to help withstand trade-induced shocks.

Implementation of WTO accession terms generally seems to be costly, and even more so when the terms are relatively more demanding or ambitious. It is difficult to assess the costs beforehand, especially from the perspective of LDCs that already face a number of development constraints. There was no specific in-depth effort during the accession negotiations of Cambodia or Nepal to assess the very complex costs faced by these countries. This situation represents a significant weakness and creates an imbalance in the current accession process.

One possible way to restore the balance is to organize an "implementation assessment" conference bringing together concerned and interested trade and development assistance officials. Such a gathering should take place before the accession process is completed and once the broad outlines of agreed commitments can be identified. Such a process would help to address concerns that the Governments of acceding countries might be pushed into undertaking commitments that they would not be able to fully implement. Such a country-specific conference would need to be anchored in a credible prior assessment of the costs of honouring the liberalization and rule-making commitments made in the context of accession. The responsibility for preparing such a report could be assigned to regional or multilateral development banks.

Prior assessment of the potential accession-related costs would strengthen the negotiating stance of acceding countries in arguing that commitments and rules should take account of their development levels, as recommended in the WTO accession guidelines. It would also help acceding countries to identify those commitments that are most compatible with their national development strategies, especially where the latter may need to decide whether accepting costs up-front would be wise from a longer-term development perspective.

(b) Development impact

The benefits of WTO accession generally come under two main categories: (a) strengthening policy and regulatory reforms to create an open, predictable trade and investment regime; and (b) improving access to major export markets on a more secure basis. Conventional wisdom holds that this would contribute to an acceding country's economic development, although this assertion is generally treated as a corollary.

Working Party reports have paid little attention to development issues, particularly issues related to trade liberalization, which have a potentially far-reaching economic and social impact. As suggested, there are strong grounds to believe that draft trade agreements could be assessed on the basis of development criteria, particularly as they are being increasingly evaluated on the grounds of anticipated implications for environmental protection and labour standards. The legitimacy and integrity of final negotiated outcomes could be strengthened if an objective methodology could be created and a development audit conducted before the final phase of the accession process. For example, in the Asia-Pacific region, UNESCAP and ADB, together with other bilateral donors, could form a group of experts from the trade and development fields with a view to developing a methodological framework for studying the development impact of WTO accession and identifying priority areas for building capacity after accession. Such a body of experts could be asked to report directly to the WTO Accession Working Party for a particular country before work on any specific accession package was completed. They could, alternatively, provide the methodological framework for assessment to be applied by regional and/or multilateral banks as suggested above.

Several factors have to be considered, even with a narrow approach to a development-oriented cost-benefit analysis. This is especially the case for LDCs. In particular, trade and development officials should ask the following questions:

(a) Will foregone tariff revenues be replenished when a VAT system is introduced and tax incentives for domestic industries are abolished? Will tariff reductions lead to higher imports and hence higher tariff revenue?

(b) Can a duty drawback scheme that is WTO-compatible assist domestic industries in importing inputs for finished products to be exported?

(c) Will the gap between bound and applied rates be large enough to cushion domestic industries from possible increases in imports of competing products or should the Government invest the resources necessary to adopt and implement contingency protection legislation, for example, in the field of anti-dumping?

(d) Are resources adequate to underpin agreed commitments with the requisite strengthening of regulatory institutions and officials?

(e) Are adequate transition phases foreseen that would comply with various international agreements while establishing a complimentary set of non-trade policies, as is required to make a success of trade and investment liberalization?

(f) Are export gains in key markets likely to materialize quickly enough to generate new sources of foreign exchange, support the development of domestic export industries and sustain support for open market policies among concerned constituencies at home?

Questions of this kind do not seem to have been asked or answered satisfactorily during the negotiations for accession for either Cambodia or Nepal. For that matter, such questions have typically not been raised for any other WTO-acceding country.

In order to generate positive development results and ensure that trade leads to economic growth, it is necessary to both ensure and increase international market access and strengthen supply-side capacities to benefit from the market access gained. Export performance depends on supply capacity, which is affected by a number of domestic policies and by resource endowments. Export performance is also affected by access conditions in international markets, which are mainly the result of trade and competition policies in the destination markets as well as the efficiency of home country trade facilitation measures and the transport infrastructure. Studies have shown that all of these factors are linked (World Bank, 2003).

However, evidence also suggests that the relative importance of these factors varies with a country's stage of development. There is a major structural weakness in the current approach to accession negotiations in this regard. No specific attention is given to the impact that accession commitments have on supply-side capacity. In addition, no positive measures have been envisaged to improve such capacity. Greater efforts to direct the donor community to address this gap are needed. Donors should commit the necessary resources to ensure that acceding countries can indeed develop successfully as a result of their enhanced integration into world markets.

Furthermore, even as acceding countries work hard to complete their own trade reforms and liberalization programmes, they continue to face daunting access problems in major destination markets. The pattern of protection prevailing in many destination markets is typically geared towards impeding key LDC exports, as evidenced by the cases of Cambodia and Nepal. In the case of Cambodia, as with many other LDCs, garments comprise the largest share of exports, which are sent mostly to the United States market, where high most-favoured nation (MFN) tariffs apply.

Moreover, phasing out textile and clothing quotas by 1 January 2005, as stipulated by the WTO Agreement on Textiles and Clothing (ATC), will have far-reaching negative implications for a number of LDCs. Specific problems of this kind should be considered when evaluating the development-related costs and benefits of WTO accession.

Phasing out quotas under ATC is inevitable. The combined costs of implementing WTO-accession commitments and trade liberalization in the garment sector could have paradoxical implications for both Cambodia and Nepal. At the time when they were making sacrifices to join the WTO, the multilateral trading system was removing a distortion that has affected the textile and clothing sector for more than 30 years: the cumbersome quota system under the Multi-Fibre Arrangement (MFA). This distortion, however, had allowed Cambodia and Nepal to develop a rapidly growing domestic garment industry. The combined effect of WTO accession and textile and clothing sector liberalization may prove too costly for both countries unless a virtuous circle is established whereby increased market access and improvements in domestic policy and the regulatory framework would be sufficient to generate a competitive supply response.

IMF and the World Bank recently decided to make available new loan programmes aimed at softening the adverse impact of trade liberalization in developing countries. The new IMF lending vehicle, called the Trade Integration Mechanism (TIM), is targeted at those poor countries that: (a) stand to suffer adverse trade developments as a result of an agreed liberalization commitment under the Doha Development Agenda (DDA); (b) witness the erosion of trade preferences if WTO successfully completes DDA; or (c) experience dislocations owing to the end-2004 repeal of quotas on textiles and clothing under MFA. The TIM could be of particular use to such acceding countries as Cambodia and Nepal in view of their vulnerability in the garment trade.

The agreed terms of accession indicate that the adjustment process may be difficult. The broader economic and social adjustment costs, such as the fate of thousands of women working in the garment industry, have been mostly ignored, and no specific attention has been paid to finding the best ways of facilitating and fostering an appropriate supply response. The usual explanation stresses that the solution to this kind of structural economic challenge lies beyond the ambit of WTO, but that seems to be of little comfort to the affected parties. It also illustrates how calls for policy integration, coherence and coordination between international agencies are insufficient when they are not backed up by specific forms of targeted concessional assistance from the donor community.

Measures related to investment promotion and trade facilitation are part of the missing link when considering the supply-side capacity of acceding countries. The benefit that is most often associated with WTO membership is the expected increase in FDI. Uncertainties about the fate of the garment industries in Cambodia and Nepal could be moderated to some extent with increased FDI in this sector. Investment opportunities also exist in other sectors, such as tourism, hydropower generation, agro-processing and light manufacturing. FDI can generate both imports and exports in all of these areas, as well as employment and access to new technologies while fostering the transfer of skills and knowledge and promoting the adoption of best practices in production and regulation.

However, as is the case with most LDCs, Cambodia and Nepal do not attract much FDI, as is shown in table 5. The signalling function of an open trade regime as a result of accession to WTO, while useful, may not be sufficient in itself to attract FDI. If the commitment to ensuring returns from accession in the form of development were taken seriously, a package of accompanying measures would be needed in addition to technical assistance and capacity-building. Such measures could usefully include specific steps by developed countries to address investment risk mitigation (such as specific insurance coverage schemes) and to boost investment promotion (such as disseminating information about investment opportunities and preparing feasibility studies) and to invest in developing countries in those key infrastructure-related sectors required to convey products to markets (Mistry and Olesen, 2003; Beviglia-Zampetti and Fredriksson, 2003).

Table 5. Overview of foreign direct investment in selected Asian developing countries, selected years

(Millions of United States dollars)

	1980	***1990***	***1995***	***2000***	***2001***	***2002***
Inward stocks						
Cambodia	38	38	356	1 336	1 449	1 503
Nepal	1	12	39	97	116	126
Bangladesh	63	147	180	983	1 062	1 107
Lao People's Democratic Republic	2	13	205	550	574	599
Thailand	981	8 209	17 452	24 468	29 158	30 226
	1985-1995 (Annual average)	***1998***	***1999***	***2000***	***2001***	***2002***
Inward flows						
Cambodia	28	243	230	149	148	65
Nepal	3	12	4	–	21	10
Bangladesh	3	190	180	280	79	45
Lao People's Democratic Republic	18	45	52	34	24	25
Thailand	1 426	7 491	6 091	3 350	3 813	1 068

Source: UNCTAD, *World Investment Report 2003* (Geneva, UNCTAD).

The lack of a direct link between accession commitments and the provision of technical assistance and capacity-building represents another structural weakness in the accession negotiations. If addressed, it would help ensure that the development benefits generally associated with WTO membership are realized. While some technical and legal hurdles may have to be overcome, ways to achieve this result could be devised with the help of various bilateral, regional and multilateral development agencies. Precedents already exist at the regional level, for instance in relations between the European Union and the African, Caribbean and Pacific (ACP) countries.

It is surely not satisfactory to see LDCs undertake ambitious legislative reform plans without a corresponding assistance plan from donor countries. Most of the reforms that Cambodia and Nepal have agreed to implement require a good deal of expertise and sizeable resources. Firm commitments from developed countries to give assistance for regulatory reform would ensure a smoother implementation phase and affords a better chance of having an impact that is meaningful, helps poor people and supports development goals.

4. CONCLUDING REMARKS

A brief and selective examination of the commitments made by Cambodia and Nepal in their accession to WTO assists policy-makers in assessing possible implications and drawing a few lessons for other acceding countries, including those in the Asia-Pacific region. The WTO accession process is not governed by a specific set of rules, but it does follow certain defined patterns. Despite assurances that only reasonable concessions and commitments would be sought from LDCs by their WTO trading partners, accession commitments generally seem to be highly ambitious. The experience of Nepal and Cambodia confirms this trend.

The most difficult task that acceding countries can expect to confront is how to forecast the combined effects of the commitments that they have been asked to undertake. As noted throughout this study, this is a particularly difficult exercise and requires that more determined efforts be made to assess comprehensively the possible costs and benefits of WTO accession from a development perspective.

Demanding a comprehensive development impact assessment or audit and directing an independent panel of leading experts to develop a methodological framework to carry it out would appear to be a modest proposal that acceding countries and development agencies in donor countries should be seeking. In this context, the possible development impacts of various commitments could be brought forward and better evaluated. This could be the basis for conducting more meaningful negotiations on special and differential treatment measures.

The process of WTO accession tends to proceed on highly mercantilistic terms, with WTO members aiming to extract the highest possible concessions from acceding candidates. This cannot be described as a two-way negotiation. Some WTO members proceed to negotiate in this way with no particular concern for the possible barriers that acceding countries face in their own markets or indeed to the average level of their own bound commitments.

WTO rules for accession are generally technocratic. A fairly detailed examination is conducted, covering the regulatory situation of the acceding country and detailing the legislative changes it needs to make to take on board the existing WTO agreements. However, no equivalent commitments in terms of assistance with the reform process have been envisaged. Pledges remain completely autonomous and subject to the vagaries and inconsistencies that generally characterize foreign aid efforts.

Modifying this general set-up appears difficult and leveraging engagements of this kind seems beyond the power of individual acceding countries. In the context of a deeper ongoing reassessment of the WTO system and its governance structure, the modalities that could emerge as a result of the current stalemate in the Doha negotiations could create an opportunity for such proposals to be taken up. Commitments of this kind would be particularly helpful to accompany any future changes or additions to the WTO rulebook that would call for important domestic regulatory changes.

Finally, the problems linked to the lacking supply response capacity of LDCs should be more meaningfully addressed, including problems related to inadequate trade and investment facilitation, so that these countries can stand a better chance of achieving some of the development benefits associated with trade liberalization. This would become possible only in the context of a thorough rethinking of development approaches in WTO. This is not an easy proposition, but the time may have come for LDCs in the Asia-Pacific region and elsewhere to start advancing bold proposals. They should do so because new ideas on development approaches could help redress the equity deficit that currently characterizes the WTO accession process. In addition, this would be a concrete means for testing the resolve of wealthy developed countries regarding their oft-professed desire to deliver on the promises made in the context of DDA.

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Ready-Made Garment Industry in Sri Lanka: Preparing to Face the Global Challenges

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ABSTRACT

With the phasing out of the Multi-Fibre Arrangement (MFA), the Sri Lankan economy, highly dependent on garment exports, has become vulnerable to the changing scenario affecting this industry in the global trading system. In such a global environment, strengthening the competitiveness of the garment industry has become a sine qua non for Sri Lanka to remain one of the suppliers of choice in her major markets. The industry therefore needs to articulate new response mechanisms to address the emerging challenges. A realistic course of action should involve addressing the major constraints in both the supply and demand sides of the industry. This paper highlights these issues and suggests some strategies for coping with the new global challenges.

1. INTRODUCTION

The garment industry in Sri Lanka expanded rapidly after the liberalization of the economy in 1977. During the 1990s, the garment industry grew at 18.5 per cent per annum. The export-led expansion of the industry led to the replacement of tea by garments as the nation's largest foreign exchange earner. Moreover, the industry has been contributing to the livelihood of nearly 1.2 million people. However, the boom

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period for the industry is gradually coming to an end, with the quota system having ended on 1 January 2005, regional trading blocs and bilateral free trade agreements proliferating and governing nearly 33 per cent of global trade, and China emerging as a major supplier of garments at very competitive rates. The Sri Lankan garment industry is now gearing itself to face these challenges.

This paper provides a broad overview of the industry and analyses how the industry is preparing itself to meet the global challenges. Section 2 provides a brief overview of the garment industry in Sri Lanka. Section 3 gives a broad picture of the competitiveness of the Sri Lankan garment industry. New trends in the global trading environment and Sri Lanka's measures to meet the challenges are discussed in section 4. Concluding remarks appear in section 5.

2. THE GARMENT INDUSTRY IN SRI LANKA: A BRIEF OVERVIEW

When Sri Lanka liberalized its economy in 1977, the country's garment industry took off immediately, mainly as a result of quota-hopping East Asian garment exporters who were attracted by the country's liberal trade regime and relocated their already well-established garment businesses to Sri Lanka. This relocation encouraged local entrepreneurs to start their own garment enterprises to exploit markets guaranteed by quotas, assisted by the liberal trade regime for importation, and subsequently, incentives granted by the Board of Investment (BOI) to selected industries.[1] Paradoxically, protectionism in the form of MFA quotas helped Sri Lanka and many other developing countries to develop their export-oriented garment industries by insulating them from direct competition from established producers.

Sri Lanka did not have a well-developed export-quality textile industry base; neither did it have a base for garment industry accessories. Thus, from the very beginning, garment production was based on imported inputs and the value added remained low – close to 30 per cent. By about the early 1980s, garment exports were growing rapidly and by 1986 garments accounted for the largest share of all exports (27 per cent). By the late 1980s, garment industry in Sri Lanka was referred to as "glorified tailor shops" because, despite a decade of growth, its links with other industries remained low and the value added remained low as before.

In 1992, BOI came into operation. BOI offered an attractive incentive package to entice garment producers to move to rural areas of Sri Lanka under the so-called 200 Garment Factory Programme (GFP). A textile quota board was established in the same year to streamline the allocation of quotas for the garment industry, including

1 The Board of Investment at the time of the take-off of garment exports, was known as the Greater Colombo Economic Commission (GCEC).

those coming under the 200 GFP. This Programme enticed well-established garment producers to open a rural branch and, in addition, new enterprises with no background in garment production came into operation to make use of the quotas. Under GFP, 154 factories were in operation and 6 factories had closed down or been merged by 1996 (Heward, 1997, p. 12). By 1992, the garment industry had become the largest foreign exchange earner in the country (US$ 400 million) – overtaking the tea industry.

By 2002, Sri Lanka's textile and garment sector accounted for 6 per cent of GDP, 39 per cent of industrial production, 33 per cent of manufacturing employment, 52 per cent of total exports and 67 per cent of industrial exports (see tables 1 and 2). Sri Lanka commands 1.34 per cent of global garment exports (see table 2).

Table 1. Sri Lanka textile and garment sector: macro data

		Under Agreement on Textile and Clothing (ATC)		
	Under MFA regime	***After first phase-out***	***After second phase-out***	***After third phase-out***
	1990	***1995***	***1998***	***2002***
Textile & garment exports (US$ Mn)	643.5	1852.5	2466.2	2425.5
as percentage of total exports	33	49	52	52
as percentage of industrial exports	64	65	69	67
Export market (as a percentage of total textile & garment exports)				
United States	67	61	64	63
United Kingdom	6	14	18	20
Cotton yarn & textile imports (US$ Mn)	427.8	1237.1	1477.6	1429.0
Employment	102 000	250 000	227 000	330 000
No. of establishments (garments)	142	678	891	NA
Cumulative foreign investment (US$ Mn)[a]	36	108	158	158
Average exchange rate (Rs per US$)	41.37	51.25	64.59	95.66

Source: Central Bank of Sri Lanka; Department of Census & Statistics, *Annual Report* (various issues); *Annual Survey of Industries* (various issues); *Sri Lanka Garments,* issue No. 80; and the data is derived from *The Apparel Digest/Sri Lanka Garment Journal,* 2001. (It should be noted that it is sometimes difficult to separate the data for garments from the data for joint textiles and garments.)

Note:

[a] Realized cumulative investment in garments at the end of the year, Board of Investment, Sri Lanka.
NA – not available.

These statistics clearly indicate that Sri Lanka is highly dependent on the industry for both employment and foreign exchange earnings. Foreign direct investment (FDI) has been very significant in the sector, accounting for 10.4 per cent of total cumulative FDI in 2003. According to the available data from BOI, foreign investors own close to 50 per cent of total garment factories and account for nearly 50 per cent of total textile and garment exports (USITC, 2004).[2] Greater dependence on imported textile materials indicates that Sri Lanka has a large export-oriented garment sector, but a small textile industry that has no capacity to supply the quantity or quality of yarn and fabrics required by the garment industry.

Table 2: Export performance of the textile and garment industry in Sri Lanka: key indicators for 1995-2003

	Export Value (Millions of US dollars)			*Export indices of T & G 1990=100*			*T & G exports as a percentage of total merchandise exports*	*Sri Lanka's share of world garment exports (%)*
Year	*Textile (T)*	*Garments (G)*	*T & G*	*Volume*	*Value**	*Unit value**		
1995	43.2	1465.5	1852.6	226	295	130	48.7	1.00
1996	199.2	1688.6	1905.9	237	303	128	46.4	
1997	306.7	1972.6	2279.3	264	363	137	49.0	
1998	228.6	2237.8	2466.4	272	393	144	51.3	
1999	225.2	2205.1	2430.3	291	387	133	52.6	
2000	271.5	2723.1	2994.6	341	477	140	54.0	1.33
2001	209.7	2334.6	2544.3	302	405	134	52.8	
2002	179.1	2246.4	2425.5	306	386	126	51.6	1.34
2003	175.3	2400.0	2575.3	313	410	131	50.2	

Source: Central Bank of Sri Lanka.

Note: * In constant 1990 dollars.

In the early 1990s, a concerted effort was made to promote backward linkages in the garment industry. Government-appointed delegations were sent overseas to attract large textile producers to Sri Lanka. A number of textile producers that had come up during the pre-1977 import-substitution regime and had found it difficult to survive in the liberalized economy were privatized in the early 1990s. Despite all such efforts, the development of backward linkages from the garment industry to the textiles sector was very slow for a number of reasons (Kelegama and Foley, 1999). In 1997, the textile industry faced a major setback. The East Asian crisis had triggered a currency depreciation in Indonesia and the Philippines – two of Sri Lanka's competitors in

[2] All firms with FDI are treated as foreign firms regardless of the size of the ownership share.

garment exports. The garment exporters found it difficult to compete without a devaluation of the Sri Lankan currency, and started to lobby the Government to this effect. Since the Government did not allow a devaluation of the currency, the garment industry lobbied for duty-free status for textile imports with the aim of bringing down their production costs.[3] The Government granted this request without considering the repercussions on the domestic textile industry. Consequently, the textile industry virtually collapsed and no effort made by the government, for example, by offering subsidized interest rates to rescue the textile industry, had any major impact. In fact, three of the privatized textile factories (Veyangoda, Pugoda and Mattegoda) that were gradually switching to manufacture textiles to meet the needs of the export-oriented garment producers had to be closed down.

Today, the Sri Lankan garment industry remains a low value-added industry, though some backward linkages had developed by the mid-1990s. There were 891 garment factories in operation in 1999 — out of which 18 per cent was categorized as large, 50 per cent medium and 32 per cent small (TVEC, 1999). In 1999, 72 per cent of the businesses were geographically located in the Western Province. Just 12 per cent of the factories control around 72 per cent of the exports (CBSL, 2002:103). Some of the top producers have developed strong and reliable links with well-known international retailers indirectly by buying intermediaries. Sri Lankan garments that were highly quota-dependent initially have now become less dependent on quotas, with 47 per cent of exports coming under the non-quota system in 2002.[4] Most Sri Lankan garment exports are destined for the United States (63 per cent) and European Union (30 per cent); hence, there is not much market diversification. The key varieties of garments that Sri Lanka exports are: HS 6204 (women's or girls' suits, and similar items under this category), HS 6203 (men's or boys' suits, and similar items under this category), and HS 6206 (women's or girls' blouses, and similar items under this category). Sri Lanka is well known as a top exporter of women's lingerie.

Sri Lanka's garment industry has a fairly reputable status in the international market. Sri Lankan garment exports to the United States market coped well with the emergence of NAFTA in 1994 despite many pessimistic views expressed at that time.[5] Sri Lankan garment industrialists have opened factories in Bangladesh, Maldives, Jordan, Kenya and Mauritius, among others, and are performing well. The large and well-established garment producers have featured in published works (Friedman, 2000). The Sri Lankan garment industry has gone through turbulent times; for instance, during the 1988-1989 civil conflict; in 1993, when countervailing duties and embargo were

[3] The benefit of this would accrue mainly to non-BOI garment exporters, which constituted a majority in terms of numbers at that time.

[4] Sri Lanka depends less on quotas compared to Bangladesh (95 per cent), Pakistan (90 per cent), Nepal (80 per cent), and India (73 per cent) (ILO, 2002).

[5] Sri Lanka's competitive position in the United States market was not significantly disturbed by NAFTA (for details, see chapter 7, Kelegama, 2004 ed.).

imposed by the United States; and in 2001, when war-risk premiums and surcharges were imposed after the bomb attack on Colombo International Airport. The industry currently employs around 330,000 people and sustains the livelihood of around 1.2 million others.

3. COMPETITIVENESS OF THE SRI LANKAN GARMENT INDUSTRY

The competitive strength of the Sri Lankan garment industry is based on cheap labour, a literate labour force, high labour standards, investment-friendly government policies and strategic shipping lanes. On the other hand, there are also competitive disadvantages, such as long lead times, weak marketing, lack of product development and low labour productivity partly due to outdated technology.

In 1983, Sri Lanka experienced civil conflict and many foreign investors, including foreign garment industrialists, shied away from the country. Some moved to Bangladesh; others moved to newly emerging low labour-cost East Asian countries, such as Cambodia and Viet Nam. Labour costs were comparatively low in these countries and, by the mid-1990s, Sri Lanka could no longer compete on the basis of low-cost labour and measures had to be taken to improve the productivity of the sector. Low productivity has offset to some extent the low labour-cost advantage of Sri Lanka.

A study on the productivity of the garment sector shows that there are a number of issues pertaining to low labour productivity in the garment industry and that there is substantial room for improvement (Kelegama and Epaarachchi, 2002). One area that requires upgrading is the development of human skills to deal with the technological changes taking place in the garment industry. To meet the growing demand for semi-skilled workers in the industry, two training institutions, *viz*, the Textile Training Centre and Service Centre and the Clothing Industry Training Institute came into operation, both in 1984. In addition, a private sector training institute, the Phoenix Clothing Training Institute, was established in 1998.

A number of design schools have emerged, with the Department of Textile & Clothing Technology in the University of Moratuwa becoming the apex body for design. Design courses have been introduced, with the collaboration of the London School of Fashion Design, to keep pace with the latest fashion developments in the world and to train workers to match the demand. The Asian Development Bank (ADB) has given a grant to set up a major fashion school at the University of Moratuwa that is expected to be in operation by 2005.

Labour costs, however, amount to 15 to 20 per cent of the overall cost. Thus, there are a number of non-labour aspects that contribute to low productivity. The introduction of CAD/CAM machinery to the garment industry has been painfully slow. At the firm level, competitive issues have not featured in strategic planning owing to the assured market guaranteed by the quota system and the laid-back attitude of some entrepreneurs (Fonseka and Fonseka, 1998). Most companies have made little effort to produce high value-added garments and there is a heavy dependence on buyers to channel garments to international markets (about 65 per cent of garment exports).[6] Until recently, most garment orders were on a no foreign exchange (NFE) basis and many garment producers preferred such orders because there was less risk involved.[7] Little effort has been made at the firm level to reduce wastage and improve the quality of work.

Owing to the lack of a fabric and accessory base (lack of vertical integration), the turn-around time of Sri Lanka's garment industry remains close to 90-150 days compared with the ideal international lead time of around 60 days. This large turn-around time is an issue in the context of competitiveness, particularly when Eastern European countries have become major suppliers of garments to the European Union, and Mexico and Caribbean countries have become major suppliers to the United States under preferential tariff arrangements. Moreover, this problem is of particular concern at a time when "just-in-time" delivery has become an accepted principle and requirement in the global market.[8]

Sri Lanka's lack of competitiveness in garment products is not solely determined by low labour productivity, firm level inadequacies and high turn-around time but also by government policies. The cost of production in Sri Lanka has escalated in recent times owing to the high cost of public utilities, such as electricity, water and telecommunications (IPS, 2003). In fact, Sri Lanka's electricity charges remain the highest in Asia as a result of poor government policies contributing to mismanagement in the electric power sector.

If Sri Lanka is to gear itself to the post-2004 challenges, a number of restructuring measures have to be taken in the garment industry. Some measures have already been taken. Until recently, the Sri Lankan garment industry did not have a strategy or plan for its future expansion. In 2002, the industry came up with a five-year strategy report. This report contains a comprehensive analysis of "strengths", "weaknesses", "opportunities", and "threats" (SWOT) and recommends a strategy for eliminating weakness, consolidating strengths, making use of opportunities and minimizing threats. The report argues for the establishment of a special research cell

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6 Business Page, *The Island*, 22 February 2004.

7 A no foreign exchange basis means that the buyer provides inputs and the garment manufacturer makes no payment for these inputs; thus, there is no importation on the part of the manufacturer.

8 Electronic point-of-sale technology – that is, the bar code – has been increasing retailers' command over suppliers since the 1980s. Retailers no longer have to buy goods up front and carry the risk of selling them. Now, when consumer purchases are tracked with bar codes, retailers can automatically reorder just enough of a product just in time to restock their shelves. It maximizes their retail sales per square metre of shop space and shifts order risks back onto suppliers and producers. With this just-in-time response comes the pressure on producers to deliver smaller orders, in less time, and according to tightly planned shipping schedules – or face fines for delays.

for the industry to keep track of international trends in garment trading, and this cell came into operation in late 2002. Having realized the need to speak with one voice in order to achieve a common goal, garment industrialists and stakeholders set up the Joint Apparel Association Forum (JAAF), a consortium of five different associations, in 2002.[9]

Meanwhile, the airport bomb attack in mid-2001 gave the industry a wake-up call. After this event, a war risk insurance charge was imposed on Sri Lankan exports undermining the competitiveness of the garment industry. This triggered a social engineering process in the industry whereby many companies started implementing various cost-cutting measures to make the industry more competitive.

Although Sri Lanka supplies garments to many leading retailers, such as Victoria's Secret, Liz Claiborne, May Department Stores, Marks & Spencer and C & A, the country does not possess well-known local brand names. Most garment exporters do not have direct contact with the final buyer and remain suppliers to such leading stores via buying offices. To address this lacuna, the industry introduced a garment-marketing course in collaboration with the Chartered Institute of Marketing in the United Kingdom. Recognizing the need for a brand that could withstand shocks in the Western market, two leading companies (Phoenix Ventures and Jewelknit) took measures to merge and develop a branded product (Brandix) in 2003. This was a positive sign in the overall progress of the garment industry in Sri Lanka.

4. NEW TRENDS IN THE GLOBAL TRADING ENVIRONMENT: MEETING THE CHALLENGES

The Sri Lankan garment industry not only needs to become competitive to face the post-2004 quota-free global challenges, but also has to take cognizance of the new trends in the global trading environment. There are new trends in the European Union and United States markets, while the emergence of China as a significant global supplier is also an important issue.

Sri Lanka gained quota-free status entry to the European Union market in March 2001, with the expectation of increased garment supply to that market. Sri Lanka currently faces competition in the European Union market from (a) least developed countries (LDCs), such as Bangladesh, which has duty- and quota-free access to the European Union under the Everything-But-Arms (EBA) scheme; (b) African, Caribbean and Pacific (ACP) countries, which enjoy preferential market access to the European Union under the Cotonou Agreement; and lately (c) Eastern European countries, some of which have become European Union members and to which some European garment

9 The five associations are: Sri Lanka Apparel Exporters Association, National Apparel Exporters Association, Sri Lanka Chamber of Garment Exporters, Free Trade Zone Manufacturers Association and Sri Lanka Garment Buying Offices Association.

factories have relocated to exploit cheap labour and proximity to their market. A comparison of Sri Lankan export performance with other countries' export performance in that market during 2000-2003 does not provide strong evidence that the quota-free entry has resulted in significant gains for Sri Lankan garment exports (Kelegama, 2004 ed., chapter 2). It appears that the window of opportunity for European Union market consolidation has been lost because of the relatively late quota-free entry.[10]

However, Sri Lanka has gained from a reduction by the European Union of GSP rates for Sri Lankan garment exports.[11] Sri Lanka has managed to maintain relatively high labour standards in factories to convince European Union inspectors that working conditions in factories are relatively satisfactory.[12] There are doubts whether these concessions would be significantly beneficial given the fact that GSP concessions are conditional on fulfilling the SAARC rules of origin (RIS, 1999).[13]

After the enactment of the Trade and Development Act of 2000, the United States adopted the Caribbean Basin Trade Partnership Act (CBTPA), the Andean Trade Preference Act (ATPA) and the African Growth and Opportunity Act (AGOA) in 2001-2002. Under these acts, garment exports from Caribbean, Latin American and sub-Saharan African countries are entitled to quota-free and preferential duty entry to the United States market after fulfilling certain conditions. These conditions are mainly related to selected textile and garment articles and fulfilling the applicable rules of origin (or reverse preferences) involving the use of United States fabrics and other inputs, which the United States demands as a *quid pro quo* and is known as the "yarn-forward rule".

There are mixed views as to the effectiveness of these arrangements. While some critics claim that the built-in reversed preferences governing these agreements have nullified the preferential advantages (Bhagwati, *The Economist*, June 2002), others have argued that, despite the reverse preference conditionality, there are overall gains

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10 Sri Lanka's ability to sustain itself in the European Union market might weaken further when the Union phases out quota restrictions on garment exports from India and China.

11 The overall reduction is about 40 per cent for the garment sector – 20 per cent under the GSP and 20 per cent under a Special Incentive Arrangement. For details, see *Quarterly Economic Review: Sri Lanka, Fourth Quarter 2003,* The Ceylon Chamber of Commerce (2004, pp. 9-10).

12 Apparel-industry Labour Rights Movement (AlaRM) Sri Lanka will not necessarily agree with this view (see also, Kelegama and Epaarachchi, 2002).

13 The rules of origin stipulate that the fabric must be knitted or woven in the SAARC region from yarn of the same SAARC country. Cumulation can only take place between two SAARC countries; for example, yarn spun and woven in India and garment made in Sri Lanka. Imported woven fabric can be used if it has been printed and finished in the SAARC region on condition that the imported greige ("grey goods", i.e., any woven fabric just off the loom that has not yet been dyed or finished) accounts for no more than 47.5 per cent of the ex-works value of the finished fabric. Non-originating non-textile trims (e.g., buttons and zippers) can be used freely. Non-originating textile trims (e.g., elastic) can be used provided that they do not exceed 8 per cent of the value of the ex-factory price of the finished garments. The use of non-originating linings or interlinings will automatically disqualify the garment product for GSP.

from these agreements (UNCTAD, 2003; Mattoo et al., 2003). In fact, a number of Sri Lankan garment entrepreneurs have set up businesses in Mauritius, Madagascar and Kenya as well as other African countries to exploit the advantages of AGOA, just as East Asian quota-hopping garment manufacturers did in Sri Lanka in the late 1970s to gain the quota advantage there.

The United States departure from multilateralism is not confined to these arrangements. Of late, the United States has been offering bilateral agreements to various countries on the basis of "WTO-Plus" considerations.[14] Chile, Singapore and Jordan have already completed bilateral free trade agreements (BFTAs) with the United States. These agreements were signed on the basis of initial agreements called trade and investment framework agreements (TIFAs).

Sri Lankan garment companies hold the view that, if a United States-Sri Lanka bilateral free trade agreement can be worked out any time soon, Sri Lanka could consolidate its garment export share in the United States market (2.7 per cent of United States garment imports in 2003 were from Sri Lanka, and 63 per cent of Sri Lankan overall garment exports are destined for the United States market) and thus could face the post-2004 challenges more effectively. In July 2002, the two countries signed a TIFA and since then substantial groundwork has been done to convert the TIFA to a full-fledged bilateral free trade agreement.[15] Sri Lanka's enthusiasm for a bilateral free trade agreement with the United States was such that, at the Fifth WTO Ministerial Conference, held in Cancún, Mexico, the country departed completely from the position of the developing countries on some issues and supported the position of the United States (Kelegama and Mukherji, 2003). Obviously, it was a *quid pro quo* to expedite the possible United States-Sri Lanka bilateral free trade agreement.

What is clear is that a United States-Sri Lanka FTA has been delayed owing to the fact that 2004 was an election year in the United States with the political establishment under pressure for more protectionist measures by the clothing sector, and it was also an election year in Sri Lanka with considerable political instability. The disaster that resulted from the December 2004 tsunami may lead to further delays as immediate government priorities lie elsewhere. Such delays may lead to the conclusion of an FTA that may be too late to be of significant assistance, similarly to the European Union quota-free status mentioned above.

The Indo-Sri Lanka Bilateral Free Trade Agreement went into effect in March 2000, and one objective of this Agreement was to afford Sri Lankan garment exporters an opportunity to diversify and capture a share of the Indian market. However, given the various para-tariffs and specific duties operating in that market and the rules of origin governing the Agreement, Sri Lankan garments have not been very competitive, to the extent that only a small number of garments have been exported to India and the quota under the ILBFTA remains significantly unmet (Kelegama, 2004, ed., chapter 8).

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[14] See, for instance, Kelegama and Mukherji (2003).

[15] *Daily Mirror*, 20 February 2004.

China's threat to garment exports from other developing countries is important and cannot be set aside. The World Bank has predicted that China's share of garment exports in the world will rise to 50 per cent by 2010.[16] In other words, Chinese exports are expected to double in six years, mostly at the expense of other developing countries. Already, the rapid rise of China's garment exports in particular categories after earlier quota removals has demonstrated how China could swallow up the share of garment exports of other developing countries.

In addition to possessing a low wage rate per worker (average US$ 40 per month), China benefits from a disciplined workforce, economies of scale through large-scale production, and the presence of many transnational corporations (TNCs) in the garment industry. Moreover, upon its accession to WTO in December 2001, China enjoys MFN status for its exports – a privilege that did not exist before. The number of product items under quota in China amounted to 20 per cent of Chinese garment exports before 1 January 2005, which is a large number. Thus, it is believed that there will be significant dominance by Chinese clothing in the post-2004 period.

However, it has also been argued that the threat from China may be exaggerated. First, it is argued that, with WTO entry, China will have to become more transparent and some of its past practices to maintain low cost of production may have to be abandoned. Consequently, the low cost advantage may become somewhat eroded (RIS, 2002). It is also argued that, although labour wages in the provinces remain low, there has been a significant increase in wages in the eastern coast, where the key garment producers are located. Monthly wages in some of these factories exceed US$ 90, which is higher than the monthly wages in Indonesia, Bangladesh, Viet Nam, India and Sri Lanka. Secondly, there is a view that the United States and the European Union will have significant control over the expansion of Chinese garments in their respective markets because of two prevailing legislative regulations: (a) the safeguard regulation from 2005-2008; and (b) the anti-dumping regulation from 2005-2015.[17] It is argued that both of these regulations will give the United States and the European Union significant power to guard against a sudden influx of Chinese garments and thus preserve the existing foothold of other developing countries in the United States and

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[16] *The Economist,* 15 February 2003.

[17] The Textile and Clothing Safeguard regulation that China agreed to as part of its WTO accession package allows WTO member countries to impose temporary quotas on Chinese textile and clothing imports in the event these imports cause "market disruption" (instead of the standard "serious injury" clause). The anti-dumping measures that China agreed to are defined as unilateral remedies that can be applied by a WTO member after an investigation and determination by the member that an imported good is "dumped" and that dumped imports are causing material injury to a domestic industry producing a like product. In response to these, the Government of China announced export tariffs on 148 textile and clothing products. However, the tariffs are low; for instance, for men's cotton shirts the levy is 0.2 yuan, or 2.5 cents – a price increase of about 1 per cent. Despite this marginal difference, the low profit margins in China make it difficult to impose a higher tariff.

European Union markets.[18] It is also argued that the United States may exert pressure on China to revalue its currency – the yuan – as in the case of Japan in 1971. A revaluation of the Chinese currency would further erode the competitive price advantage of Chinese garments.

It is difficult to exactly say what threat China will pose to a garment exporter in Sri Lanka. At least from the Sri Lankan experience thus far, the threat seems to be real. Three items – bag and luggage (670), W/G [Women's or Girls'] Coats (835), W/G Suits (844) – that were removed from the quotas in January 2002 went completely out of production by mid–2003 owing to competition from China. Two leading producers of some of the above-mentioned items, which employed a large number of people, had to close down consequently.[19]

The prevailing uncertainty has been aggravated by the WTO Agreement on Textiles and Clothing (ATC), which stipulates the phasing out of the MFA. Developed countries did not strictly adhere to the phase-out mechanism of the MFA, however. For instance, by 1 January 1998, compared with the target of 33 per cent of product integration, the United States and the European Union had integrated only 1 per cent and 7 per cent, respectively (ESCAP, 2000, p. 71). Moreover, developed countries have exploited a loophole in the MFA, where the ATC does not impose any obligation on countries to limit their integration to particular products subject to restrictions. Therefore, Sri Lanka will not feel the full impact of the final phasing out of the MFA until early 2005.

It has been estimated that the items for which restrictions were relaxed in 2002 constituted only about 4 per cent of all restricted products exported by Sri Lanka to the United States. The remaining 96 per cent were under restraint until end-2004 (Weerakoon and Wijayasiri, 2004). Thus, a sense of complacency crept in among garment companies towards making the required adjustments, although this changed somewhat after the social engineering process that started after mid-2001 and may change altogether in the course of 2005.

An earlier study highlighted the fact that nearly 40 per cent of Sri Lankan garment producers will go out of production after 2004 (Kelegama and Epaarachchi, 2002). The study argues that a number of new mergers and acquisitions will take place in the industry. Some large producers may resort to subcontracting through small units, while small units that fail to obtain orders will have to close down. To support small and medium-sized units in the garment industry, the Government has launched a credit guarantee scheme, as proposed in the 2004 Budget. Under this scheme, loans could be obtained without collateral.

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[18] The American Textile Manufacturers Institute recently estimated that, without safeguards, approximately 1,300 firms could go out of production, with the loss of 630,000 jobs by 2006 (*The Island*, 27 August 2003).

[19] A total of 6,450 jobs were lost owing to the closure of North Carolina Sheet and Towel and Pillowtext Corporation (*The Island*, 27 August 2003).

In its Five-Year Strategy, JAAF has argued that Sri Lanka should now shift from the low end of the market to the middle and upper levels. Currently, only 10 per cent of local manufactures end up in specialty brands, while 50 per cent is taken by foreign department stores and the balance by foreign discount stores. During the five-year period ending in 2007, the industry plans to increase penetration into specialty stores by 20 per cent and department stores by 60-70 per cent and reduce the dependence on discount stores by 10-30 per cent.

The plan outlines a format for achieving these objectives with a detailed discussion on: (a) a strategic framework for implementation; (b) a strategic initiative and relevant action plans for the industry; (c) an additional strategic initiative in support of small and medium-scale enterprises; (d) implementation plans; and (e) cost estimates for the strategic plan. The industry has formed eight committees to look into various aspects of the industry: (1) bilateral and multilateral issues; (2) marketing; (3) logistics and infrastructure; (4) backward integration; (5) small and medium-scale enterprises; (6) human resources, technology and productivity; (7) labour; and (8) finance. The government has allocated Rs. 100 million to increase productivity in the garment industry through the Five-Year Strategy.

The Sri Lanka Joint Apparel Association Forum coordinates the strategy management. The Association has hired a number of experts to coordinate and support its work. Although strategies have been implemented to face the post-2004 challenges effectively, the debate goes on for the post-2004 scenario – both optimistic and pessimistic views have been voiced. Optimists, such as the Central Bank of Sri Lanka, have put forward the following viewpoints: first, it is stated that, since 12 per cent of the garment manufacturers control 72 per cent of exports, there are reasons to believe that these top-end factory units are well established, commanding market niches and thus well placed to meet the post-2004 challenges. Thus, it is argued that these top-end manufacturing units can absorb some of the smaller factories and expand their production to be competitive in the market. Secondly, it is argued that the non-quota exports at present amount to 47 per cent of garment exports; thus, a quota phase-out will not create a serious problem. Thirdly, it is argued that, if the high end of the market could be captured by producing value-added garment products – which larger units have done – Sri Lanka need not worry about competing in the world market

While one can agree with the first point, there are serious reservations about the others. First, it is inappropriate to form a judgment based on increasing non-quota exports because what is a non-quota product for Sri Lanka may be under quota for another country, such as China. The performance of such a non-quota product when the same product comes out of quota in China – at least if one goes by past experience – may not be positive. Second, the top end of the market is equally competitive; other countries that see their quotas in this segment removed will also be aiming at this segment and competition would therefore intensify at this end of the market as well. Sri Lanka will face an uphill battle to be competitive at the top end of the market (Fonseka, 2004).

The pessimists, on the other hand, argue that whatever the percentage of exports that is controlled by the top 12 per cent firms, the garment industry as a whole is not competitive enough to show a solid performance in the post-2004 period (Fonseka, 2004, and others). From the global demand front, it is said that the threat from China will be overwhelming. Moreover, it is argued that the share controlled by other Asian countries is expected to shrink from the current 32 to 20 per cent by 2010. Consequently, there will be competition among Asian countries to capture part of this shrinking share and in that process Sri Lanka may not necessarily be a winner.

Furthermore, inadequate preparation for the post-2004 period due to the back loading factor of the MFA phase-out is also highlighted by the pessimists. From the domestic supply side, the inadequate development of backward linkages, weak forward integration, low labour productivity and increasing production costs, inter alia, are pointed out by the pessimists to highlight the lack of competitiveness. Those who argue along these lines assert that at least 100,000 workers will lose their jobs and various new mechanisms will have to be devised to look after those displaced from the garment industry.

A mixed picture emerges from current trends in the garment industry. On the negative side, it is observed that, out of the 859 firms operating in 2001, about 150 had closed down by mid-2002.[20] Garment factories are experiencing a shortage of labour due to the poor working conditions and accommodations prevailing in some of the factories.[21] In 2003 and 2004, garment exports have shown a decline in performance compared with the year 2000 (see table 2). On the positive side, the top 12 per cent of factories are performing well, there has been an increase in the number of international orders, and a number of foreign garment companies, such as Levis, are opening factories in Sri Lanka.

Given the strong foundations of the garment industry, Sri Lanka still has a chance of being a supplier of choice in the major international markets; however, to retain such a position, substantial restructuring is essential. Thus, irrespective of the current mixed picture, there is an urgent need to restructure the industry to face the post-2004 period without complacency about a possible United States – Sri Lanka FTA that will come to Sri Lanka's rescue, or that the ATC will not be implemented properly after 2004, owing to concerns in the European Union and United States markets.

5. CONCLUDING REMARKS

The Sri Lankan garment industry is at a crossroads. The challenge lies in improving its competitiveness. Rectification of the anomalies highlighted in the preceding sections alone would be inadequate; other methods of increasing competi-

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20 "Treasury officials fail to provide succour to garment industry" (*The Island*, 21 June 2002).

21 JAAF recently launched a media programme to build the image of the garment employees after realizing that the shortage of workers is due to a social stigma attached to garment workers and the poor working conditions in some firms.

tiveness should be explored. One strategy is to reposition the Sri Lankan garment industry from a South Asian context and increase competitiveness by increasing vertical integration, capturing economies of scale, focusing on horizontal specialization, incorporating innovative designs and building a stake in global marketing networks.

A recent report by RIS (2004) argues that the region as a whole could meet the challenge collectively if it pursued horizontal integration, i.e., cooperation in the same or similar lines of production and exports. Such a South Asian strategy envisages a particular South Asian country that has gained export specialization in certain textile or clothing product lines acting as a host for relocated plants from other South Asian countries. In this way, the textile and clothing sector can become a regionally integrated sector as countries vacate certain lines of production and gain in other lines of production according to their relative competitive advantage in the global market. Such restructuring would promote intra-South Asian investment flows that would be trade-creating *vis-à-vis* the global and regional markets. Vertical integration from one stage of processing to another according to comparative advantage can be considered in the subsequent phase. South Asia would thus not lose in the value-added chain.

Ramaswamy and Gereffi (1998) showed that the buyer-determined value-added chain is prominent in garment manufacturing. One way of entering the chain is by having a stake in the global marketing network. For example, in the tea sector, the Indian company Tata bought over the global marketing network of Tetley. A similar strategy can be adopted in the garment sector, but a regional strategy in this regard will be more effective than an individual South Asian country effort. RIS (2004, p. 36) argues:

> "Much of the value addition in garments for instance takes place at the stage of branding and marketing. The South Asian countries should consider setting up South Asian level mega-companies to foster an integrated South Asian garment sector…In order to secure their market overseas and to realize a greater proportion of value added, the South Asian exporters should consider taking over a few marketing and distribution chains in their lines of production in developed countries. Given the scale of resources involved in such take-overs, it may be beyond the capacity of individual exporting companies or individual member countries. However, this could be done by forming a regional consortia of the South Asian exporters."

The Sri Lankan garment industry has gone through turbulent times and is now facing new challenges. The groundwork has already been laid to prepare and face this challenge. What Sri Lanka would like to see is a minimum disruption in the adjustment process because the garment sector is the largest foreign exchange earner and a key generator of employment. However, if Sri Lanka can no longer maintain its comparative advantage in the garment sector, then new sectors will emerge to replace it; in the short run, however, the economy will incur a significant cost from such industrial restructuring and there will be social costs. It is for this reason that both the Government and private sector industry are exerting themselves in support of the garment sector.

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Least Developed Countries in Trade Negotiations: Planning Process and Information Needs

*Debapriya Bhattacharya**

ABSTRACT

This paper highlights the importance of information in the context of the growing involvement of least developed countries in trade negotiations. It provides an overview of the negotiation process, emphasizing the importance of planning. Based on a review of the relevant literature, the steps involved in the negotiation process are discussed and illustrated using examples drawn from the Bangladesh experience. The paper then identifies the information and knowledge needs of the LDCs at each step of the process.

One of the distinguishing features of the evolving multilateral trading system (MTS) is the emergence of the LDCs in the negotiations. LDCs were able to actively and effectively identify and pursue their shared interests during the preparations for the Fifth WTO Ministerial Conference, held in Cancún, Mexico in 2003 and during the Conference itself. Slowly, but steadily, LDCs have realized their responsibilities and started building the capacity to defend their interests in trade negotiations at the multilateral level and at the bilateral and regional levels as well.

(Continued on page 70)

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* The author is Executive Director of the Centre for Policy Dialogue, Bangladesh. An earlier version of this paper was presented at the UNESCAP Ad-Hoc Expert Group Meeting on Enhancing Access to Information Sources for Negotiations under the Doha Development Agenda, Bangkok, 23-25 June 2004. The author acknowledges the efficient research support of Ms. Sharmin Farhana Rahman, Research Associate, Centre for Policy Dialogue, Bangladesh, in the preparation of this paper.

(Continued from page 69)

Effective negotiation involves thoughtful planning and preparation. The paper observes that the negotiation process may be divided into the following seven steps: (a) identification of the problem to be resolved through negotiation; (b) identification of interests of all parties involved; (c) an effective consultation process with the relevant stakeholders; (d) the establishment of a negotiating machinery and supporting institutions to develop the negotiating agenda; (e) the formulation of a negotiating strategy; (f) the actual negotiation; and (g) the assessment of the negotiation outcome before an agreement is signed. This model highlights the fact that actual negotiations are only one of many steps in a negotiation process and that planning steps account for most of that process.

In the context of multilateral trade negotiations, the paper suggests that coalition-building among LDCs during the actual negotiations is key to reaching a successful negotiation outcome. However, the availability of relevant information at each step of the negotiation process is also essential. Information needed for the negotiation should be determined well in advance. The paper discusses the information required at each stage of the negotiation process but also identifies the kind of information that may be needed for different types of trade negotiations, such as the WTO accession negotiations, negotiations on new issues, and trade dispute settlement negotiations. Sources of information are also discussed.

LDCs and other developing countries often lack the ability to access relevant information because of limited political strength as well as lack of financial and human resource capacity. Appropriate training in knowledge and information management for negotiations would be useful to ensure that LDCs go to the negotiating table with the information that they need. In that context, improving the flow of information among negotiators and relevant government ministries and agencies is particularly important.

1. INTRODUCTION

The least developed countries (LDCs), in their attempt to benefit from the globalization process and to improve access to regional and global markets, are increasingly taking part in trade negotiations. Clear understanding and effective handling of negotiations are now two of the major conditions for achieving success in the competitive environment of world trade. The purpose of this paper is therefore to review the basic concepts and steps involved in a negotiation process and to identify the information and knowledge needs of LDCs at different stages of trade negotiations, emphasizing the importance of negotiation planning.

(a) Definition of trade negotiations

The term "negotiation" originates from the Latin word *negotiari,* which means "to carry on business". Negotiation may be defined as a process whereby two or more parties seek an agreement to establish what each shall give or take, or perform and receive in a transaction between them (Saner, 2000). Alternatively, it is an act of discussing an issue between two or more parties with competing interests, with an aim to identify acceptable trade-offs for coming to an agreement (Raihan, 2004).

Negotiations are of different types and forms, and various nomenclatures have been developed to classify them (for example, see Monning and Feketekuty, 2004). In this paper, the focus is on multilateral trade negotiations, which may be defined as inter-governmental negotiations on trade-related issues involving all members of the Word Trade Organization.[1]

(b) LDCs and trade negotiations

At the conclusion of the Uruguay Round of multilateral trade negotiations, the total number of founding LDC members of WTO was 30.[2] Since the launch of WTO in 1995, only two more LDCs, viz. Nepal and Cambodia, have been able to accede to WTO. However, 10 other LDCs are negotiating accession and are associated with WTO as observers.[3] LDC members are also taking a more active role in the WTO trade negotiations.

The Uruguay Round promised to generate significant welfare benefits for all countries through the strengthening of the multilateral trading system. However, the LDCs also faced the major challenge of addressing possible negative effects from the obligations thrust upon them under the single undertaking of the Uruguay Round agreements. These obligations have had to be met in the absence of the promised trade-related technical assistance (TRTA) for capacity-building in the LDCs. At the First WTO Ministerial Conference, in Singapore (1996), while the concerns of LDCs were highlighted in the Plan of Action, new issues were added by the developed countries for subsequent negotiations.[4] The High-Level Meeting (1997) and the subsequent Second

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1 However, information in this paper may also be relevant for other trade negotiations, including bilateral and regional negotiations.

2 The LDCs are: Angola, Bangladesh, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Congo, Djibouti, Gambia. Guinea Bissau, Guinea, Haiti, Lesotho, Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Myanmar, Niger, Rwanda, Senegal, Sierra Leone, Solomon Islands, Tanzania, Togo, Uganda, Zambia.

3 These are Bhutan, Cape Verde, Equatorial Guinea, Ethiopia, Lao People's Democratic Republic, Samoa, Sao Tome and Principe, Sudan, Vanuatu and Yemen.

4 These new issues were commonly referred to as the Singapore issues and included the following: (a) trade and investment; (b) competition policy; (c) transparency in government procurement; and (d) trade facilitation. On 1 August 2004, the WTO General Council decided that negotiation would take place on only one of the four issues, i.e., trade facilitation.

WTO Ministerial Conference, in Geneva (1998), approved the Integrated Framework, which promoted demand-driven TRTA to effectively meet the individual needs of the LDCs.

After the breakdown of the Third WTO Ministerial Conference, in Seattle (1999), some of the major concerns of the LDCs were incorporated into the work programme of the Fourth WTO Ministerial Conference, in Doha (2001). These included issues related to the implementation of existing agreements, the elimination of tariff and non-tariff barriers for products of interest to LDCs, the phasing out of subsidies and trade-distorting domestic farm support in the developed countries, and the implications of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) on public health. As a result, the work programme of the Doha Round was called the Doha Development Agenda (DDA).

During the preparations for and the discussions at the Fifth Ministerial Conference, held in Cancún, Mexico, September 2003, the LDCs actively and effectively identified and pursued their interests. Various drafts of the declaration of the Cancún Ministerial Conference incrementally integrated the views of the LDCs. Even if no declaration resulted from the Cancún Conference, it was the first ministerial conference at which the LDCs established themselves as an influential group whose views were taken note of in WTO negotiations.

Slowly but steadily, LDCs have thus been realizing their responsibilities and trying to build their capacities in order to more effectively underscore their concerns and interests in a body dominated by both economically and politically powerful trading nations. Their recent experience has shown in part that they have a long way to go, particularly in the area of trade negotiations. There is now greater recognition that LDCs need to develop their own positive agenda in order to make effective use of the multilateral trading system. This means mobilizing their own scarce resources for technical preparations, identifying areas of interest, and mounting a joint effort towards capturing the initiative from the very beginning of the negotiation (Bhattacharya and Rahman, 2004).

While at the same time being involved in multilateral trade negotiations, either as members of the WTO or as observers in the process of accession, most LDCs in the region are engaged in an increasing number of bilateral and regional trade negotiations and agreements. Bangladesh, for example, is currently involved in all three categories of trade negotiations: aside from being one of the leaders of the LDC group at WTO, it is currently discussing bilateral free trade agreements (FTAs) with India, Pakistan and Sri Lanka, and has recently finalized a trade and investment framework agreement (TIFA) with the United States of America. At the regional level, Bangladesh is negotiating the details of a South Asia Free Trade Area (SAFTA) with Nepal, Bhutan and the Maldives (along with India, Pakistan and Sri Lanka). Issues currently being negotiated include a schedule for tariff reduction, rules of origin, and a dispute settlement mechanism. Bangladesh also joined the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMST-EC), another regional agreement in the process of forming an FTA that would include Nepal and Bhutan, but also Thailand, Myanmar and India.

Cambodia is another LDC that has been involved in trade negotiations within the context of ASEAN and at the multilateral level, as the latest WTO member. The only Latin American LDC, Haiti is active in negotiations under the Free Trade Area of the Americas (FTAA) and the Central American Free Trade Area (CAFTA). The African and some Pacific island LDCs, along with non-LDC partners, are involved in trade negotiations with the European Union under the African, Caribbean and the Pacific States (ACP) – European Union Cotonou Partnership Agreement.

The growing number of bilateral and regional trade initiatives, combined with the increasing number of issues being addressed in multilateral trade negotiations under the DDA, requires that LDCs in Asia and the Pacific build additional negotiating capacity.

2. THE NEGOTIATION PROCESS AND THE IMPORTANCE OF PLANNING

Thoughtful planning and preparation based on good research and analysis are as important for the outcome of negotiations as good negotiating skills at the bargaining table.

The key steps in a negotiation process are summarized in figure 1 on the basis of a review of the relevant literature.[5] The seven steps leading to a negotiated agreement are discussed below, with emphasis on the five steps involved in planning the negotiations.

Step 1: Problem identification

Negotiations take place when parties identify a problem or opportunity that they believe can be resolved or positively exploited through a negotiated agreement. The first question to be answered at the start of the negotiation process is whether there is a problem (or an opportunity) that cannot be resolved (or realized) on the basis of domestic action and that may be amenable to intergovernmental negotiations. For example, the opportunity associated with liberalized service trade is that it may increase economic growth and contribute to poverty alleviation, while the major problem is that most of the countries are protective in this area. Recognizing the necessity of preference on the movement of service suppliers under Mode 4 of the GATS, Bangladesh emphasized this issue during the WTO Ministerial Conference in Cancun and succeeded in achieving recognition of this aspect in the final draft of the Ministerial Declaration. This would not have been achieved if the problem had not been identified at an early stage of the negotiation process.

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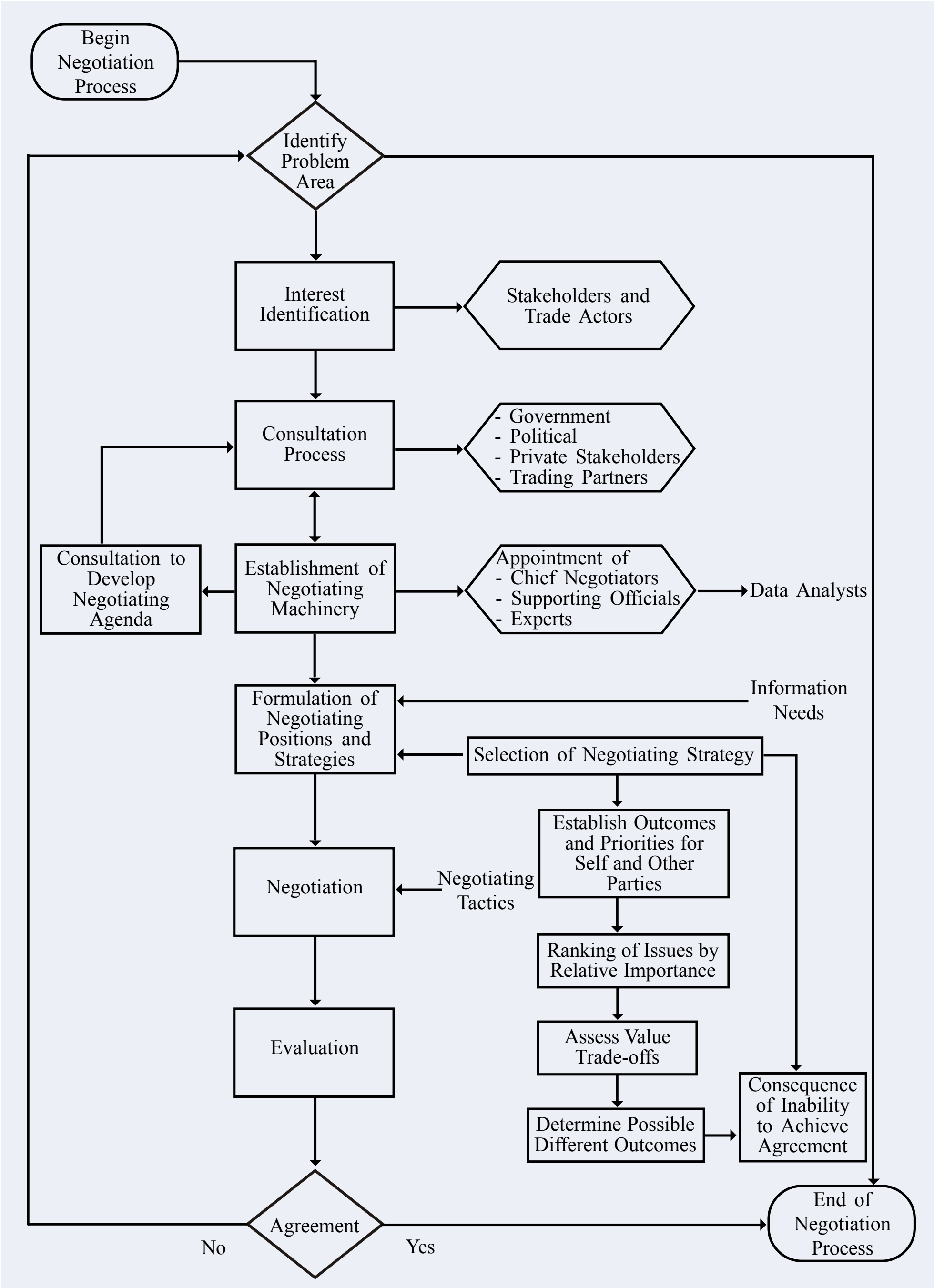
[5] Centre for Trade Policy and Law (2003), Monning and Feketekuty (2004), Saner (2000) and the World Bank Institute (WBI, 2004).

Figure 1. The negotiation process



By understanding the nature of a problem or conflict, the interests of other parties can be anticipated and proposals and options can be formulated. This usually involves:

- *Establishing the history of the conflict*

This essentially involves the following two questions:

a. What is the history of the conflict between or among parties? In a trade dispute, the history may include past practices, tariffs, quotas, dumping or other trade-related practices that have defined a trading relationship.

b. What has changed since the original conflict began? This may include changes in political parties or representation, in key players within administrations or in business interests.

- *Identification of multiple components and deconstructing the problem*

Once the problem has been deconstructed into its discrete parts, the key issues can be identified and prioritized. Multiple solutions can then be evolved for different aspects of the problem.

Step 2: Interest identification

Once the problem is well understood, one has to identify who may benefit and who may lose in the negotiation. It is particularly important to recognize whether there are any powerful interest groups that may either support the efforts to negotiate a solution to the problem or strongly oppose the negotiations.

Monning and Feketekuty (2004) explain that interests are at the core of what drives parties in a negotiation. A better understanding of one's own interests as well as those of the counterparts will lead to a successful negotiation outcome. In international negotiations, interests may revolve around issues of economic interests; domestic policy objectives, such as environmental integrity and resource protection; national security; domestic political considerations; bureaucratic interests; national legal requirements; issues of legitimacy (recognition); and moral or ethical standards. The ability to identify the divergent interests or varying priorities of the different negotiating parties and their stakeholders can provide the basis for generating workable solutions.

Stakeholders, while not directly involved in the negotiations, include individuals, groups and organizations that may be affected by the trade negotiations depending on their outcome. Three major categories of domestic stakeholders are identified by the World Bank Institute (WBI, 2004):

a. First, various government ministries and departments responsible for administering the regulations likely to be covered by the negotiations;

b. Second, the enterprises producing the goods or services likely to be covered by the prospective negotiations;

c. Other stakeholders can include labour unions, non-governmental organizations and consumer groups.

By the end of step 2, domestic stakeholders and their general interests should be identified.

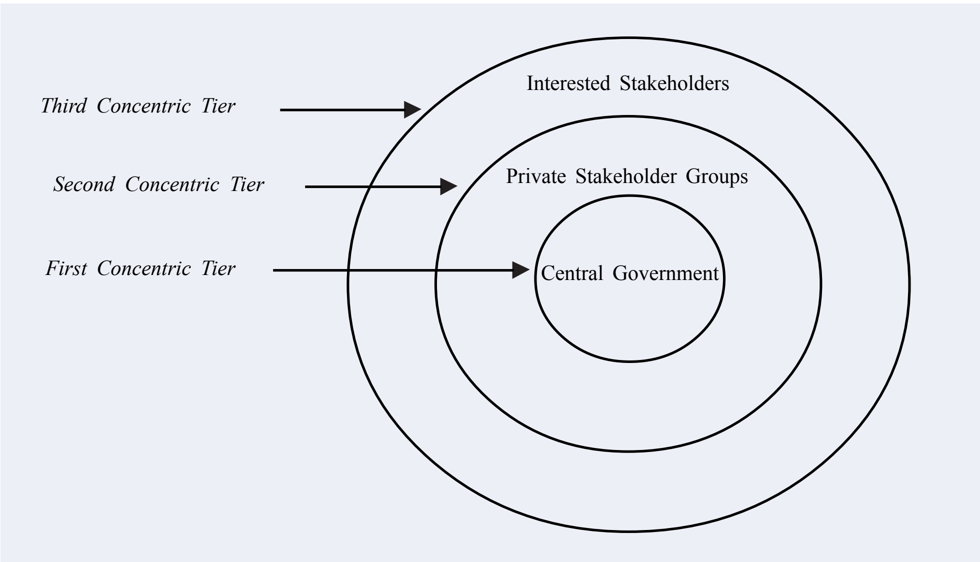
Step 3: Consultation process

Once stakeholders and their interests have been identified, it is important to plan and organize an effective consultation process to further understand their needs and gather information needed to develop a negotiating agenda and determine a national position on each of the issues to be negotiated.

By their very nature, international negotiations involve people of different national, ethnic, racial, religious and cultural backgrounds. These people represent Governments, businesses, NGOs and other entities that have a stake or interest in the outcome of the negotiations. However, only those people who are sufficiently interested and influential may be involved in the consultation process (WBI, 2004).

Figure 2 provides a graphic representation of the three groups of stakeholders that should be involved in the consultation process. The innermost circle should consist of the stakeholders within the central Government, i.e., the key ministries and departments responsible for the regulations covered by the negotiations. Consultations with the members of the inner circle would be frequent and regular, and may be held throughout the consultation process.

Figure 2. Actors in the consultation process



The second concentric tier is comprised representatives from key private stakeholder groups who may be invited to participate in various advisory bodies. These advisory bodies can give negotiators direct feedback on proposed negotiating positions and serve as a vehicle for building consensus with the most influential private stakeholders. Such advisory bodies can also serve as sources of information on trade opportunities and problems, industry practices and the most difficult barriers to trade expansion.

The third concentric tier includes all other interested stakeholders, who may be invited to participate in briefings or conferences covering the negotiations, during which they will be given an opportunity to express their views.

Consultations held during the negotiation process may include:

- Interdepartmental consultation – to develop and assess the analytical basis for the negotiation and to pool all relevant information available from government officials
- Political consultation – to assess the political basis for negotiation and to secure strong political commitment to trade negotiations from top decision makers
- Ongoing consultations with central, provincial/state governments, private sector, and other interest groups as required – to build broad-based support for the negotiation (and avoid surprises). This may require the establishment of an institutional machinery to facilitate consultations among all affected interests
- Consultations or pre-negotiations with trading partner(s) – to confirm interest and test issues

Step 4: Establishment of a negotiating machinery and development of a negotiating agenda

At this stage, the chief negotiator and a team of supporting officials drawn from relevant ministries and government agencies are appointed. The team of negotiators may also be assisted by experts hired by the Government or provided by business associations, civil society and other organizations. Individuals and institutions in this group are referred to as trade negotiation actors, as they work directly on the negotiation and assist the negotiating parties in reaching an agreement, often by providing much needed information, analysis and feedback.

In Bangladesh, the government ministries play the most vital role in the negotiation of trade agreements, especially the Ministry of Commerce, the Ministry of Finance, the Ministry of Foreign Affairs and the Tariff Commission. Other ministries and entities, such as the Ministry of Planning, the Board of Investment also provide direct or indirect support.

Bangladesh became more proactive about WTO-related issues after the Doha Development Agenda (DDA) was adopted, as did most LDCs. As a result, the Ministry of Commerce set up a special "WTO cell" to improve its capacity to negotiate on the DDA. The Government is also setting up the Bangladesh Foreign Trade Institute (BFTI), an institution under public-private partnership that will work as a think-tank for the Government and private entrepreneurs in the field of international trade.

Many of the private actors, civil society groups and think-tanks in Bangladesh also play an important role in trade negotiations. The participation of these private actors contributed to the success of the Second LDC Trade Ministers' meeting, held in Dhaka just before the Cancun Ministerial Conference, in June 2003[6]. The growing capacity of Bangladesh with regard to trade negotiations was further recognized when its Government was requested to provide support in preparing the Declaration of the Third LDC Trade Ministers' meeting, held in Dhaka in May 2004.[7]

The compilation and assembling of various types of information becomes necessary at this stage of the negotiation process (CTPL, 2003). Further consultations may be held to develop the negotiating agenda on the basis of issue identification, empirical and policy research analysis, and inputs from stakeholders and trade actors. If necessary and desirable, a separate negotiating track could also be established to address trade-related issues (such as environment, labour and intellectual property rights).

Step 5: Formulation of negotiating positions and strategies

On the basis of available information, continuing analysis and consultations, negotiating positions and strategies may be formulated. The selection of a negotiating objective at the very beginning of this step is highly recommended in order to provide a clear focus for both the preparatory work leading to a negotiation and to the management of the negotiation itself.

Eight success factors in negotiation planning are listed in Box 1. As part of the strategic planning for the negotiation, systematic analytical methods may be used to establish priorities and to assess value trade-offs. Steps involved in developing a negotiating strategy may include:

- Establishing outcomes and priorities for oneself
- Estimating outcomes and priorities for other parties
- Identifying and assessing major trade-offs
- Identifying all possible outcomes and consequences

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[6] The Second LDC Trade Ministers' meeting was held from 31 May to 2 June 2003. The Declaration issued by the ministers is available at www.wto.org as document WT/L/521.

[7] The Third LDC Trade Ministers' meeting was held on 4 and 5 May 2004. The Declaration issued by the ministers is available at www.wto.org as document WT/L/566.

Box 1. Success factors in negotiation planning

- Widest possible range of options
- More attention to common ground
- Greater attention to long-term factors
- Setting upper and lower limits rather than fixed target points
- Planning of issues without establishing a rigid sequence
- More time devoted to studying the conflict
- Less attention paid to own objectives than to a jointly achieved solution
- Less attention to tactics: these are often overrated

Source: Adler (1982) and Dupont (1986) in Saner (2000).

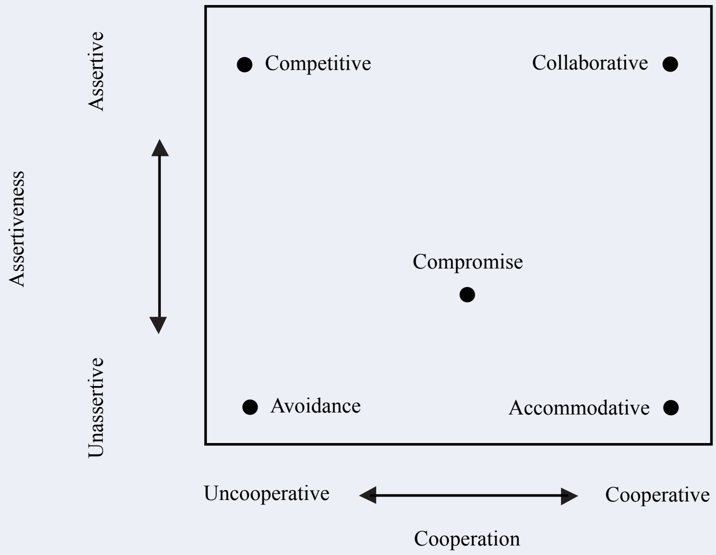
When establishing preferred outcomes and priorities for oneself as well as for other parties, it may be particularly useful to rank the issues related to the negotiation according to their importance and relevance to the problem. Each issue may be assigned an importance weight (for example, on a scale from 0 to 1) not only from the perspective of the party ranking the issues but also that of the other parties.

Maximum and minimum expectations from the negotiation of each issue should be determined. The maximum expectation from the negotiation should be the opening position of the negotiators, while the bottom line (minimum expectation) should be their reserved position. A number of alternative outcomes should be identified in between these two extreme positions on each of the issues to be negotiated (CTPL, 2003). All the possible outcomes should be taken into account and the consequence of inability to achieve an agreement should also be determined.

Evaluating the consequence of a failure to reach an agreement is one of the major challenges in strategizing and formulating the whole negotiating position. The countries should reserve their alternatives for such outcomes and perform an appropriate analysis of the non-agreement consequences, though it is never in anyone's expectation to fail in negotiating and thus reach no agreement. In this connection, an example may be cited from the ongoing negotiations under BIMST-EC. During these negotiations, Bangladesh demanded compensation for the LDCs due to revenue lost during trade liberalization undertakings. The other negotiating parties, particularly the developing countries did not agree to this demand. Bangladesh could not offer any alternatives to show flexibility and became the only LDC that did not sign the agreement. It later withdrew its demand and joined BIMST-EC.

An important aspect of the strategy is the selection of an appropriate behaviour during the actual negotiation of the different issues. As shown in figure 3, negotiating behaviours, also referred to as modes of conflict management, can be classified into five broad categories depending on the combination of assertiveness and cooperation that is selected.

Figure 3. Modes of conflict management



Source: Thomas and Killmann (1974) in Saner (2000).

1. Competitive behaviour. The essence of this power-oriented behaviour lies in its effort to achieve goals by trying to persuade the other party to make concessions. Under a competitive strategy, the other party may be convinced to concede by:

- Arguments to encourage concessions
- Firm commitment to demands
- Refusal to reveal/share information
- Delays
- Misrepresentation
- Rejection of the other's demands for concessions
- Withholding of concessions
- Refusal to exchange offers
- Threaten walk out or retaliate

The competitive mode of behaviour may be useful for achieving desired results on some of the issues under negotiation, but it may also lead to impatience and the loss of flexibility, leaving little room for movement towards cooperative approaches and a constructive solution to the conflict.

2. *Accommodative behaviour*: This behaviour gives the highest priority to cooperation and reaching an agreement. It is the opposite of competitive behaviour, as the negotiator is willing to adjust most self-interested objectives in order to satisfy the interests of the other party.

3. *Avoidance.* This behaviour combines non-cooperative behaviour with a lack of assertiveness, generally leading to a no-win solution in which the interests of none of the parties are met. This strategy could be used to defer or postpone awkward issues that might not be amenable to an agreement until a more favourable moment. It is a position that is extremely versatile and possibly useful, but it should be used in a focused and targeted manner, since frequent avoidance of conflict reduces the chances of satisfactory results in the future.

4. *Collaborative behaviour*: Collaboration requires the parties to familiarize themselves thoroughly with the conflict and its causes in order to seek a constructive joint approach. Without losing sight of their own principles or interests, each party works through the differences separating them and learns from the other's point of view and experiences. This strategic choice of behaviour may be implemented by:

- Signalling a desire for agreement
- Exchanging information about needs/priorities
- Brainstorming and jointly assessing options

5. *Compromise.* Parties in the negotiation may come to a compromise in order to achieve a satisfactory alternative that might be partially acceptable to both of them. The positions for such a solution lie between avoidance and collaboration. It is where the parties make moves towards one another or look for rapid agreement that is satisfactory because it is acceptable to them.

The following aspects should be considered when selecting a strategic behaviour:

– Importance of the negotiation
– Consequences of non-agreement
– Common interests of the parties
– Relationship quality
– Power to impose demands

Step 6: Negotiation

It is during this phase that the negotiation strategy will be implemented and requests will be made, concessions offered and compromises reached. In the context of multilateral trade negotiations, an effective and well-known method for gaining support for negotiating proposals and to increase negotiating power is to build coalitions among like-minded groups and countries. According to the WBI (2004), a coalition partner may support efforts to prepare negotiations in some or all of the following ways:

- Help brainstorm possible solutions (options) to present in the negotiation
- Reach out to their constituents (members) to involve them in collateral legislative, lobbying, media or other supportive activities
- Help to raise resources, including funds, to advance various aspects of a concerted campaign that will support the negotiators
- Provide market research, scientific research and other data to support the negotiating objectives

Findings from the research community, international governmental organizations (IGOs) and non-governmental organizations (NGOs) could also be used to press for a particular point of view. In that form, partnerships can also go beyond strictly speaking negotiating parties and include IGOs or NGOs representing civil society groups. A point to note is that it is necessary to first work with coalition partners in order to align on the issues of the greatest importance to them, then work with the other parties.

The LDCs could gain significantly if they are able to build up coalitions and stand firmly against groupings of powerful developed countries. The united stand that LDCs displayed at the Cancun Ministerial Conference is one of the best examples of the effectiveness of coalition-building and partnership, especially in a multilateral trade negotiation. The developed countries failed to insert new issues into the agreement, mainly because such a coalition had been formed by the LDCs together with other developing countries. During the Conference, Bangladesh and some African countries also helped each other in the case of cotton and Mode 4 of the services agreement.[8]

Step 7: Assessment

After the actual negotiation has finished and the elements of an agreement have been put together, a short evaluation of the whole outcome becomes necessary to decide whether a successful agreement is possible, or another round of negotiations might be needed. Assessment is required after the parties reach a point of consensus. Making an assessment tends to be a task assigned to officials with legal expertise, who base their effort on the substantive work done by the negotiators and work in close collaboration with them. However, it is useful to assign the legal officers to the negotiating team from the start in order to assist in the development of draft texts. If consultations have been pursued throughout the draft text, political approval should be a final, formal step that would create little or no difficulty.

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[8] See for example, the Consolidated Position of African Union/ACP/LDC Position, WTO document WT/MIN(03)/W/17. An assessment of what happened in Cancún may also be found in UNESCAP (2004).

3. INFORMATION REQUIREMENTS

Information and skilled analysis of that information are the key determinants of a party's ability to negotiate a successful outcome. The highly technical nature of trade negotiations means that success will depend on each party's ability to develop solid arguments based on reliable information and exhaustive analysis (Tortora, 2000). This is particularly true in the case of LDCs, which generally lack the ability to influence negotiations solely on the basis of their economic and political influence.

Careful research and analysis is needed at every step in the negotiation process, particularly during the planning steps leading to the actual negotiations. Information that is required for any trade negotiation generally includes the following about one's own country and other countries:

- Economy, economic policies and foreign trade
- Policies affecting foreign trade in goods and services
  - Import export regulations
  - Internal policies affecting trade
- Trade-related intellectual property regime
- Trade and economic relations with third countries
  - Agreements with other countries
- Barriers to trade
  - Information on domestic support and export subsidies
- Competitiveness studies of key industries and sectors under negotiation
- State trading

Information requirements would vary depending on the stage of the negotiation process as well as the nature or type of trade negotiations.

(a) Information requirements at different steps of trade negotiation

An overview of the information required at each step of the trade negotiation process is presented in Box 2.

Examples of how the collected information may be used to prepare negotiating requests and offers in the case of WTO negotiations on trade in services are as follows (WBI, 2004):

- Analysis of information drawn from the export data, economic studies, industry surveys and studies of other economies should lead to conclusions regarding the services in which the country already has or could easily develop competitive exports.

Box 2. Information required at each step of the trade negotiation process

Steps of negotiation	***Required information / analysis***
Step 1 – Problem identification	Detailed information on the trading regime of one's own country: – Country's import and export figures – Investment figures, both local and foreign – Detailed statistics on trade in goods and services – Production capacity and prices of goods and services
Step 2 – Interest identification	– Trade data of neighbouring and partner countries – National trading rules and policies – Trade rules and policies of other countries
Step 3 – Consultation process	– Who are the trade actors: the related government departments – Interested stakeholders involved with the identified problem – Interested political parties – Interested trading partners
Step 4 – Establishment of negotiating machinery and development of a negotiating agenda	– Best negotiators available in the required field – Available supporting government officials – Research and analysis done in the required field
Step 5 – Formulation of negotiating positions and strategies	– Importance of related or linked issues – Available concessions – Common interests of the negotiating parties – Quality of political and trading relationship – Possible solutions – Consequence of non-agreement
Step 6 – Negotiation	– Position of other negotiating teams – Possible strategy of the other countries – Coalition partners
Step 7– Assessment	– Consequence of the agreement – Barriers to implementation

- Analysis of information about foreign regulatory barriers and industry assessments of their relative importance, when combined with the analytical conclusions regarding potential export industries, can lead to conclusions regarding the foreign regulatory barriers that should be targeted in the requests submitted to other countries in the first stage of the negotiations.
- Analysis of import data, economic studies, industry surveys, studies of other economies and inputs provided by domestic ministries or departments can lead to conclusions regarding the services in which the country

has weaknesses, and in which liberalization commitments should only be made on the basis of long phase-in periods, or precluded altogether.

- Analysis of information on regulatory issues can lead to conclusions on how requests and offers in particular sectors or with respect to particular horizontal measures should be framed.
- Information on the positions and interests of both domestic and foreign stakeholders is crucial for the development of negotiating positions, the development of requests and offers, and the development of negotiating strategies and tactics.

(b) Information requirements in various types of negotiation

Information requirements are likely to vary depending on the type of negotiation. For example, the information required for negotiating accession to an existing trade agreement is very different from the information that is needed for a trade dispute settlement. The negotiator must decide at the very beginning of the negotiation process which type of information should be gathered. Box 3 provides an overview of information requirements by type of trade negotiation.

Box 3. Information needs by type of trade negotiation

Types of negotiation	*Required information*
Accession	• Rules and procedures for accession • Detailed information on the country wishing to access • Demand by the member countries • Countries that have already become members by the accession procedures: – Details of the accession process – What were the problem areas – How were they resolved – What were the key measures – Reasons for delay/success • Consequences of the outcomes
Trade negotiation: built-in-agenda	• Current state of the negotiations • Details of the issues involved • Offers/proposals of interested countries • Existence of any modalities • Possible area/scope of disputes

(Continued)

Box 3 *(Continued)*

Types of negotiation	***Required information***
New negotiating issues	• Progress achieved on the old issues • Detailed information on related matters concerning the new issues • Countries that are opposing/supporting the issues • Possibility of a coalition being built on the new issues • Consequences of opposing/supporting the issues
Dispute settlement	• Details of the issue that is the subject of the dispute • Causes of the dispute (own and that of the disputant) • Disputes that have already taken place on similar issues • Rules and procedures for dispute settlement • Members of the dispute settlement unit

(c) Collection of information

Once it has been decided that particular information is relevant and necessary, the next question is where to find that information. Collecting information in one's own country might be comparatively easy, but major challenges will lie in assembling information about the other negotiating countries. Box 4 lists possible sources of trade-related information.

Box 4. Possible sources of trade-related information

Required information	***Possible source of information***
Import and export	• Official data • Major exporters and industry associations in individual sectors can supplement the official statistics to provide additional data that can provide insights at a product level • Help in assembling this information can also come from a number of international institutions, such as the International Trade Centre in Geneva, multilateral development banks and bilateral economic development assistance agencies, such as the United States Agency for International Development (USAID) and the Canadian Economic Development Agency (CIDA)

Box 4 *(Continued)*

Required information	***Possible source of information***
Competitive strengths and weaknesses of industries in the country	• Initial information: trade data • Additional insights into competitive strengths can come from economic studies carried out by academic experts, assessments provided by industry experts and a review of the export performance of other countries at a similar stage of economic development and similar economic circumstances
Information about foreign trade barriers	• Best provided by industries: the necessary canvassing of the industry can be done either by the trade negotiators themselves, by a consultant hired for the task or by a general industry association • Insights into trade barriers can also be found in surveys done by third countries, particularly third countries with large research units and staff
Information about regulatory issues	• Best sources are the other government stakeholders responsible for areas of negotiation and international organizations that have carried out regulatory studies, including WTO, UNCTAD, World Bank, OECD and other sectoral bodies

Source: The World Bank Institute (WBI), 2004.

The search for information should start from one's own country and organization. Trade actors and researchers need to accumulate local information first. Box 5 shows the possible sources of information in Bangladesh for various trade-related data.

Even when approaching a new problem or situation, there might be valuable information available locally about the history of a counterpart, anecdotal information about various negotiators and their styles, habits or preferences, and records or archives about a particular trade or economic issue. Other useful sources of information may include:

- Researchers and negotiators: they could be quite helpful in finding information as they are in contact with or have access to other researchers, negotiators, intelligence services, economists and experts. This could prove helpful in assembling country profiles, economic trends, historical information and a current analysis of issues related to the negotiation;
- The Internet: search inputs could be country, region, names of negotiators, products, economic studies and subject fields pertinent to the negotiation;

Box 5. Selected sources of trade information in Bangladesh

Information	*Source*
Import/export and L/C openings	Foreign Exchange Policy Department, Bangladesh Bank
Imports, FDI	Statistics Department, Bangladesh Bank Bangladesh Board of Investment
Tax revenue earnings	Board of Revenue Research and Statistics Division
Non-tax revenue and revenue expenditure	Ministry of Finance
Government borrowing, loans, domestic credit	Bangladesh Bank
Capital market (DSE)	Stock Exchange
Food grain production	Agricultural Division, Bangladesh Bureau of Statistics
Foreign aid	RD, Ministry of Finance
Foreign investment (EPZ)	BEPZA

- News and media outlets: coverage of key regions, countries or issues could be identified as sources of specific records. Monitoring of news and current events during the negotiations is necessary as well. A change in stock values, a natural disaster, a political change or other factors might also influence the country's negotiators during a negotiation.

Information could also be accumulated during the negotiating round by asking questions of the counterparts. Information that has not been offered or volunteered by a counterpart in an opening or affirmative statement may be shared or revealed in response to a question (Monning and Feketekuty, 2004).

The availability of information often depends on the nature of the relationship and trust, as well as national policy. Current national policy might preclude sharing relevant information with other parties in a negotiation, even though the relationship between the parties is good. Constraints to accumulation and analysis of information by LDCs typically include:

- Limited resources (financial and human)
- Limited access to technology (Internet access, hardware and software availability)
- Conflicting priorities and events: political, environmental, international
- Quality and quantity of information: reliability, validity, format, recent/old data

- Limited data analysis capacity (lack of training and tools)
- Unwillingness of other countries to share data, as well as unavailability of data in own country

4. CONCLUDING REMARKS

The success of the Uruguay Round induced a large number of LDCs to join the WTO with the promise of growth and development through the benefits of open trade. Unfortunately, not as much as expected has been achieved to date, apart from the fact that the burdens on LDCs have increased in some areas. LDCs have not been able to significantly improve their share of global trade thus far, despite some external support and assistance. In order for them to do so, adequate domestic development in the form of capacity-building is required. LDCs have to build their human and institutional knowledge base for identifying trade interests and effectively communicating with trading partners in order to create the capacity to increase their share of world trade.

The planning phase is one of the most crucial parts in the negotiating process. All parties, actors and stakeholders related to a negotiation should work closely so that detailed planning and sharing of information can be done openly and without restraint. LDCs and other developing countries often lack the ability to access relevant information because of limited political influence, as well as a lack of adequate financial and human resource capacity. Appropriate training in order to strengthen knowledge and information management for negotiations would be useful to ensure that LDCs come to the negotiating table with the information they need.

In that context, improving the flow of information between the negotiators and the relevant government agencies and ministries is particularly important. Ministries in charge of multilateral trade negotiations should provide their permanent representatives in Geneva with the necessary guidance. This includes providing special support to gather and organize relevant information on trading partners from local and international sources, so that it can be easily retrieved by negotiators. Research institutions and think-tanks should also join with the Government to engage in extensive analysis of the data and information.

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Export of Software and Business Process Outsourcing from Developing Countries: Lessons from the Indian Experience*

Nagesh Kumar and K.J. Joseph

ABSTRACT

India's emergence as a globally competitive supplier of software and services has attracted worldwide attention. Against that background, this paper explores the contribution of this sector to the economy and highlights the role of policy initiatives and institutional interventions undertaken by the State in accomplishing this unique success, with a view to drawing lessons for other developing countries. It is shown that the software and service sector not only contributes significantly to export earnings and GDP but also emerges as a major source of employment generation in the country. Besides, the information technology (IT) sector has served as a fertile ground for the growth of a new entrepreneurial class with innovative corporate practices and has been instrumental in reversing the brain drain, raising India's brand equity and attracting foreign direct investment (FDI) leading to other associated benefits. These and other benefits, the paper argues, have had an opportunity cost in terms of the adverse impact on other sectors competing for skilled manpower. It is also argued that India's success owes largely to the cumulative investments made by the Government over the past five decades in building up a national innovation system, which laid the foundation for the development of skill- and technology-intensive

(Continued on page 92)

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sectors, such as IT software and related services. This included a system of higher education in engineering and technical disciplines, the creation of an institutional infrastructure for science and technology (S&T) policymaking and implementation, building centres of excellence, a national information infrastructure and numerous other institutions for technology development, among other initiatives. This is not to neglect the role that private sector investment played, especially during the last decade, in taking India's software sector to further heights. In a sense, India presents a case of proactive State intervention with an active role for the private sector. The Indian experience thus tends to suggest that the developing countries aspiring to develop a software and service sector cannot afford to neglect the development of a vibrant national innovation system while adopting a liberal trade and investment policy regime. On the whole, while a bad policy could drive investment away and impair growth, a good market-friendly policy per se does not necessarily attract investment and facilitate growth.

1. INTRODUCTION

Economists have long noted that services in general are cheaper in developing countries than in developed countries. This has been attributed mainly to an abundant supply of labour – the major input in the production of services – in developing countries, leading to low wages. Since the technology for producing services does not differ significantly from one country to another, lower wages result in a lower cost of producing services in developing countries (Bhagwati, 1984). Yet, developing countries in general have been unable to benefit from this cost advantage mainly because most of the services were embodied in their provider and their export called for the transborder movement of labour. But the movement of labour, unlike capital, was subjected to series of restrictions.

Though the process of globalization, which inter alia implied the free movement of products and factors, accelerated momentum during the last two decades, there has been hardly any relaxation of the restriction of labour mobility. However, advances in information and communication technologies (ICTs) have made possible the "splintering off" of many of the services from its providers, which in turn has led to what is often called the "offshoring of services".

No wonder India, with its large pool of skilled manpower, has emerged as a major exporter of IT software and related services, such as business process outsourcing (BPO). In fact, one of the notable achievements in India during the last decade has been the emergence of an internationally competitive IT software and service sector. A number of studies have looked into different aspects of India's IT software export boom (Schware, 1987, 1992; Sen, 1995; Heeks, 1996; Kumar, 2000, 2001; Arora et al, 2001; Joseph and Harilal, 2001; Parthasarathi and Joseph, 2002; Joseph, 2002).

With the recent emergence of business process outsourcing delivered over the Internet, the so-called IT enabled services (ITES-BPOs) as a major source of employment and foreign exchange,[1] an obvious issue arises: are there any lessons from India for other developing countries aspiring to take advantage of the opportunities offered by the export of ITES, which is considered less demanding as compared with software? In this context, this paper examines the various factors that facilitated the emergence of India as a major IT software and service provider in the world market.

The remainder of the paper is organized as follows. Section 2 highlights the performance of software and service sector in India, its contribution to the economy and also the opportunity cost of the export-oriented growth strategy. Section 3 undertakes an analysis of the various policy initiatives and institutional interventions made by the State in facilitating the observed growth performance, followed by the concluding observations.

2. RISE OF INDIAN SOFTWARE AND RELATED SERVICE INDUSTRY: A PERSPECTIVE

(a) Growth of output and exports

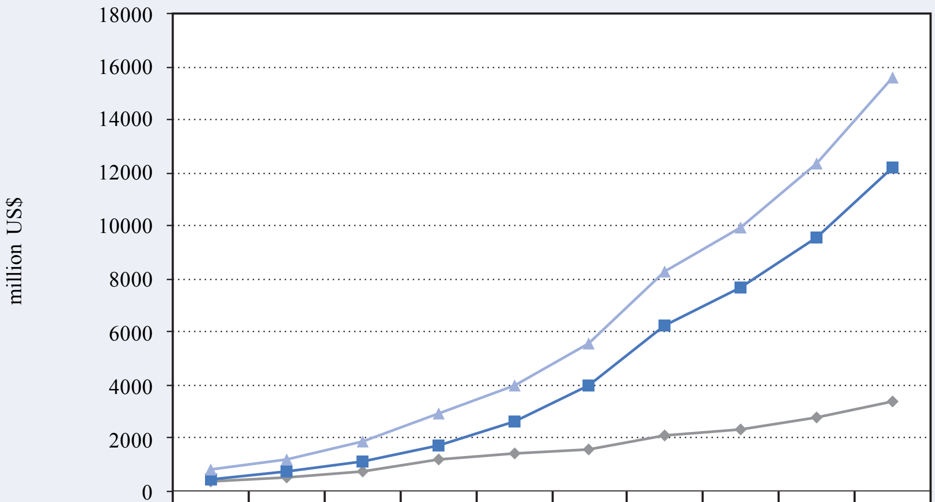
The Indian software and related service industry, which include ITES-BPO, has grown at an unprecedented rate over the past decade or so. The output value of India's software and service sector increased more than 18 times from less than US$ 830 million in 1994-95 to US$ 15.5 billion in 2003-04. The sector growth, fueled mainly by exports, is clear from the fact that exports of software and services increased by more than 25 times during the same period (see figure 1).

With such rapid growth, the software and related service sector today accounts for over 2.6 per cent of GDP in 2003-04 compared with 0.5 per cent in 1996-97, representing a more than fivefold increase. Its share of India's exports of goods and services has increased almost seven fold (from 3.2 per cent to 21.3 per cent) during the same period. Viewed from an international perspective, India's share of the world IT software and service market is 3.4 per cent, compared with only about 0.8 per cent of global trade. Furthermore, India's share of the global market for customized software that is outsourced across borders is also more significant. According to one estimate, it had reached 18.5 per cent by 1999 (NASSCOM, 2000).

The rapid growth of software exports in the 1990s has been moderated since 2001. The annual compound growth rate of exports fell from 54 per cent during 1996-2000 to 25 per cent during the following three years. Another development taking place in the industry at the dawn of the new millennium was the rapid emergence of

[1] Here it may be noted that the major importing country, the United States of America, has come up with measures to restrict the offshoring of services.

Figure 1. Trend in production and export of software and services



	1994-95	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04
Domestic	360	490	759	1 177	1 411	1 577	2 081	2 311	2 769	2 374
Export	485	734	110	1 759	2 600	3 962	6 217	7 647	9 545	12 200
Total	835	1 224	1 859	2 936	4 011	5 539	8 298	9 958	12 314	15 574

ITES-BPO as a more dynamic component of software and service exports from the country. In 1999-2000, total ITES exports were only of the order of US$ 565 million and are estimated to have increased to US$ 3.6 billion in 2003-04. ITES-BPO exports grew by 59 per cent during 2002-03 to 2003-04. Hence, but for the rise of BPO exports, the growth of software exports would be even slower than what is shown above. As a result, the share of ITES-BPO in total software and service exports more than doubled, from about 14 per cent in 2000 to more than 29 per cent in 2003-04.

(b) Employment generation and other indirect externalities

(i) Creating jobs

As shown in table 1, the software and ITES-BPO sectors accounted for 813,000 jobs by 2003-04. Of these, nearly 500,000 (260,000 jobs in software industry and 245,000 jobs in ITES-BPO) have been primarily for export-oriented activities. In particular, jobs in ITES-BPO have risen rapidly, from 42,000 in 1999-2000 to 245,000 in 2003-04. One may argue that the ITES-BPO services that are booming currently are relatively low value-adding and low skill-intensive activities. However, because ITES-BPO services are low value-adding, they are likely to make a greater contribution to the local economy in terms of creating job opportunities for millions of college pass-outs without technical or professional qualifications. Our estimate of the employment per million dollars of exports in the ITES-BPO sector is found to be about 70, which is more than twice that of the software sector. Thus viewed, ITES-BPO appears to have the potential of generating substantial employment for the growing number of educated youth in the country.

Table 1. Indian software and ITES sectors: professionals employed

	1999-2000	*2000-01*	*2001-02*	*2002-03*	*2003-04E*
Software exports sector	110 000	162 000	170 000	205 000	260 000
Software – domestic sector	17 000	20 000	22 000	25 000	28 000
Software – captive in user organizations	115 000	178 114	224 250	260 000	280 000
ITES-BPO	42 000	70 000	106 000	171 000	245 500
Total	284 000	430 114	522 250	661 000	813 500

Source: NASSCOM, 2004.

Note: E – estimated.

(ii) Expanding the base of entrepreneurship

Apart from creating jobs for highly qualified professionals as well as ordinary college pass-outs, the rise of the software industry has provided opportunities for expanding the local base of entrepreneurship. The initial start-up costs in the sector are rather low and economies of scale are not particularly significant especially for service enterprises. Hence, the entry barriers are low. This has helped a number of technical professionals to start on their own. Many of the leading software enterprises of today were started by first generation entrepreneurs. Infosys, Satyam, Mastek, Silverline and Polaris, among numerous others, were started by software professionals and engineers with small savings and loans at very modest scales to begin with (Kumar, 2001). At a smaller level, too, it has provided opportunities for the development of entrepreneurship among the relatively less qualified professionals as well. A study of smaller or informal sector enterprises in the software and services industry in India reveals how many rewarding entrepreneurship opportunities exist for low initial set-up costs. The rates at which even these smaller enterprises have been growing means that they do not stay small for very long (Kumar, 2000).

(iii) Reversing the brain drain

The rapid rise of the software industry in the country has also helped to reduce the extent of the brain drain by creating rewarding employment opportunities within the country, a trend also supported by the availability of venture capital to implement new ideas. The rise of the software industry has also prompted a number of non-resident Indians to return to the country to start software ventures. According to some estimates, the rate of returning of professionals increased from 2 per cent in 1991 to 8 to 10 per cent in the late 1990s, with several senior software professionals returning to India to set up their own companies. Apparently, in Hyderabad alone, about 100 companies have been set up by returning software professionals (Kumar, 2001). Furthermore, the export orientation of the Indian software industry benefited from the presence of a substantial number of non-resident Indian engineers working in United States multinational enterprises (MNEs). Lateef (1997) and Arora et al. (2000) observe that some of them have played an important, though yet to be documented, role in facilitating contacts between buyers in the United States and potential suppliers in India. Non-resident Indians in the software industry in the United States have also invested back home in subsidiaries that develop software for their United States operations. These include investments in subsidiaries of Mastech, CBS Inc. and IMR, among others.

(iv) Creating a brand value for the country in knowledge-based industries

Despite the large pool of trained engineering manpower, India's image in the world has been that of a poor and underdeveloped economy having a comparative advantage only in low-skill and low-technology industries. As a result, the country has suffered from a disadvantage in exporting knowledge-intensive goods. The emergence of the country as a centre for outsourcing such a highly knowledge-intensive service as software is helping to change the public perception of India and is focusing attention on the potential of the country in knowledge-based industries. This changing perception is helping India emerge as a destination for the global or regional research and development (R&D) centres of MNEs (see Kumar, 2003). This changing perception about the country's strengths is also shaping bilateral relations with different countries.

(v) Facilitating capital inflows

The development of the software industry has led to an increased flow of capital to the country in three forms: foreign direct investment (FDI) by outside MNEs in their subsidiaries and joint ventures in India, foreign institutional investments (FIIs) in software companies in India through stock purchases, and capital raised abroad by Indian software companies. It has been estimated that MNE affiliates account for 23 per cent of exports of software services and 26 per cent of ITES-BPO exports.

(vi) Spatial agglomeration and regional distribution

The development of the software industry in different parts of the world is characterized by a strong tendency towards clustering because of agglomeration economies. In India, the software industry developed initially in Mumbai. Bangalore subsequently emerged as a centre of software industry development, especially after the entry of Texas Instruments in the mid-1980s. In addition to Bangalore and Mumbai, Delhi and the suburban communities of Noida and Gurgaon have emerged as the third most popular location for software units. As Bangalore has become saturated owing to the limits of its infrastructure and the scarcity of space, Hyderabad and Chennai have started to provide alternative locations in the south. The top five cities together account for 80.5 per cent of the top 600 companies. But other cities, such as Calcutta, Pune, Thiruvanantpuram, Ahmedabad and Bhubneswar, are becoming increasingly popular locations. Two important factors in this agglomeration are the availability of high-speed data communication links and built-up space provided in software technology parks and the availability of skilled manpower. The less skill-dependent nature of the ITES-BPO activity makes it more easily diffused across the country, thus generating linkages with the rest of the economy.

(c) Upgrading and capability-building

How about Indian performance in terms of indicators related to the upgrading of capability? Certain indicators suggest that Indian industry has been moving up the value chain while also expanding exports of relatively lower-end BPO services.

Although the magnitude of exports of software and services from India has grown rapidly over the past decade, the general perception is that these are exports of low-value services. That perception emanates from the fact that, in the early years, the bulk of the software export activity of Indian enterprises consisted of lending their software professionals to their clients to deliver their services "on site". It was considered to be a rather lower level of skill intensity compared with software product designing and development and has been derisively termed "body shopping" (Heeks, 1996). However, the Indian software industry has since come of age in terms of capabilities, sophistication, range of expertise and worldwide reach.

(i) Moving away from body shopping

Indian companies have progressively demonstrated their technological and project management skills by successfully completing turnkey projects for large companies. As a result, the proportion of on-site exports ("body shopping") in India's software exports has begun to come down, from 90 per cent in 1988 to only 40 per cent by 2003-04. The bulk of India's software is now developed "offshore" at the home bases of exporters in India and exported.

(ii) Increasing focus on high-value consulting and packaged software

Thus far, Indian software enterprises have generally focused on services that are considered to be low value-adding. Having established themselves as suppliers of these services, Indian companies are now making a conscious effort to increase exports of high-end consulting with the development of domain expertise and the export of packaged software. Infosys, for instance, is focusing on the export of end-to-end services. As Indian software enterprises establish their credentials and competence, they are consciously seeking fair value for their work. This, however, may be applicable for leading companies such as TCS, Infosys, HCL Technologies, WIPRO and Satyam Computer Services, which are providing higher-end programming solutions for their clients. Infosys has successfully renegotiated its per man-hour charges with its clients. It reportedly commands US$ 90 per hour (Kumar, 2001).

(iii) Growing product development capability

Over the past few years, Indian companies have also managed to develop and launch a number of proprietary software products. A niche market has been created in banking, financial and accounting software. These include I-Flex, which has been used by over 240 financial institutions in 69 countries. Polaris has developed a proprietary retail banking software called Polaris Point and is tying up with Bull, France, for its marketing in Europe. Banking solutions from Infosys (Financle, Bankaway and Payaway) have been adopted by 22 domestic and 16 overseas banks in 12 countries. TCS has launched packaged software for the banking insurance, securities, accounting and health-care industries. TCS has also launched its branded integrated suite of software tools, Mastercraft, which is claimed to have been received well in the United States and Europe and carries a price tag of US$ 150,000. WIPRO Technologies has recently launched two branded products, viz. Teleprodigy, a billing system for ISPs, and WebSecure, an Internet security package. It is focusing on global brand-building and plans to come up with a branded product every year. NIIT and Pentamedia are developing multimedia products on CD-ROMs in large numbers. A number of even smaller software companies have developed packaged software which is sold in the domestic market. For example, Tally, a popular accounting package for small and medium-sized enterprises used by 50,000 companies and approved by professional accountants' associations in India and the United Kingdom of Great Britain and Northern Ireland, was developed by a smaller, highly specialized, software company (Kumar, 2001). Despite these efforts, the share of products and packages in Indian exports of software is still marginal at 3.2 per cent. However, given the high entry barriers in the package market, the entry of Indian companies is nevertheless significant.

(iv) Locally anchored capability

There is a qualitative difference between achieving export success on the basis of subsidiaries of foreign-based MNEs and achieving it on the basis of indigenous enterprises that keep capabilities anchored locally. India's export success is primarily driven by local enterprise, resources and talent. The role played by MNEs in software development in India is quite limited. Although all the major software companies have established development bases in India, their overall share in India's exports of software is rather small. MNEs do not figure among the top six software companies in India, ranked either on the basis of overall sales or exports. Among the top 20 software companies too, no more than 6 are MNE affiliates or joint ventures. Foreign subsidiaries include the software development centres of software MNEs and subsidiaries of other MNEs that develop software for the applications of the parent company. The latter include subsidiaries of financial services companies, such as Citicorp, Deutsche Bank, Churchill Insurance and Phoenix Life Mutual, and telecommunication MNEs, such as Hughes and Motorola. In addition, MNEs have set up 16 joint ventures with local enterprises; examples include British Aerospace with Hindustan Aeronautics, Bell South with the Telecommication Corporation of India and British Telecom with the Mahindra Group. In all, 95 companies have controlling foreign participation. Exports by MNE affiliates accounted for 23 per cent of total software and services exports in 2003-04 compared with 19 per cent in 1998-99 (see Dataquest*,* 2004 and Kumar, 2001, respectively).

(v) International quality accreditations and process maturity levels

International orientation and the increasing professionalism of Indian software enterprises has prompted them to align their processes with global best practices and to obtain international certifications. For instance, almost all major Indian software companies have obtained the International Standards Organization 9000 (ISO 9000) certification (Nasscom, 2004). Furthermore, as many as 50 Indian companies have received SEI-CMM (Software Engineering Institute, Capability Maturity Model of the United States) Certification at Level 5 from 74 such organizations worldwide, 54 of which are outside the United States (NASSCOM, 2004). This shows that Indian software enterprises, especially the leading ones, have strived to attain excellence in their professionalism and in their adherence to global best practices.

(vi) Moving up the value chain: evidence from recent trends in enterprise performance

An analysis of enterprise performance found Indian software enterprises moving up the value chain in terms of rising productivity, net export earnings, export intensity, declining unit cost of production and improving profit margins since 1997 (Kumar, 2001). Another study has shown that there has been upward mobility in the competence of firms (Joseph and Abraham, 2002).[2]

(d) Opportunity cost of exports and domestic linkages

The opportunity cost of software exports could be considerable. On the one hand, India's best talents and capabilities are employed for exporting software services, while software for domestic use is largely imported from abroad. Inadequate attention being paid to the domestic market by the industry has stunted the diffusion of IT technology. For instance, the availability of software in local languages could have facilitated a widespread diffusion of IT in the country. The lost opportunity of productivity improvement through the diffusion of IT in India could be substantial. On the other hand, Indian software companies' contribution to productivity improvements in the United States industry could be significant. To some extent, the prevailing fiscal incentive regime, i.e., the availability

2 Since conventional measures of innovation, such as R&D, are limited when it comes to capturing innovation in a service sector, such as ICT, the study developed an index of claimed technological competence (ICTC) using information from the firms themselves on their areas of specialization. The theoretical base of the index has been drawn from the literature on technological opportunity.

of tax incentives for export profits, diverts attention towards exports by making them more rewarding compared with serving the domestic market. There is a need to rethink the relevance of the tax incentives for the software industry.

Most of the export-oriented software companies operate as “export enclaves” with little linkages with the domestic economy, if at all (D’Costa, 2003). MNE subsidiaries in software development, in particular, derive almost all of their income from exports to their parents. Hence, hardly any vertical linkages are developed with the domestic software market or the rest of the economy. The enclave nature of the operation generates very little knowledge spillover for the domestic economy. The bulk of the work done is also of a highly customized nature having little application elsewhere. Given the high salaries and the perks of foreign travel, there is no movement of personnel from these companies to domestic firms. The employees of export-oriented firms are generally lured by foreign companies. There is considerable movement of personnel from domestic market-oriented firms to export-oriented firms or foreign subsidiaries (Kumar, 2001; Joseph and Harilal, 2001). In terms of technological complexity and sophistication, some projects in the domestic market are more advanced and challenging than export projects (Arora et al., 2000). The rise of the software industry has suddenly caused a general scarcity of engineers in all disciplines and this has led to sharp rise in their salaries. The engineering industry in the country is having difficulty finding an adequate number of engineers. The impact of rising salaries on the competitiveness and the bottom line of the engineering industry and other industries that compete for engineering talent with the software industry is not yet clear. However, it has certainly made their work more difficult.

3. RISE OF SOFTWARE AND SERVICE EXPORTS IN INDIA: THE ROLE OF GOVERNMENT INTERVENTIONS

It is clear from the above that the rise of the export-oriented software and related service industries in India has been an interesting development with a number of valuable development consequences. Some observers have tended to argue that India’s success in the software industry has been an outcome of free play in the market and of benign State neglect (Arora et al., 2000). It is argued here that India’s success in the industry is owed primarily to cumulative investments made by the national Government not only in building a supply base for qualified manpower but also in building institutional infrastructure for capability development. While the series of policy initiatives and institutional interventions made by the national Government during the 1960s and 1970s laid the foundation for the development of a vibrant software industry in India (Kumar and Joseph, 2004), it was the Computer Policy of 1984 that gave a special thrust to software development by highlighting the need for institutional and policy support on a number of fronts. The policy, for example, called for the setting up of a separate Software Development Promotion Agency (SDPA) under the erstwhile Department of Electronics (DoE). The import of inputs needed for software development was made more liberal. The policy emphasized that:

> "Effective software export promotion on a sustained basis can be effective in the long run only if it is planned as a part of an overall software promotion scheme covering both export and internal requirements including import substitution. Also planning for software development is integrally connected with the plan for hardware development and system engineering" (Government of India, 1985).

Against this background, the need was felt for more concrete policies towards the promotion of software development and export. Accordingly, an explicit software policy was announced in 1986 and software was identified as one of the key sectors in India's agenda for export promotion. The policy underlined importance of integrated development of software for the domestic and export markets (India DoE, 1986). To facilitate the stated objectives, the policy emphasized the need to simplify existing procedures pertaining to all aspects of software development and production for the domestic as well as the export market. It also provided software firms with various commercial incentives, such as tax holidays, a tax exemption on income from software exports, export subsidies and the duty-free import of any hardware or software to be used 100 per cent for export purposes.

With the initiation of economic reforms in the early 1990s, the Finance Ministry made an assessment indicating that, apart from the general orientation of all industries towards export markets, India's comparative advantage was in software and not in hardware. Therefore, a major thrust was consciously given to software exports. Accordingly, new policy measures have been initiated, among which are the following: (a) the removal of entry barriers against foreign companies; (b) the removal of restrictions on foreign technology transfers; (c) the participation of the private sector in policymaking; (d) provisions to finance software development through equity and venture capital; (e) measures to make available faster and cheaper data communication facilities; and (f) the reduction and rationalization of taxes, duties and tariffs (Narayanamurthy, 2000).[3]

Recognizing the potential of IT-related industries and software for India's development, the Prime Minister created the National Task force on Information Technology and Software Development (NTITSD) in May 1998 under the chairmanship of the Deputy Chairman, Planning Commission. NTITSD submitted a report outlining a national IT plan comprising 108 recommendations for software and 87 recommendations for hardware (India, NTITSD, 1998). These recommendations have since been notified by the Government in the *Gazette of India* dated 25 July 1998 (India, MIT, 2000). NTITSD has set before the country an ambitious target of US$ 50 billion worth of software exports by 2008. DoE was upgraded to a full-fledged Ministry of Information Technology (MIT) in October 1999 to coordinate the promotional role of the Government in the industry.

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[3] Mention needs to be made of the substantial reduction in duties and tariffs across the board for components and sub-assemblies, zero duty on software imports and zero income tax on profits from software exports.

(a) Supply of trained manpower for software development

The Government has permitted private investment in IT training since the early 1980s. Privately run centres offer courses of varying duration, ranging from short-term specialized courses to longer-term basic courses. However, the quality of the training imparted by these institutions has been uneven. In 1990, DoE devised a scheme called DOEACC jointly with the All India Council for Technical Education (AICTE) to provide accreditation according to the specified level of a course.[4] By January 2004, the DOEACC Society had accredited a total of 850 institutes. The Society conducts examinations in all four levels twice a year and grants certificates and diplomas (India, DIT, 2004).

The demand for software personnel, especially engineering graduates, has grown rapidly since the mid 1990s owing to the expansion of software development activity in India as well as the growing brain drain. In view of this, increasing the supply of IT professionals is one of the challenges that the country has faced. NTITSD has made a number of recommendations for augmenting the quantity and quantity of trained manpower for the software industry. In line with these recommendations, the capacity of the higher education system in engineering has been expanded, and new institutions have been set up (Kumar, 2000). In India today, 253 universities and 13,150 colleges produce 2.46 million graduates and about 290,000 engineering degree and diploma holders every year. English is widely used as a medium of instruction, which in turn provides an ample supply of manpower for ITES services at a much lower cost as compared with other countries. It has been estimated that, on average, the labour cost in the Indian ITES sector is only about 14 per cent of that in the United States. While the current supply of IT manpower is considered adequate, there is concern about the quality and supply of middle-level manpower (India, MIT, 2001).

(b) IT infrastructure: software technology parks

A notable institutional intervention has been the establishment of software technology parks[5] (STP) to provide the necessary infrastructure for software export. The first ones to come into being were those in Bangalore, Pune and Bhubaneshwar in August, October and December 1990, respectively. In 1991, four more STPs were set

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4 Foundation course (O); Advanced Diploma (A); MCA Level (B); and M. Tech Level (C).

5 A software technology park in all respects is similar to a free trade zone exclusively for software. The specific objectives are:

- To establish and manage infrastructural resources, such as data communication facilities, core computer facilities, built-up space and common amenities;
- To provide services (import certification, software valuation, project approvals, etc.) for the users who undertake software development for export purposes;
- To promote the development and export of software and software services through technology assessments, market analysis, marketing support, etc;
- To train professionals and to encourage design and development in the field of software technology and software engineering (India, DoE, 1996).

up by DoE in Noida, Gandhinagar, Trivandrum and Hyderabad. There are currently 39 centres with about 7000 units registered and in 2002-03 they accounted for about 80 per cent of the country's software exports. The infrastructure facilities available in these STPs include, among other things, modern computers and communication networks, which are beyond the reach of individual firms. The STPs also envisage a transparent policy environment and a package of concessions (India, DIT, 2004).

In June 2000, a new STP was set up in Silicon Valley, composed of a Business Support Centre and an India Infotech Centre, with a view to facilitating software export by small and medium-sized firms to the United States.[6] The centre also fosters business relationships by providing access to financial institutions in the United States, venture capital funds and specialized trade bodies to promote partnerships and strategic alliances between American and Indian ICT software and service companies.

(c) IT infrastructure: reforms in the telecom sector

Realizing the importance of telecommunication in the overall development of the economy in general and that of the IT and software service sector in particular, the Government initiated a number of policy reforms that helped create a highly competitive environment, leading to a drastic reduction in telecom costs but also to increased access and better quality services. Perhaps the first step was the announcement of the National Telecom Policy in 1994, opening up the telecom sector to competition in basic services as well as value added services, such as cellular mobile services, radio paging and VSAT Services. It also set targets for the provision of telephone on demand and the opening up of long distance telephony. This was followed by the Telecom Regulatory Act of 1997, which led to the establishment of the independent Telecom Regulatory Authority of India (TRAI). Later, the New Telecom Policy of March 1999 focused on removing some of the bottlenecks and moving the liberalization process forward (Singh, et al., undated). These policy reforms have resulted in a very rapid expansion of the telecom network in the country. This has been possible because of all telecom services were opened to the private sector without any restriction on the number of operators, except for the cellular mobile phone segment because of frequency constraints. Private sector investment has been helping to bridge the resource gap to a considerable extent, as was envisaged.

The Government also permitted foreign investment in laying submarine cables, which led to such joint ventures as the one between Bharati Telecom Singapore Telecommunications, Ltd. (SingTel) and Bharti Enterprises of India, a US$ 650 million joint venture to build the world's largest cable network in terms of capacity. Today, submarine cables account for about 30 per cent of international long distance dialing and, with additional investment in the pipeline that share is expected to increase in the near future.

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6 "STPI now opens office at Silicon Valley, USA", *The Economic Times*, New Delhi, special supplement on software technology parks in India, 11 June 2000.

Recent initiatives include permission to offer Internet telephony, and the opening of national long distance service to private operators by abolishing the monopoly of VSNL in international long distance. Along with these policy measures, a liberal policy for Internet service providers was announced. As of December 2002, licenses had been granted to 573 ISPs, of which 24 had been given clearance to commission 55 international gateways for the Internet using satellite media (India, DoT, 2004).

As a result of the liberalization of the policy towards FDI in general and foreign investment in the field of IT and telecommunications, between August 1991 and December 2002, 858 proposals for FDI amounting to Rs. 5,627.9 million were approved and the actual flow for FDI during the above period was Rs. 956.2 million. In terms of approval of FDI, the telecom sector is the second largest after the power and oil refinery sector. From January to December of 2002, the actual FDI inflow was of the order of Rs. 108.1 million.

(d) R&D capability-building

DoE has placed heavy emphasis on R&D activities relating, among other fields, to the development of computer software by supporting these activities at different institutions, such as TIFR, IITs, IISc, select universities (such as Jadavpur University), ISI, and CSIR Laboratories since the early 1970s. The Technology Development Council has been supporting R&D projects since its inception in 1973 (India, MIT, 2000a). These programmes for technology development have led to the building of capabilities and have provided experienced manpower for the rapid development of the industry in the coming years.

For instance, the capabilities built in the process of early work on data communication at TIFR, started in the late 1970s and anchored at the DoE-supported National Centre for Software Technology (NCST), which was set up in Bombay in 1984, proved instrumental for the development of country wide networks and the Internet in the country in the 1990s. Government S&T agencies have set up a parallel Supercomputer Education and Research Centre (SERC) and Department of Computer Science and Automation at IISc, which provide high-end expertise and manpower to the industry in software.

Apart from NCST, DoE has set up another institution for technology development in the 1980s, viz. the Centre for Development of Advanced Computing (C-DAC). C-DAC has developed India's first supercomputer, Param, and has developed software in Indian languages. Electronics Research and Development Centre (ER&DC) set up by the DoE also plays an important role in R&D in IT and electronics. The Government has also stimulated and supported R&D activity through tax incentives and direct funding on a limited scale by DoE.

(e) *Institutional infrastructure and patterns of spatial agglomeration in the IT sector*

IT and software development in different parts of the world is characterized by a strong tendency towards clustering because of agglomeration economies. As mentioned above, the software industry was initially concentrated in Mumbai (formerly Bombay) and later spread to Bangalore, Delhi, Hyderabad and Chennai. Today, the top five cities together account for the bulk of total exports. The pattern of concentration in the software development industry in and around select cities illustrates the key importance of institutional infrastructure for the activity.

Table 2 shows that the cities with a high concentration of software development activity enjoy a disproportionate share of the national innovative infrastructure, the skill base and other resources for technology development. Because of significant agglomeration economies present in skill- and knowledge-intensive activities, such as software development, the fact that these cities have this disproportionate share of the national innovative infrastructure has served as a magnet for software development activity.

To sum up the discussion, it has been shown that India owes its success largely to the cumulative investments made by the Government over the past five decades in what is now termed national innovation systems (NIS). These include a system of higher education in engineering and technical disciplines, the creation of an institutional infrastructure for S&T policymaking and implementation, and the building of centres of excellence and numerous other institutions for technology development. The Government of India recognized the potential of the country in computer software in the early 1970s and started building the necessary infrastructure for its fruition, in particular, for manpower training. The Government also facilitated technological capability-building with investments in publicly funded R&D institutions and supported their projects by creating computing facilities and developing infrastructure for data transfer and networking. The patterns illustrated by the clustering of software development activity in select centres are further evidence that publicly funded technological infrastructure serves as a magnet for investment from private sector and foreign firms in skill-intensive activities, such as software development. While government interventions laid the foundation, it was the high rate of growth in world demand, due, inter alia, to the Y2K problem and greater participation by the private sector, that enabled the industry to take off.

4. CONCLUDING OBSERVATIONS

The export performance of India's software and service sector during the last decade has been unprecedented. As a result, the software and service sector accounts for over 20 per cent of India's total exports and 2.6 per cent of GDP. In addition, there has been a marked decline in the share of on-site services and today almost 60 per cent of India's software and services export takes the form of offshore services. Furthermore, India's software sector is moving up the value chain, albeit slowly. The rise of the

Table 2. Illustrative S&T infrastructure in four IT clusters in India

Type of NIS Infrastructure	*Bombay*	*Bangalore*	*Delhi and environs*	*Hyderabad*
Institutions of Higher Technical Education and Excellence	IIT-B; Bombay University; SNDT Women's University; Bajaj Institute of Management and several other engineering and management institutes	IISc; University Visvesraya College ; of Engineering;; SKSJ Technology Institute; 28 private engineering colleges; Indian Institute of Management	IIT-D; Delhi College of Engineering; Delhi University Department of Computer Sciences, Roorkee University of Engineering (within 200 kms) J.N. University; Jamia Milia Islamia Engineering College; FMS; IIFT; plus several private institutions	J.N.Technological University; Hyderabad University; Osmania University; Kakatiya University
Public Funded Research Laboratories and Institutions	TIFR; NCST; BARC; UDCT; SAMEER	ISRO; NAL, CMTI; Electronics and Radar Development Establishment; Aeronautical Development Establishment; Gas Turbine Research Establishment; Centre for Aeronautical Systems Studies and Analysis; ER&DCI	NIC; NPL; Institute for Systems Studies and Analysis; SPL; C-DOT	National Remote Sensing Agency; RRL; NGRI; IICT; Defence Electronic Research Laboratory; DRDL
Local Software Champions	TCS; PCS; Tata Infotech; Mastek; L&T ITL; APTECH; COSL; Datamatics; Silverline	Infosys Technologies Ltd.; WIPRO Information Technologies	HCL Technologies; NIIT Ltd.; CMC Ltd.	Satyam Computer Services Ltd.
High Speed Data Communication Facilities	Earth Station of STPI	Earth Station of STPI	Earth Station of STPI	Earth Station of STPI
High Technology Enterprises (mostly public sector)	L&T; Godrej; Tata group and a large number of engineering and electronics enterprises	ITI; BEL; HAL	Central Electronics Ltd.; NRDC; EIL; RITES; ETTDC; ET&T; RITES; TCIL	ECIL; BHEL

Source: Kumar, 2001.

software and related service industry has also generated jobs and a number of other favourable externalities. However, the industry is characterized by high spatial concentration and the software export activity continues to be an enclave, with limited linkages with the rest of the economy. Given the fact that IT users benefit somewhat more than IT producers (IMF, 2001) and that the marginal social benefit of a dollar's worth of software consumed is more than a dollar's worth of exports, India needs to focus more on the diffusion of ICT into different sectors of its economy.

While it has been argued that India's success in software and related services is the outcome of benign State neglect, the present paper shows that such conclusions not only conceal more than they reveal but are of little relevance for countries that are in the process of developing such capacity because there are many developing countries that have assigned a prime role to the market and have nonetheless achieved limited success. While India's success is due to the cumulative efforts of the last five decades and transplanting experience from one country to another has its limits, developing countries aspiring to develop a software and service sector can learn much from the Indian experience. In general, while developing countries can adopt liberal trade and investment policies, they can hardly afford to ignore the development of a national innovation system, which is a prerequisite for building capabilities in skill- and technology-intensive sectors, such as software and services. The Indian experience tends to suggest that, while a bad policy could drive investment away, a good market-friendly policy per se does not necessarily attract investment or facilitate growth.

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UNESCAP Papers:
Special Focus on the Tsunami

Global and Regional Mechanisms for Promoting Trade and Investment in Tsunami-Affected Countries*

ABSTRACT

This paper analyses the immediate and medium- to long-term economic impact of the earthquake and tsunami that struck the Indian Ocean rim countries in the Asian and Pacific region in December 2004 with special focus on trade and investment. It observes that fisheries, agriculture and tourism are the most affected sectors but that, in many cases, casualties and damage in these sectors are largely outside the formal economy. As a result, the impact on GDP in the affected countries is rather limited but the poverty impact is expected to be considerable. The paper makes the argument that, while aid can and does provide immediate disaster relief, the long-term rehabilitation needs of the affected areas can probably be addressed more effectively through sustained trade and investment growth, as trade and investment create jobs and provide sources of income for the thousands of people displaced as a result of the disaster.

Trade and investment are principal instruments for the mobilization of the capital necessary for reconstruction and rehabilitation. They were recognized as essential sources of financing for development in the Monterrey Consensus of the International Conference on Financing for Development. As trade and investment are, by definition, cross-border phenomena, global and regional cooperation mechanisms play an important role in their promotion. The paper

(Continued on page 114)

* This paper was prepared by Mr. Marc Proksch, Economic Affairs Officer, Trade Policy Section, Trade and Investment Division of UNESCAP, with inputs from other staff of the Division.

(Continued from page 113)

argues that the tsunami, while an isolated event by itself, can act as a catalyst for more rapid global and regional trade and investment liberalization, which would act as an engine of economic growth. The region has witnessed several natural and man-made disasters over the past few years, and this trend is likely to continue. It is therefore argued that global and regional mechanisms could be set up in trade and investment, which would offer a medium- to long-term approach to providing assistance for private sector enterprises, in particular the small and medium-sized enterprises (SMEs), which are the principal agents of trade and investment.

At the global level, such mechanisms should focus on advancing the multilateral trade negotiations within the framework of the Doha Development Agenda (DDA), the establishment of special GSP schemes for disaster-affected countries, and a review of trade remedies targeting such countries. It is suggested that common formats and templates for such schemes be developed. At the regional level, economic integration should be advanced through consolidation, expanding and deepening existing regional trading arrangements. For tsunami-affected countries, BIMSTEC and ASEAN are singled out as convenient existing mechanisms for providing long-term assistance through regional cooperation in trade and investment. Due attention should also be paid to trade facilitation and investment guarantee schemes.

Among the various international and regional organizations, UNESCAP is the largest United Nations organization in the region and, as such, could play a fundamental role in the effort to forge a consolidated regional economic integration process by researching and developing common formats and frameworks and through its technical assistance work in training and policy dialogue on trade and investment. In so doing, it is recommended that UNESCAP actively cooperate with its global and regional partners while paying due attention to small island developing States and to the SME sector.

1. INTRODUCTION

The massive earthquake that shook the Indian Ocean south-west of the Indonesian island of Sumatra and the tsunami that immediately followed in the early morning of 26 December 2004 can easily be ranked as one of the most destructive natural disasters to have afflicted the Asian and Pacific region in modern times. What makes this disaster different from its predecessors is its global dimensions, as many countries around the world, particularly in Europe, thousands of miles away from the disaster area, sustained casualties in high numbers. As of late January 2005, the death toll was approaching 160,000, with thousands still missing and thousands more seriously injured, many of them disabled for life. Two observations can be made at this point. First, while many casualties are foreigners (i.e., non-locals, mostly tourists from Europe), most of them are locals, often poor people making a living from industries such as fishing and tourism, industries that took an immediate hit and will take some time to recover. Second, the events triggered an unprecedented inflow of pledges of foreign aid, topping US$ 5 billion, not only from Governments but also from the private sector and individuals; this, in an era when donor fatigue has hampered many relief efforts around the world, can arguably be attributed to the relatively high incidence of foreign casualties coupled with the celebration of Christmas at the time of the disaster.

In the short term, this aid has been essential for addressing immediate needs: medical care, disease control, food and shelter, psychological counseling, body retrieval, burials, debris clearing etc., but also for providing immediate financial relief for many people who have lost their livelihoods. The challenge is to allow these people to pick up the pieces and enable them to go back to work and be self-sufficient. For this purpose, aid can only go so far. Other events, disasters and wars will divert attention from the tsunami-stricken region and the aid flow will ultimately dry up. It also remains to be seen how much of the pledged aid will actually be disbursed. Experience from past disasters shows that actual disbursements of aid turn out to be a mere fraction of the amounts pledged.[1] In addition, there are concerns about how much of the aid disbursed will actually reach those most in need. Trade and investment as traditional private sources of finance will therefore assume immediate importance. Trade and investment not only generate financial resources for disaster relief and economic rehabilitation but also contribute directly to poverty reduction through employment and income generation. This relationship exists, of course, without natural disasters. However, such disasters can have a catalytic effect by boosting trade and investment and reviving potentially useful economic mechanisms for regional cooperation in trade and investment, whether they already exist or are in the planning stage but suffering from a lack of political will, commitment or adequate resources.

This paper briefly analyses the economic impact and implications of the events triggered by the tsunami and seeks to outline modalities for global and regional cooperation for the purpose of strengthening trade and investment for disaster-affected countries in general, and for the tsunami-affected countries in particular. Section 2 contains a preliminary assessment of the economic impact and implications for the five most affected countries, i.e., Indonesia, Sri Lanka, India, Thailand and the Maldives.

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[1] For instance, following the December 2003 earthquake in Bam, Islamic Republic of Iran, which killed some 30,000 people, pledges of US$ 1.1 billion were made but only US$ 17 million was actually received. In Afghanistan, donors pledged US$ 2 billion in 2002 for the first year of rebuilding but only US$ 90 million was actually disbursed. However, public donations may be positively influenced by the relatively large amount of money pledged through private donations and actually disbursed.

Section 3 explores various mechanisms and initiatives that could, at the global level, promote trade and investment in tsunami-affected countries and benefit disaster-affected countries in general. Section 4 makes the case for regional economic integration as a long-term modality to assist the tsunami-affected countries. Section 5 explores the role of UNESCAP in providing technical assistance for tsunami-affected countries. Section 6 summarizes the main conclusions.

2. PRELIMINARY ASSESSMENTS OF ECONOMIC IMPACT AND IMPLICATIONS[2]

(a) General assessment

Preliminary reports issued following the disaster by various agencies, including the Asian Development Bank (ADB), as well as the Economist Intelligence Unit (EIU) point to a relatively minor economic impact, though the impact on poverty is much higher.[3] The main reason is that most of those killed were not part of the mainstream formal economy and many of those affected lacked the immediate to medium-term means to provide for themselves. In Aceh, in Indonesia, which has by far the highest death rate, the most important economic contributor is an LNG plant, which was not damaged.[4] The damage occurred mostly in rural areas while key economic and densely populated urban centres and industrial hubs were spared. Unlike the Asian financial and economic crisis of 1997 or the outbreak of SARS in 2003, the aftermath of the tsunami is unlikely to affect consumer confidence. Financial markets and currencies have remained stable. The direct economic impact will consist largely of negative effects on consumption and business activity in the areas affected but for a much shorter period of time than, for instance, in the case of economic shocks, outbreaks of a contagious disease, or terrorist attacks because the risk and uncertainty factors are much smaller. It is not likely that a tsunami will recur any time soon, although the Indian Ocean is earthquake-prone and measures have been taken to establish tsunami warning mechanisms, which would further reduce business risk. The impact of the disaster on human life, however, is another matter: the long-term social consequences will be quite serious, and the social costs resulting from children having been orphaned, families fractured and so many people traumatized will be enormous.

The three most affected economic sectors are agriculture, fisheries and tourism. With regard to fisheries, the economic impact has been relatively small, as most fishermen are self-sufficient and do not contribute to the formal economy. However, a

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2 Figures presented in this section are derived from various information sources as of 20 January 2005. These figures are only estimates in most cases and are therefore subject to revision.

3 According to ADB, one million Indonesians could sink into poverty as a result of the disaster, along with a combined 900,000 in India and Sri Lanka.

4 EIU, "Asia's Tsunami: the impact", London, January 2005.

longer-term impact may be felt as a result of environmental damage that affects fish stocks while the public perception of "contaminated" fish may undermine the sale of fresh fish in local markets. With regard to tourism, the impact is probably highest in the Maldives, Sri Lanka and particularly Thailand. Thailand suffered much fewer casualties than Indonesia or Sri Lanka but has the largest foreign tourist casualty toll and the greatest extent of damage to tourist facilities. The agricultural sector has also suffered, as seawater has penetrated deeply inland, destroying crops and contaminating wells and irrigation channels. It may take 2 to 5 years to restore the damage done, and the Secretary-General even estimated 10 years. Other sectors, such as the construction sector, should benefit and could absorb some of those left unemployed as a result of the disaster. ADB estimates that the disaster may add more than 2 million to the number of people officially listed as poor, and, according to a recent ILO report, more than 1 million people may have lost their jobs because of the damage inflicted by the tsunami. However, according to the report, with the right kind of assistance, close to 85 per cent of the unemployed could be back to work within two years. A more detailed assessment follows below. Table 1 provides some rough estimates of the impact on the four most affected countries.

Table 1. Summary of tsunami impact on the four most affected countries

Country	*Number of dead/missing (as of mid January 2005)*	*Estimated damage or reconstruction costs (US$ billion)*	*Expected reduction Of GDP for 2005 (percentage)*
Indonesia	> 115 000	> 4	0.3
Sri Lanka	> 30 000	> 2-3.5	1-2
India	> 15 000	> 2-5	0.1
Thailand	> 5 000	> 1-1.5	0.3

Source: News bulletins and other sources.

(b) Country assessments

(i) Indonesia

The resource-rich Indonesian province of Aceh, in the northern part of the island of Sumatra, bore the brunt of the earthquake and the tsunami: over 115,000 confirmed dead, thousands more missing and two thirds of the province badly affected. An estimated 500,000 people have lost their livelihood. Aceh accounts for just over 2 per cent of Indonesia's GDP and population, with most casualties being subsistence farmers and fishermen. According to ILO, unemployment in affected areas could be higher than 30 per cent, compared with 6.8 per cent before the tsunami. There is no tourism in Aceh as a result of the long-standing civil conflict. Famous tourist destinations in Indonesia, such as Bali and Lombok, may actually be able to attract more tourists, especially those who would have gone to Phuket or other holiday destinations in Thailand. However, most of Aceh's economy consists of agriculture, and much agricultural land was inundated and affected by salination. While Indonesia is a major Asian tourist destination, tourism accounted for only 3.9 per cent of GDP in 2004. EIU therefore expects that GDP growth in Indonesia in 2005 will drop by only 0.3 percentage point from an originally forecast 5.7 per cent growth to 5.3 per cent. Indonesia's central bank expects no effect at all on the economy and points to the fact that the Jakarta Stock Exchange has actually made gains since December 2004. Nonetheless, the immediate cost of reconstruction is high. The Government has estimated that it may need to spend as much as US$ 150 billion on roads, power plants and other infrastructural projects to create more jobs and accelerate the pace of economic growth over the next five years. Reconstruction in areas devastated by the disaster could require an additional US$ 4 billion. In this regard, debt relief may be very welcome. Indonesia's external debt stands at US$ 134.4 billion, among the highest in the region, and the country owes more than US$ 3 billion, including principal, to Paris Club nations in 2005 and US$ 8.8 billion over the next two years. While Indonesia is receiving much of the aid disbursed so far, the inaccessibility and remoteness of devastated areas along with security considerations may undermine the effectiveness of this aid, at least in the short run.

(ii) Sri Lanka

According to preliminary reports, the economic impact seems to be largest in Sri Lanka. Over 30,000 were killed, 437,000 were displaced and thousands are still missing. The country is still coping with a civil conflict but witnessed economic revival in 2004 amidst hopes for a lasting peace. IMF now expects the 5 per cent GDP growth rate for 2004 to drop to 4 per cent in 2005, although according to some estimates it may even drop to 3 per cent. IMF forecasts a rise in inflation of 14 per cent in 2005, up from the previous estimate of 12 per cent, and a rise in the trade deficit to US$ 2.69 billion, up from the pre-tsunami estimate of US$ 2.28 billion. Over 400,000 workers along the coastline have lost their jobs and sources of income. Reconstruction costs are estimated at US$ 3.5 billion. The relatively small size of the country intensifies the economic impact. As in the other affected countries, tourism and fisheries are the most affected sectors. Although fisheries account for only 3 per cent of GDP, most of the fishery communities have been wiped out. According to FAO, some 80 per cent of the fishing vessels along Sri Lanka's coastline have been damaged, half of them irreparably.[5] Fish stocks have been affected as a result of reef damage and silt pollution, and damage to mangrove forests and reed beds, which are major breeding grounds for fish. Agriculture has been affected by the pollution of seawater as far as 3 km inland, which has destroyed crops and may even have contaminated the water table. Tourism accounts for 4.6 per cent of GDP but is an important foreign exchange earner. It is particularly

[5] As reported in *The Economist*, 8 January 2005.

important in the southern parts of the country, where beaches and historical sites, including the world heritage site of Galle, have been badly damaged. On the other hand, major tourist hotels and resorts have suffered minor damage and are already back in operation. Tourist earnings were expected to fall by 15 per cent compared with 2004. There is also a chance that the events may consolidate the ceasefire into a lasting peace with the Tamil Tigers, who control most of north-eastern Sri Lanka, where damage is also extensive but where less information on actual casualties and damage is available. Total damage to the country is estimated at over US$ 1 billion. Sri Lanka will therefore depend to a large extent on aid in the short to medium term as it has a budget deficit, which prevents the Government from redirecting large quantities of funds towards disaster areas. Sri Lanka's external debt stands at US$ 10.2 billion and the country would therefore benefit from debt relief.

(iii) India

In India, the damage has been confined to the coastal areas in the south-east, in particular Tamil Nadu State. While the casualty toll is not as high as in Indonesia and Sri Lanka, it is still considerable, with over 15,000 dead, and the number of people affected is much higher, at an estimated 2.72 million. Total damage may range from official estimates of US$ 1.6 – 2 billion to as much as US$ 6.5 – 7 billion based on a reduction of GDP by 0.4 per cent over the next four years.[6] Tourism accounts for about 2 per cent of GDP and even in Tamil Nadu there is not much coastal tourism. The fisheries sector in Tamil Nadu has been badly affected, however, but, as it accounts for only 0.7 per cent of GDP in Tamil Nadu, it will hardly affect national figures. India's manufacturing and agricultural centres have not been affected, and, as a result, the overall economic impact is expected to be very limited. India has indicated that it has sufficient financial resources to deal with the disaster. In fact, India actually disbursed aid to Sri Lanka and the Maldives.

Damage in the Andaman and Nicobar Islands could be as high as US$ 600 million; overall infrastructural damage is limited, however, as there was not much to begin with. According to BBC reports, about 70 per cent of the islands' jetties have been damaged. This has negative implications for the fishing industry, which accounts for two thirds of local employment.

(iv) Thailand

In Thailand, the economic impact is expected to be higher, especially in the tourist areas of the south. Thailand accounts for 27 per cent of the South-East Asian tourism market and has by far the highest foreign tourist death toll, about half of the total. Tourism accounts for around 6 per cent of Thailand's GDP.[7] Many resorts were

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6 Estimates by Citigroup as reported by BBC available online at <http://news.bbc.co.uk/1/hi/business/4154277.stm# Indonesia>.

7 This figure doubles when the indirect impact is included.

wiped out in the tsunami in the most popular tourist areas of Phuket, Phangna, Krabi and Khao Lac. The six southern provinces affected account for 1 to 2 per cent of GDP. While preliminary estimates of the damage hovered around half a billion dollars, according to the Tourism Authority of Thailand, total revenue lost following the tsunami may potentially reach US$ 1 billion, while the Thai Shrimp Association estimated the total damage to the shrimp industry at US$ 500 million. Official estimates forecast a drop in GDP by only 0.3 per cent. EIU expects a drop of over 1 per cent. According to EIU, consumer spending, tourism services (and, hence, exports) and even car manufacturing are sectors that are negatively affected. With purchasing power falling in the south, retail sales will drop. A total of 200,000 jobs may be at risk. Other affected industries are the fisheries and seafood industries. The fisheries industry accounts for only 1.7 per cent of GDP but about 20 per cent of the fishing boats in the affected regions that were officially registered suffered damage. The shrimp industry in particular, despite a sound infrastructure, will be doubly affected: by the tsunami and by anti-dumping duties levied by the United States.

However, Thailand is a relatively advanced developing country and has already mobilized substantial amounts of resources for disaster relief. It has emphasized the importance of technical assistance rather than financial assistance. The Government approved a package of close to US$ 1.8 billion in financial aid for individuals and businesses affected by the tsunami. Soft loans for small and medium-sized enterprises will be made available, as will scholarships for affected students. The Government has indicated that the six affected provinces in the south will have access to duty-free imports. Government spending for disaster relief is therefore expected to offset the GDP losses as a result of the disaster to some extent. In the meantime, tourists are already returning to the south, although it will take some time before the situation is back to normal. Overall, tourists have responded very positively to the Government's quick action and the assistance received from local people, which has enhanced Thailand's positive image. As part of the relief package, the families of each foreign visitor killed, injured or missing would receive 30,000 baht from the Government and the expenses of foreigners looking for missing relatives would be paid.

(v) The Maldives

The Maldives are far more dependent on tourism than the other affected countries. The industry employs almost two fifths of the workforce and contributes 74 per cent to GDP, including indirect impacts. Many resorts were badly damaged. Hotel occupancy has dropped to less than 50 per cent. While the overall casualty toll and damage are small in absolute terms, it is high for a small country, such as the Maldives. According to the Government, the country needs US$ 239 million in emergency aid, and about US$ 1.3 billion over the next three to five years. According to ADB, the proportion of people living on less than US$ 2 a day will rise from 43 per cent in 1998 to more than 50 per cent. According to the Government, the country's map will probably have to be redrawn.

(vi) Other countries

Other countries affected by the tsunami include Malaysia, Myanmar and Bangladesh. The extent of damage in Myanmar is believed to be considerable but less than that in Thailand. However, the casualty toll and damage in Bangladesh are negligible (with only two reported dead), and in Malaysia it is relatively minor and confined to a small area (mostly Penang island).

3. GLOBAL MECHANISMS FOR TRADE AND INVESTMENT

(a) Trade and investment versus aid

Though the earthquake and tsunami disaster took place in Asia, its repercussions and implications are global. While the overall economic impact is limited and short-term, its impact on poverty is much greater and long-term. It is important that countries in the region exploit the current attention and momentum to call for greater attention to global and regional mechanisms to boost trade and investment. After all, as was pointed out before, sustained trade and investment growth offer the best prospect for economic rehabilitation, long-term economic growth and development, and poverty reduction.

Various mechanisms can be envisioned to boost trade and investment at the global and regional levels. While aid serves as an essential and immediate response to disasters, many countries are wary of dependence on financial aid from donors, which often comes with strings attached. For that reason, such countries as India and Thailand have been reluctant to accept aid in the first place. Fortunately, those countries most affected by the tsunami are relatively prosperous. None of them is classified as a least developed country (LDC). However, earthquakes and other natural disasters as well as man-made disasters, such as terrorism and war, are becoming more common. Donor fatigue has undermined the effective mobilization and disbursement of aid in many such disasters. Therefore, it is more important than ever for the countries of the region to manage and finance their own needs through sustained trade and investment.

(b) Accelerating multilateral trade liberalization

Many countries have competitive advantages that are promising but are still waiting to be fully exploited. While inadequate domestic policies are partly responsible for this, another important reason is that those countries are constrained by trade barriers, both tariffs and non-tariff barriers (NTBs), which hamper the full exploitation of these countries' competitive advantages. Agricultural domestic and export subsidies, tariff peaks and escalation, such trade remedies as anti-dumping, restrictive quality controls for health purposes and technical barriers to trade (TBT) prevailing in their major export markets are major trade barriers that still have to be adequately addressed in the current multilateral trade negotiations under the Doha Development Agenda (DDA) in WTO.

DDA is slowed down by disagreements in areas of primary concern to developing countries. As mentioned above, agriculture figures prominently in the negotiations but, despite a much-heralded and much-postponed Framework Agreement adopted on 1 August 2004 with some major commitments in agriculture, a comprehensive multilateral trade agreement is still far off. Another issue currently being tackled in the negotiations on non-agricultural market access (NAMA) concerns the modalities for tariff reductions in industrial goods. Here, the Framework Agreement is much less clear. With the abolition of textiles and garment quotas under the Multi-Fibre Arrangement (MFA) at the end of 2004, for instance, many countries in Asia and the Pacific, where this industry is very important in terms of employment and income generation, still face prohibitively high tariff rates in their major export markets in this industry, routinely the European Union and the United States. For instance, the garment industry in Sri Lanka, a country that was heavily affected by the tsunami, accounts for 35 per cent of employment and more than 40 per cent of output in the manufacturing sector and generates over 50 per cent of total export earnings. In LDCs, such as Bangladesh and Cambodia, these figures are even higher. With the phasing out of MFA, these countries may lose their competitiveness to China and India. While strengthening competitiveness and industrial and economic restructuring are long-term and often difficult solutions, in the short to medium term their problems could be partly addressed through special Generalized System of Preferences (GSP) schemes (see below).

Another argument can be made in the service industry. Many Asian and Pacific countries have developed competitive advantages in the service industry, which is also hampered by restrictive trade barriers. In particular, restrictions on the movement of natural persons (mode 4 under GATS) have been a long-standing concern and are still under negotiation in WTO.

(c) Reforming GSP schemes

Various countries offer a GSP scheme to developing countries. The utilization rate of these privileges, usually consisting of preferential tariffs over MFN, is often low as a result of restrictive rules of origin, restrictive standards and other constraints. In other cases, GSP applies to sectors in which beneficiary countries may not have a competitive advantage in the first place. Furthermore, as a result of continuing MFN tariff reductions, the tariff preferences under GSP are being increasingly eroded. The argument can therefore be made that GSP schemes should be reviewed for the purpose of making them more meaningful in terms of (a) product coverage; (b) tariff rate offered; (c) inclusion of NTBs; (d) immediate cessation of trade contingency measures; and (e) relaxation of rules of origin. The European Union, in fact, has already undertaken such an exercise and will release its new GSP conditions soon, while Canada already applies the world's most liberal GSP scheme. It remains to be seen, though, whether such initiatives are enough. Often, the margin of preference is simply not enough to allow for meaningful market access, even with more liberal rules of origin, while prevailing trade remedies, such as anti-dumping, do much damage and undermine the credibility of GSP schemes.

GSP schemes are not the most efficient modality for channeling assistance to developing countries, but they have contributed to export growth in some cases. A case could be made for strengthening them through the inclusion of an automatic trigger permitting zero-duty and zero-quota access for products and services from countries significantly affected by natural or man-made disasters. Criteria for eligibility would have to be established. LDCs have long called for such access. Only the European Union through its Everything but Arms (EBA) initiative, applies such a scheme, but there are still many conditions attached, including relatively restrictive rules of origin. Countries could agree to a self-triggering mechanism for disaster-affected countries, which should be relatively liberal, with rules of origin allowing regional cumulation.

For instance, for a country like Sri Lanka, reeling from the aftermath of the tsunami, generous preferential tariff margins with flexible rules of origin allowing regional cumulation (close to 90 per cent of fabrics and textiles are imported) would be very beneficial. Similar schemes should be designed for other disaster-affected countries and modalities and criteria for such schemes should be established, preferably in a multilateral fashion through WTO, but as a comprehensive multilateral agreement on non-preferential rules of origin is still in the making,[8] preferential rules of origin as part of existing GSP schemes would already go a long way.

Similar schemes could be set up within the framework of the Generalized System of Preferences for Developing Countries (GSTP). A great deal of global trade takes place among developing countries but faces trade barriers often higher than those encountered in developed countries.

(d) Addressing abuse of trade contingency measures

The increasing use of trade remedies, such as countervailing measures and anti-dumping tariffs, has undermined the gains from multilateral trade liberalization and GSP schemes.

The shrimp industry in India and Thailand is a case in point. The industry in these countries and others, such as China and Viet Nam, recently incurred anti-dumping duties in the United States. Though not as high as originally expected, such duties undermine trade and prevent countries such as India and Thailand from fully exploiting their competitive advantage in this area. After a review, the United States International Trade Commission (USITC) announced a 6.03 per cent anti-dumping duty for Thailand and a 9.45 per cent duty for India. Following the tsunami, USITC announced the possibility of revoking those duties. This would be particularly important for India, which exports 45 per cent of its shrimp to the United States. While this review is

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[8] An Agreement on Rules of Agreement is part of the Uruguay Round agreements but is very basic and only outlines principles. Negotiations to establish multilateral disciplines and rules for non-preferential rules of origin are ongoing and are part of DDA.

helpful, it also shows that the United States shrimp industry can apparently live with the waiver of such duties. The question then arises: why have them in the first place, in particular as the case for dumping is not clear cut? No official judgement has been made in the absence of the case being brought before the WTO dispute settlement mechanism.[9] Another question arises: to what extent is such a waiver fair for countries such as Viet Nam, which suffer from even higher anti-dumping duties. While Viet Nam was not affected by the tsunami, it has been affected by repeated years of heavy flooding, which has claimed many lives. Thailand, however, has claimed that the tsunami had little impact on the shrimp industry as the infrastructure is in good shape and most shrimp farmers are located in the Gulf of Thailand rather than in tsunami-affected areas.[10] However, Thai shrimp industry experts claim that United States anti-dumping duties are more damaging than the tsunami. Thailand is the largest shrimp exporter in the world.

(e) Trade facilitation

In this context, another issue crying out for immediate attention is trade facilitation. It is estimated that the benefits from effective trade facilitation may even outweigh those from tariff reductions. Customs delays and red tape bring many headaches for businesses, especially SMEs. In particular, in such important sectors as textiles and clothing, competitiveness will be determined to a large extent by the time required to bring goods to market in the aftermath of the quota phase-out. Already, customs formalities have been waived for the import and delivery of disaster relief materials and equipment. However, a longer-term solution for disaster-affected countries in this regard is called for, while a multilateral agreement on trade facilitation under DDA would offer multilateral rules to this effect and vastly improve the transparency and predictability of customs clearance and formalities.

(f) Investment and enterprise development

In the area of investment, global approaches are somewhat less clear cut, in particular as there is no multilateral agreement on investment. There is no doubt that investment could receive a potential boost from disasters, in particular in the construction industry. However, when such disasters occur in countries with less than a desirable investment climate, foreign investors are hesitant. For instance, in Indonesia, foreign direct investment (FDI) has steadily declined since the 1997 crisis. Generous incentives offered by local governments only go so far, generally failing to be a major determinant for FDI. Yet, FDI has been recognized together with trade as two of the most stable long-term sources of financing in the Monterrey Consensus. While the Multilateral Investment Guarantee Agency (MIGA) of the World Bank offers guarantees against

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[9] Thai shrimp producers insist that they do not dump their shrimp in the United States.

[10] Nevertheless, according to the ADB report, the shrimp industry in Thailand sustained losses of US$ 500 million; about a third of all shrimp farmers were affected.

certain non-commercial risks (i.e., political risk insurance) to eligible foreign investors for qualified investments in developing member countries covering risks associated with transfer restrictions, expropriation, breach of contract, and war and civil disturbances, coverage for risks associated with natural disasters is apparently not included. In addition, the home countries of foreign investors could consider offering special incentives to their foreign investors for investment in disaster-affected countries, including guarantees against risk from operating in those countries. In some of them, investment guarantee schemes already exist.

(g) Debt relief

Finally, there is debt relief. Countries such as Indonesia and Sri Lanka have considerable external debt and would stand to benefit substantially from debt relief. The United States has stated that countries may need to choose between debt relief and aid. However, debt relief, while attractive at first sight, has some disadvantages. Firstly the decision made by the Paris Club on 12 January 2005 on debt relief for tsunami-affected countries would offer a debt moratorium but would not cancel all debt. Payments would be suspended but not written off. Secondly, writing off debt would worsen the sovereign debt rating of the countries concerned, which might affect their ability to borrow in the future. Thirdly, as much of the debt involved is public, write-offs and relief may help Governments, but it is not altogether sure how such debt relief would translate into increased financial assistance to disaster-affected areas. In contrast, trade privileges and investment incentives in the sectors most affected by the tsunami, such as agriculture and fisheries, could be a more effective way of channeling relief to people working in these sectors, as it would at least offer people the opportunity to help themselves and would enable countries to maintain greater political sovereignty.

4. REGIONAL MECHANISMS FOR TRADE AND INVESTMENT

(a) The case for regional economic integration

While global scenarios for trade and investment cooperation go a long way towards assisting disaster-affected countries as well as disaster-prone countries, similar mechanisms can be designed at the regional level, and various regional trade agreements (RTAs) and regional financing mechanisms already exist. For instance, in the wake of the 1997 financial and economic crisis, countries in the region launched the Chiang Mai initiative and the Asian Bond Market, which offered countries affected by the crisis access to financial assistance from regional mechanisms. Similar financial assistance modalities for immediate disaster relief, e.g. through the establishment of a regional relief fund, could be considered. However, for long-term assistance, the strengthening of existing mechanisms for regional cooperation in trade and investment is needed more than the creation of new ones. Already, the Asian and Pacific region has witnessed a proliferation of RTAs and bilateral trade agreements (BTAs) following the rather slow progress of the multilateral trade negotiations. Most of these agreements involve preferential trade agreements (PTAs) rather than full-fledged free trade agreements. Such disasters as the tsunami could breathe new life into such mechanisms and deepen the commitment under such agreements, while expanding their scope and membership.

Some issues need to be considered in this regard. Regional integration has been an aspiration ever since the establishment of ASEAN in 1967, but it faces a multitude of complexities. If multilateralism is complex, regionalism is even more so. It is a process that is inextricably linked to political objectives, cultural affinities and historical perspectives. Regionalism should therefore be studied from different angles. Apart from RTAs, regional integration arrangements refer to wider forms of regional liberalization and economic cooperation schemes, such as that under economic partnership agreements (EPAs), the Asian and Pacific Economic Cooperation (APEC) framework, growth triangles and other constellations of economic cooperation. Regionalism has sought to integrate Asian and Pacific economies into the world (rather than create discriminatory blocs) to the benefit of long-term development. More recently, however, events may be taking a turn that raise concerns as to how stable this mutually supportive accommodation between multilateralism and regionalism really is.

(b) Regional integration frameworks for tsunami-affected countries: BIMSTEC and ASEAN

There are various existing regional integration frameworks that could develop regional mechanisms for trade and investment promotion in tsunami-affected countries. These include the South Asian Association for Regional Cooperation (SAARC), the Bangkok Agreement, BIMSTEC and ASEAN. Of these groupings, BIMSTEC (renamed the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation) and ASEAN probably offer the best prospects in this regard.

BIMSTEC is of particular importance to the tsunami-affected countries, as the disaster affected the Indian Ocean rim countries, most of which are BIMSTEC members.[11] Under its multisectoral approach, the grouping would be ideally placed to address the problems caused by the tsunami, but it has been conspicuously silent, probably due to its fledgling institutional structure which is not well prepared to respond effectively to disasters of such magnitude. While immediate disaster relief is rather a national concern, medium- to long-term considerations, in particular in the area of trade and investment, would call for a more involved approach towards strengthening regional cooperation within the framework of BIMSTEC.

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[11] Originally, BIMSTEC stood for Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation. In 1994, Bhutan and Nepal joined this grouping. Indonesia, which was most affected by the tsunami, is not a member.

As far as ASEAN is concerned, this group has strong ambitions to evolve into an ASEAN Economic Community by 2020. A special ASEAN leaders' meeting on the aftermath of the massive earthquake and tsunami was held in Jakarta on 6 January 2005. The ASEAN leaders, who were joined by the Heads of State/Government of Australia, China, Japan, the Republic of Korea and New Zealand, and special envoys from other donor countries and heads of international organizations, including the Secretary-General of the United Nations adopted the Declaration on Action to Strengthen Emergency Relief, Rehabilitation Reconstruction and Prevention. While the Declaration is strong on initiatives for early warning systems and education as well as international disaster relief and the involvement of the private sector, no reference is made to the essential role of regional and global trade and investment in the medium to long term.

Apart from the ASEAN Investment Area (AIA), little headway has been made in regional cooperation in the area of investment. However, in the aftermath of such disasters as the tsunami, there is an urgent need to pool resources in order to attract and promote investment in affected industries and areas in a consolidated manner. It should be possible to develop databases of SMEs seeking foreign partners for the purpose of developing effective horizontal and vertical linkages as well as backward linkages and drawing SMEs into the supply chain of transnational corporations (TNCs). In the tourism sector, special regional incentives could be granted to those who invest in tourism infrastructure. Such incentives should be worded in such a way as to minimize the risk of large companies displacing SMES. Similar investment could be encouraged in the fisheries industry. National and regional funds could be set up for loans or loan guarantees to SMEs, which traditionally suffer from lack of effective access to finance. National and regional training programmes could be set up for SMEs that lost key staff in the disaster, while ownership rights should be either re-established or strengthened. Joint advertising campaigns and investment road shows could also be organized. Lastly, regional cooperation in the business sector should also be actively encouraged. Many enterprises demonstrated in the aftermath of the tsunami that they take their social responsibility seriously. Likewise, they have an important role to play in rebuilding the economy. With respect to the tsunami-affected countries, BIMSTEC and ASEAN would offer the best framework for such schemes and their institutional framework could be strengthened for this purpose.

In the end, the strength of BIMSTEC and ASEAN lies in cooperation and the sustained integration of both groupings. At the moment, both groupings are in different stages of development, with ASEAN much more advanced. However, given the recent adoption of the SAARC Free Trade Area (SAFTA) as well as emerging FTAs between India and ASEAN, BIMSTEC could act as a useful bridge between SAARC and ASEAN. As ASEAN is also negotiating FTAs with China, Australia and New Zealand, and to a lesser extent with the Republic of Korea and Japan, Asian and Pacific regional economic integration, at least in trade and investment, is perhaps not such a far-fetched goal. Such integration would go a long way towards facilitating short-term relief and long-term rehabilitation of areas affected by disasters in the region depending on the scope and extent such integration would assume.

5. THE WAY FORWARD AND THE ROLE OF UNESCAP

The Special ASEAN leaders' meeting on aftermath of the earthquake and tsunami, held in Jakarta in January 2005, emphasized the important role of the United Nations system in coordinating immediate global activities related to relief, rehabilitation and reconstruction programmes and projects following the tsunami disaster. In response to the disaster, UNESCAP immediately established the Task Force on Tsunami Disaster Management and co-chairs with UNDP the Inter-Agency Regional Task Force on Tsunami Disaster Rehabilitation and Reconstruction.

However, UNESCAP, as a regional commission of the United Nations, has no clear mandate for disaster relief and its immediate involvement is therefore expected to be limited. However, in the medium to long term, UNESCAP's principal mandate of fostering regional economic cooperation is important for boosting trade and investment in the region by promoting and strengthening existing regional and subregional economic cooperation mechanisms, which may receive a boost from the tsunami disaster. In this regard, the tsunami should not be seen as an isolated event. The region has been host to a string of disasters, both natural and man-made, ranging from the 1997 economic and financial crisis to health scares, such as SARS and avian flu outbreaks, and terrorist attacks in Bali, Indonesia, and southern Thailand. Most of these disasters are of a cross-border nature or have cross-border implications and therefore require regional cooperation to effectively deal with them. Disasters are likely to be a recurrent event and the region should contemplate setting up mechanisms within existing regional cooperation frameworks for immediate action in trade and investment focusing on the private sector as the principal agent for resource mobilization. Such mechanisms have proved to be more efficient and faster than government-sponsored schemes relying on official resources, which may be pledged but not actually disbursed or may not actually reach those most in need, such as SMEs. In addition, special consideration should be given to least developed countries and small island developing States which are most vulnerable to shocks and disasters.

In the area of trade, UNESCAP has strived for some time to bring order to the chaos caused by the multitude of RTAs and BTAs and other forms of economic partnership agreements proliferating in the region through its comprehensive trade and investment cooperation framework (CTICF). Thus far, the framework has been conceptualized but more work needs to be done to operationalize it. Such an effort is not simple and will ultimately require the full participation, and hence the political will and commitment of the members and associate members of UNESCAP at both the government and the private sector levels. As a first step, templates and common formats and standards could be developed for such a cooperation framework with the aim of consolidating, expanding and deepening them in a manner consistent with and contributing to the multilateral trading system. Such frameworks could include mechanisms for quick and efficient disaster relief through relaxed conditions for trade and investment. In this regard, UNESCAP could assist in developing criteria that would automatically trigger such mechanisms in case of disasters of a subregional or regional character. Obviously, the efforts towards creating common frameworks will be long-term and fraught with pitfalls not in the least as the configuration and vastly differing interests of countries in the region will not easily allow them to devise a one-size-fits-all model. Still, such efforts would be worthwhile in order to attempt to at least consolidate overlapping and duplicating RTAs and BTAs, which would militate against trade and investment as effective tools for long-term disaster relief and development.

Similar exercises are already under way by other institutions, both at the governmental level (e.g. APEC) and non-governmental level (e.g. Institute of Policy Studies of Sri Lanka and RIS India, in cooperation with other research institutions). It is important that UNESCAP cooperate with these initiatives rather than duplicate them and that it expand them to include cooperation in investment and finance as well as other economic areas.

In all its efforts and technical assistance activities, UNESCAP should actively engage the private sector, with special attention to SMEs. Currently, the Asia Pacific Business Forum, established by UNESCAP, offers a unique forum for region-wide private sector cooperation.

UNCTAD has called for various measures to be taken at the global level in the area of trade, preferably within the context of DDA:

(a) A temporary provision of duty-free treatment for imports from the affected countries, in line with World Trade Organization (WTO) rules and disciplines;

(b) An immediate suspension and/or termination of all special trade-restraining measures, such as anti-dumping actions, against products originating in the affected countries, such as seafood and processed agricultural products;

(c) Immediate measures to strengthen the capacities of the affected developing countries and their businesses to restore the infrastructure needed to conform with sanitary and phytosanitary standards for their exports;

(d) Relaxation of market access for service providers from the affected countries, so as to help generate additional foreign exchange;

(e) Special measures to revive the tourism industry and infrastructure, including a more supportive approach to travel advisories and improved access to information and distribution channels;

(f) Action to support the rebuilding of trade logistics and other related service infrastructure.[12]

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[12] UNCTAD press release: UNCTAD/PRESS/PR/2005/006 28/01/05.

Similar mechanisms could also be embedded in existing RTAs, and BTAs, with priority to long-standing regional integration mechanisms, such as ASEAN, BIMSTEC and SAARC, without detriment to the efforts to multilateralize them but with the cognizance that multilateralization may take some time. Clearly, UNESCAP and UNCTAD need to cooperate fully in such endeavours within the context of overall United Nations coordination. In this respect, the involvement of UNDP would also be highly desirable given that agency's high profile in addressing both immediate and long-term needs. Such cooperation is opportune as the United Nations has been designated as the overall relief coordinator and may therefore assume long-term dimensions towards fostering regional economic cooperation.

In all those efforts, special consideration should be given to small island developing States, which are located in vulnerable regions of the world in relation to the intensity and frequency of natural and environmental disasters and their increasing impact. They face disproportionally high economic, social and environmental consequences, as highlighted not only by the earthquake and the tsunami but all other events, such as the hurricane/cyclone/typhoon season in the Caribbean and the Pacific. In this context, the Mauritius Declaration[13] recognized that international trade is important for building resilience and the sustainable development of such States, and called upon international institutions, including financial institutions, to pay appropriate attention to the structural disadvantages of those States.

6. CONCLUSIONS

The earthquake and tsunami of 26 December 2004 have wreaked havoc in the Indian Ocean rim countries and revealed the urgent need for countries to step up regional cooperation in a vast array of sectors and areas, including trade and investment for long-term and sustainable resource mobilization. While the rationale for such cooperation does not and should not, in principle, require disasters of this scale, such events nevertheless stimulate efforts in this regard. This momentum should not be lost. UNESCAP could play a catalytic and substantive role in this regard. In particular, as RTAs and BTAs are proliferating in the region, potentially undermining the benefits of the rule-based multilateral trading system, there is a need for a comprehensive consolidation exercise to bring order to the chaos caused by the "spaghetti bowl" of overlapping and often duplicative regional integration arrangements. At the same time, mechanisms, standards and criteria for immediate trade and investment-related assistance for disaster-affected areas should be developed at the global and regional levels, along

[13] *Report of the International Meeting to Review the Implementation of the Programme of Action on the Sustainable Development of Small Island Developing States,* Port Louis, Mauritius, 10-14 January 2005 (A/CONF.207/11), chap. I, resolution 1, annex I.

the lines suggested by UNCTAD. Again, such efforts should preferably take place at the multilateral level but could be expedited at the regional and subregional levels within existing frameworks.

UNESCAP could take the lead in the Asian and Pacific region in this regard, in active collaboration and coordination with the other principal United Nations agencies and subregional organizations.

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Regional Economic Cooperation in Trade and Investment for the Rehabilitation of Tsunami-Affected Countries: a Private Sector Approach*

ABSTRACT

The rehabilitation of tsunami-affected regions is a long-term project and usually does not command the same attention from donors in the international community as short-term relief operations. On the other hand, it has been observed that a new phenomenon or trend in international assistance or donation is emerging. The media have reported that more and more transnational corporations (TNCs) are providing their material support and expertise directly to the relief operations.

This paper proposes new mechanisms for trade and investment cooperation that allow the private sector to assist in the rehabilitation of the tsunami-affected regions. In this regard, four main proposals covering the following are examined: (a) special economic zones; (b) special temporary LDC status; (c) special investment regimes; and (d) special company status.

The paper also discusses other private sector initiatives and measures that could be explored, given the increasingly significant and direct role that the private and civil sectors have undertaken in the recent tsunami relief operations.

The paper addresses the need for regional cooperation in trade and investment for tsunami-affected countries and the critical role of UNESCAP in this regard, in particular with respect to coordination among the various agencies involved in providing technical assistance in trade and investment.

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1. INTRODUCTION

The Indian Ocean tsunami has caused immense destruction in South and South-East Asia and in some parts of Africa. The disaster has not only resulted in great loss of life and widespread destruction but also created immediate and long-term economic, social and psychological issues for the survivors. There are also many effects on the greater regional and global economy. The Asian Development Bank (ADB) has estimated that 1.5 million people will soon be put into the region's "new poor". It also estimated the costs of rebuilding the affected regions at a minimum of US$ 7 billion.

It is clear that, currently, international relief operations and efforts are focused on the short-term humanitarian needs of the victims. Of concern is that much less work and attention is focused on the medium- to long-term rehabilitation of the millions of affected people and the areas in which they live. In particular, the rehabilitation and restructuring of local economies and the business sector is a priority concern that requires urgent attention.

The objectives of this paper are to provide some suggestions for regional cooperation in trade and investment to assist in the rehabilitation of the business sector, as the principal agents for trade and investment, in tsunami-affected regions. Section 2 will provide a brief overview of the implications of the tsunami disaster for the private sector. Section 3 outlines some suggestions for public sector action at the regional level that would help the private sector, while section 4 provides some suggestions for the private sector itself to assist in the rehabilitation efforts. Section 5 provides some recommendations for international and regional organizations, such as UNESCAP, while section 6 presents conclusions.

2. IMPLICATIONS OF THE TSUNAMI DISASTER FOR THE PRIVATE SECTOR

The economic recovery of disaster-affected regions and economies is a complicated and less understood area of disaster research. In particular, in the longer term, it is of paramount importance that trade and investment be promoted in tsunami-affected countries, as trade and investment would generate resources for sustainable recovery that might not be fully covered by aid. Returning the livelihood to the surviving victims is a much larger challenge and is more costly than short-term emergency humanitarian aid. It requires even stronger support from the international community than the short-term relief effort. Long-term economic recovery requires substantive support for the business sector as the principal agent of trade and investment.

In order to design efficient mechanisms for long-term technical assistance in trade and investment, one could consider the categorization of the groups most affected by the tsunami described below.

(a) Self-employed workers

A great number of the people affected are self-employed farmers and fishermen whose livelihoods have been destroyed or severely affected by the loss of land and boats. For example, cultivable land in Aceh, Indonesia, has been turned into a wasteland and mangrove swamps have been flooded and contaminated with salt water from the tsunami. In Sri Lanka, 80 per cent of the nation's fishing fleet was destroyed or damaged.

In the short term, these people would require financial assistance through grants or soft loans to recover or repair the tools of their livelihood, i.e., fishing boats and nets, and would need to be allocated cleaned up land for farming activities.

(b) Unskilled workers

The main difficulty, as with all economic dislocations, is remedying the plight of low-skilled or unskilled workers, many of whom lost their jobs as a result of the tsunami. For instance, in the tourism resort areas of Phuket, Thailand, and the Maldives, more than 200,000 workers are expected to be retrenched, as significant damage to infrastructure has been sustained by the hotels and properties where they worked. These workers range from sweepers and hotel cleaners to white collar managers whose workplaces were destroyed in a matter of minutes.

It is important at this point in time that social safety nets be put in place to ensure that this group of people is not overlooked or mistreated. The upgrading or acquisition of skills through basic vocational training, such as carpentry, gardening, cooking or sewing, while they are in temporary camps could be considered. Once they are trained, they can participate actively in gainful employment.

(c) Small and medium enterprises

The most effective way to help employees and companies to recover from the disaster is to provide them with the opportunity to regain economic viability. The issue of employment generation is closely intertwined with the rehabilitation of the labour-intensive small and medium enterprise (SME) sector, allowing it to emerge from the ashes of destruction that have swept the affected areas. It must be recognized that only with the successful rehabilitation of the SME sector can the employment of thousands of workers be successfully restored and expanded. The pressing task and challenge ahead would be to create an enabling business and investment environment for the affected companies and entrepreneurs to rebuild their businesses.

SMEs face formidable challenges in restarting their operations. Some of these enterprises probably have some limited form of insurance coverage against flood and fire. However, such insurance coverage is unlikely to be sufficient given the large extent of damage suffered in the tsunami-affected areas. Nonetheless, the early disbursement of any insurance benefits that the SMEs are entitled to would be a significant contribution for them to take the first step in restarting their operations.

SMEs, while having access to funding, have very limited leverage regarding terms and conditions, such as interest rates, amount of loans and collateral required. To encourage them to restart their operations, it would be necessary for Governments, international organizations and financial institutions to declare a moratorium on loans/ debt repayments for businesses operating in the tsunami-affected areas. In addition, there is a need to increase liquidity in the capital markets, such as stock and bond markets, to allow SMEs to access short-term loans and capital to restart their operations.

A special subgroup of SMEs consists of sole proprietorships. They are expected to be the worst-affected group within the business sector. Many stories have emerged of numerous sole proprietorships, such as tailors, taxi drivers, motel owners, spa operators and the like having their entire inventory and physical assets swept away by the tsunami. Unlike other SMEs, which as a last resort could simply wind up their operations and restart under a new entity, these sole proprietor businesses are personally liable for all outstanding debts.

In the case of sole proprietorships, the main task is to re-establish the viability of the business model they previously had to ensure that they would have the incentive to restart their businesses. As in the case of the self-employed, a simple restoration of the main tools to do business, e.g., a sewing machine for a tailor, a taxi for a driver, a bathtub for a spa operator, would be a crucial step in the right direction. If such goods can be imported without the usual customs duties and government taxes, the benefits to sole proprietorships would be enormous.

However, the tools of trade are only part of the equation. Governments and international organizations have recognized that the re-establishment of business linkages for all SMEs is equally important. For example, a tailor needs to have demand for his products, for example, from tourists near his location. He or she should also be given the opportunity to export his goods to customers elsewhere. The lifting of travel restrictions, such as visa requirements, coupled with inexpensive tour packages, would give a tremendous boost to the tourism sector and SMEs providing products and services in this sector.

For those SMEs involved in exports, in the longer term it is also important to improve market access, in particular for agricultural and fisheries products, which are usually subject to stringent non-tariff barriers in developed countries. If the international community could assist in obtaining a decent economic value, including profits, for these products for a few years, it would help the tsunami survivors to regain their footing more quickly.

3. PUBLIC SECTOR MECHANISMS FOR PROMOTING REGIONAL COOPERATION IN TRADE AND INVESTMENT

The strategy to resurrect the economic well-being of the affected areas should be based on the premise of economic efficiency. In response to the need for rehabilitation, Governments and international organizations could take the lead in the recovery and development of the tsunami-affected areas through regional cooperation with a focus on assisting the private sector.

According to the International Disaster Response Law Project, commissioned by the International Federation of Red Cross and Red Crescent Societies and published in March 2003, the import of relief goods and equipment was an issue of great concern for various international agencies. In most countries, the imposition of heavy taxes or cumbersome bureaucratic procedures on the import of goods necessary for relief efforts presented a source of constant frustration. This situation prevailed despite awareness by some personnel of the recommendation on the tax-free and expeditious import of relief supplies, reached by the States members of the World Customs Organization.[1]

On the other hand, there were some positive experiences, in which Governments had temporarily waived import taxes and significantly hastened the processing of paperwork and other administrative processes relating to relief goods and equipment. In some cases, the countries are signatories to the Convention on Temporary Admission (Istanbul Convention) of 26 June 1990 allowing for the total conditional relief of duties and taxes for disaster relief goods.

In other cases, regional agreements had been put in place to facilitate the importation of certain goods between nearby countries, as well as manuals containing procedures and guidelines for implementing the agreements for use by the respective ministries of foreign affairs. These had made a very positive impact on humanitarian assistance and effectively resolved the operational challenges by enabling the fast and efficient importation of relief goods within the region.

It is clear that there is a crucial need for a regional framework for relief efforts within the tsunami-affected areas. There are many existing organizations that coordinate the management of disaster warning, natural risks, humanitarian aid and developmental assistance. Given the present level of telecommunications technology and the ease of transportation, there is clearly ample room for improvement and management of the allocation of tasks and resources. Networking seems to be the most efficient way to move forward because it minimizes the political conflicts and sensitivities between countries.

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1 Recommendation of the customs cooperation council to expedite the forwarding of relief consignments in the event of disasters, World Customs Organization document T2-423 (8 June 1970).

While various regional cooperation mechanisms exist for disaster relief and coordination, including the tsunami early warning network, the UNESCAP/WMO Panel on Tropical Cyclones, UNESCO Tsunami Warning System, the Asia Disaster Preparedness Center, the establishment of the ASEAN Regional Haze Task Force, the Asian Disaster Reduction Center and the East Asia Natural Hazards Mapping Projects, there are no major regional cooperation schemes in trade and investment. Any such regional cooperation mechanism would require adequate financial and human resources, technology, access to communication networks, political commitment and a proper institutional framework.

The tsunami disaster is expected to hasten discussions on how formalities could be addressed on an accelerated basis on such issues as the temporary admission of goods with total conditional relief of duties and the taxes and the facilitation of clearance of goods at points of importation. In addition, it would shed light on the need to maintain investment incentives to discriminate in favour of a less-developed or disaster-hit region, or alternatively, the need to undertake temporary protectionist measures to avoid exploitation in the region.

In addition, the catalytic effect could spill over into other financial areas, such as the development of ASEAN capital markets, for example, the ASEAN Bond Market, to raise/mobilize capital within ASEAN to support the development and reconstruction of disaster-hit areas.

With respect to regional cooperation in trade and investment, four main proposals are presented: (a) the establishment of special economic zones; (b) the granting of special temporary LDC status; (c) the establishment of special investment regimes, and (d) the granting of special company status.

(a) Establishment of special economic zones

One proposal is to create special economic zones within the tsunami-affected countries. The major benefits for companies operating in the special economic zones would be multi-pronged as follows:

(a) Duty-free imports of capital equipment and raw materials for production within the zone;

(b) Income tax holiday for eight years and other tax breaks;

(c) Exports originating from this zone would be granted GSP status and concessions from developed nations;

(d) Removal of land ownership and usage restrictions.

To facilitate the implementation and reap the benefits of this proposal, it is further recommended that trade within the same special economic zone or between zones (across borders) should be duty-free. In particular, companies registered within a zone residing in two geographical territories should be governed by a common set of laws and regulations. A joint committee should be established to define the common set of rules and regulations for the companies and products to be imported and exported from the special economic zone.[2]

The special economic zones would create an incentive to consider manufacturing operations in the tsunami-affected regions through access to cheaper raw materials and capital equipment. The tax breaks would allow companies to retain their profits for the first few years either to compensate for their losses during the disaster or hopefully for reinvestment back into the special economic zones. The GSP qualifying status will further allow products manufactured in the tsunami-affected regions greater market access into the lucrative developed markets. The removal of land ownership and usage restrictions will allow companies to expand rapidly the necessary physical infrastructure, such as private shipping berths, railroad tracks, roads or even water treatment facilities to support the development of the special economic zones as and when required without having to wait for administrative licences.

The perimeter of the special economic zone could be determined by the boundaries of the affected area where disaster struck with visible damages. Companies to be registered in the zone could be requested to meet certain criteria, such as a commitment to the rehabilitation programme for the tsunami-affected regions. In addition, priority should be given to companies that had previously operated in the tsunami-affected regions.

The operating principles and mechanisms of the special economic zone could be embedded in one of the existing regional trade agreements. It is probable that there are at least two potential agreements to host the Special Economic Zone initiative; the first being the Bangkok Agreement and the second being the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC)[3]. The Special Economic Zone could represent a fast track towards trade liberalization benefits[4] from these economic agreements.

The obvious advantage of using the Bangkok Agreement under the UNESCAP umbrella is that it has the operative framework and procedures (e.g. tariff reduction, rules of origin, etc) already finalized and implemented. Two of the five most affected countries are Bangkok Agreement members (i.e., India and Sri Lanka). On the other

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2 This is similar to the concept of growth triangles, and regional cooperation mechanisms, such as BIMSTEC and JDA (Joint Development Area, set up by Malaysia and Thailand to jointly engage in the exploration and extraction of natural gas).

3 BIMSTEC consists of Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand.

4 In ASEAN, the ASEAN Industrial Cooperation Scheme (AICO) provides similar fast tracking of ASEAN Free Trade Area (AFTA) tariff benefits for companies operating under this Scheme.

hand, BIMSTEC has the advantage of having most countries in the affected area in its membership with the stated objective of creating a free trade area by 2017. However, it is noted that the Special Economic Zone does not have to involve only one regional trade agreement.

Regardless of which regional trade agreement is used as the implementation vehicle for the Special Economic Zone initiative, it would be necessary to ensure that the agreement is opened for accession by non-members. Once the membership is addressed, it would be necessary to notify WTO to seek preferential status for the Special Economic Zone, in particular, the need to seek GSP treatment from developed countries.

(b) Granting temporary LDC status

The Special Economic Zone may take some time to establish. Meanwhile, it would be helpful to start with some of its components. Tsunami-affected countries should temporarily, (i.e., until they have substantially recovered from the disaster) enjoy substantial GSP benefits at the level of LDCs, with a minimal number of restrictions from developed trading nations. For example, Sri Lanka would be able to enjoy preferential market access for its fisheries products and textile products once its fishing fleet is replenished and its textile factories are rebuilt.

(c) Establishing special investment regimes

Special investment regimes for the tsunami-affected areas are proposed, which could include exemptions from WTO trade-related investment measures (TRIMs) and other investment rules related to national treatment (as in services) and export performance criteria. To create a more favourable climate for substantial investment in tourism infrastructure, such as luxury hotels and golf courses, longer tax holidays and incentives could be negotiated on a case-by-case basis. It is therefore crucial that sufficient flexibility be allowed and applied in such instances without running afoul of WTO principles and rules. The establishment of special investment regimes could be carried over into the special economic zones.

(d) Granting special company status

The fourth proposal is to identify and create a new category of companies tasked with supporting the redevelopment efforts of the tsunami-affected areas. It is proposed that such companies could be registered as “charities” or something similar, and given the privilege of duty-free imports to support their efforts in the redevelopment exercise. These companies could initially focus their attention on short-term relief products, such as emergency food rations, medical supplies, tents and water, and at a later stage move to construction equipment for infrastructure development and industrial equipment, such as water purification plants.

4. NGO AND PRIVATE SECTOR INITIATIVES AND MEASURES FOR PROMOTING REGIONAL COOPERATION IN TRADE AND INVESTMENT

There are many issues that have hindered public sector support for medium-term economic recovery efforts. The greatest of these are efficiency, effectiveness, and the extremely complex political, economic and social side-effects associated with them. It has become increasingly clear that aid is not a panacea. Although externally driven, humanitarian aid has inevitably taken on roles within the conflicts and societies in which they are distributed.

Apart from political issues, there is the problem of the effectiveness and cost of delivering aid to the recipient. The concerns of international aid agencies and donors are that scarce resources are correctly channelled to the most appropriate disaster areas, that the right recipients receive the resources and that there is zero or minimal leakage during the delivery of assistance. Some sources suggest that the cost of delivery is about 40 per cent, i.e., for every dollar donated, only 60 cents goes to the intended recipient. It is therefore critical that an efficient accounting and auditing system be in place to address this pertinent issue from the onset.

An effective and timely relief operation has the capacity to save thousands of lives. However, it is also an expensive and difficult undertaking. Potential beneficiaries may be located within a zone of conflict or in areas with poor or damaged infrastructure, making it difficult or dangerous for humanitarian agencies to deliver assistance. As a result, help may reach only the most accessible areas, to the detriment of other beneficiaries who may be just as needy. Thus, the execution of each element should be decentralized into manageable tasks to be conducted by operational units in the tsunami-affected regions.

Thirdly, rehabilitation efforts are not glamorous and do not catch the attention of the general public and policy makers. Moreover, the politics of regional and economic cooperation are fraught with contentious issues. This is evidenced by the recent ministerial meeting in Phuket, Thailand, for the setting up of an Indian Ocean tsunami warning system.

These problems have led to an increase in the popularity of direct participation by private organizations, such as NGOs and TNCs, whereby they deliver the goods or services directly to the recipients.

(a) Non-governmental organizations (NGOs)

In order to provide affected populations with the resources needed to restore their livelihoods, international relief agencies have funded cash- and assets-for-work programmes as a key part of their relief assistance. Currently, NGOs are developing cash-for-work programmes in waste management, land rehabilitation, debris removal, shelter construction, daycare construction and livestock care. For example, the NGO Exnora's waste management programme will employ youths to clean up community areas and recycle waste in temporary settlements and the general community, providing them with a source of income, while benefiting the general population. In addition, Food for the Hungry will restock small businesses through an assets-for-work programme.

NGOs are mostly exempt from red tape and are more flexible in their mobility. However, their constraint is determined by the scale of their operation. If their operations are getting bigger, bureaucratic requirements will start to interfere. The level of economy of scale of NGOs operations is thus important in determining the efficiency of their operations.

(b) Corporate sector

While official aid has been instrumental for immediate disaster relief, it has been observed that assistance from the private sector could be mobilized within hours of the disaster in providing emergency medical supplies and airlift capabilities to reach the victims in the shortest possible time. Coupled with NGOs, such as the Red Cross and the Order of St. John and St. John Ambulance, the private sector could help facilitate many of the government initiatives highlighted above.

In this context, it is worth pointing out that the private sector, in fact, has been extremely successful in some of their own global initiatives, such as setting standards against the exploitation of child labour or supporting the Green Movement in promoting recycling and the preservation of rainforests and wildlife. Most TNCs have firmly established corporate social responsibility (CSR) programmes ranging from environment conservation to action against child labour. During the tsunami disaster, many companies contributed significant resources in terms of services and products to enhance the emergency relief efforts. For example, pharmaceutical company Bristol-Meyers Squibb provided for the shipment of medical supplies to Sri Lanka and Indonesia via a dozen medical mission boxes, valued at over US$ 20,000 each and hand carried by volunteer medical teams dispatched to the tsunami-disaster areas. Air cargo companies, Air Sri Lanka, Thai Air International, Garuda, Federal Express, UPS and others donated their services for relief efforts. Johnson & Johnson provided assistance directly from its facilities in India to support the distribution of emergency aid to the tsunami disaster regions.

Many of the TNCs are, in fact, willing and eager to do even more. What is needed is the framework to allow these companies to effectively participate in the relief and rehabilitation effort. Mainstreaming disaster risk management into development planning is a legitimate corporate exercise.[5] However, it is more important to create an environment that allows the private companies, especially TNCs with strong international networks, to participate directly in these programmes.

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5 "Governance: institutional and policy frameworks for risk reduction" by UNDP/BCPR, Prevention Consortium Secretariat, UN-HABITAT and UNV, Thematic Discussion Paper Cluster 1, World Conference on Disaster Reduction, 18-22 January 2005, Kobe, Hyogo, Japan.

The first and obvious choice is to attract and convince corporations to establish their production facilities in the tsunami-affected areas. The production facilities will generate employment for the people and will at the same time ease the problems related to existing facilities and, hopefully, attract new investors. As the business enterprise is not a charity organization, these production facilities have to be economically viable.

While the establishment of special economic zones and special investment regimes would be helpful in this regard, the corporate sector itself might wish to come up with its own special "tsunami rehabilitation programme" (TRP) to invest and trade within the tsunami-affected areas. The TRP could be deployed as a trademark for companies operating in these areas to give a distinct label to their products to boast consumer recognition and support for the products and services produced. Companies might wish to pledge a minimal sum towards the humanitarian aid and development assistance within the tsunami-affected areas for every TRP product sold on the international market.

Companies operating in the tsunami-affected areas could undertake further community programmes to support the rebuilding of the community infrastructure, assisting in the training of unskilled workers and providing temporary food and shelter for victims facing chronic difficulties.

The private sector could also assume some of the current functions of the relief efforts from Governments. At the moment, numerous government agencies are working in the tsunami-affected areas to provide rehabilitation services, such as health care and education. However, this is not necessarily the most efficient way to carry out relief or rehabilitation activities. Private enterprises, if tasked, could be more efficient than Governments in executing these activities. More thought could be given to the idea of engaging professional companies to carry out these activities at the local and regional levels in cooperation with national and local governments and international agencies retaining the role of coordinator.

Despite every good intention of the private sector with regard to the relief operations, there is always the fear of a publicity backlash for the companies involved. In particular, such corporate initiatives might be misinterpreted as a public relations exercise designed to take advantage of the tsunami disaster to increase the company's profile. In this regard, national Governments might wish to consider and establish some frameworks to enable an orderly corporate engagement in relief efforts.

5. ROLE OF TRADE AND INVESTMENT COOPERATION IN DEVELOPMENT ASSISTANCE

The following five main players that can provide short-term emergency relief operations, humanitarian aid and long-term development assistance, inter alia, in trade and investment in the tsunami-affected areas can be identified:

(a) International and regional organizations: the most important actor in the provision of humanitarian aid and development assistance is the United Nations and its various agencies, funded by its Member States. The World Bank and the Asian Development Bank (ADB) directly fund development projects, inter alia, in trade and investment;

(b) National development agencies: in addition to multilateral assistance, many countries direct aid unilaterally through their own foreign-aid and development agencies. In the area of trade and investment for example, there are often various, if not always effective, schemes for assistance to SMEs;

(c) Non-governmental organizations (NGOs): NGOs increasingly play a key role in providing humanitarian aid and development assistance, both directly and as partners to United Nations agencies. They often have advantages over international organizations or foreign Governments. For example, they are less constrained by political factors and their diversity and independence allow them to work in very difficult places. However, in the area of trade and investment, their involvement is rather limited;

(d) The military: the military acts primarily to ensure a secure environment in which relief agencies can operate. In some circumstances, the military may also provide aid directly, usually when international organizations and NGOs find themselves overstretched or unable to deal with security problems. The military can be used to manage and coordinate the overall humanitarian response and to deal with technically and physically demanding needs, such as restoring communications and supply routes. These are fundamental requirements for restoring business activity and trade and investment. However, long-term military involvement in these areas is unlikely;

(e) Private enterprises: lastly, private enterprises, in particular TNCs, are playing an increasingly important role in providing social services, and thus contribute to the public organizations mentioned above. It is not difficult to predict that their role will increase in the near future, given their resources, capability and willingness.

Given the various kinds of agencies involved in immediate disaster relief and long-term development assistance, coordination and effective leadership in this regard are extremely important in order to minimize duplication and conflicting activities and to maximize the exchange and flow of intelligence in an often difficult and stressful working environment.

There is therefore a need for a regional agency that provides support for coordination among various international agencies, within the United Nations, and between United Nations agencies. Coordination between and among national Governments and with the various international agencies would also be vital. Until a new system is in place, there is a need for a neutral agency to assume this task. UNESCAP, as the largest United Nations entity in the Asian and Pacific region, may be well placed to perform this role, at least in the short to medium term.

The ever increasing number of agencies on the ground, the difficulty of obtaining accurate information and the unpredictability of humanitarian crises all conspire to make effective management and coordination extremely difficult. Solving this problem requires improved intelligence gathering and sharing, as well as tight management and coordination. While this is important for short-term emergency relief, coordination assumes an even more important role in long-term development assistance.

As far as trade and investment cooperation issues are concerned, UNESCAP has implemented various activities in the region on a regional cooperation basis. These activities include technical assistance to developing countries in helping them gain market access and to strengthen their supply-side capacities so that they can benefit from such market access. Its technical cooperation programme with WTO is well recognized. Given its regional coverage, UNESCAP could also assume the coordinating role for all the agencies involved in the area of trade and investment, at least until a more efficient institute is established or evolved. It could assume this task in close collaboration with the Asian Development Bank (ADB). The main coordination functions required at this stage are listed below.

(a) Establishment of the Special Economic Zone through trade and investment privileges

It would be useful for UNESCAP to conduct a feasibility study to ascertain the benefit and cost of this initiative. This study could be submitted to the affected countries and other member countries of ASEAN, the Bangkok Agreement and BIMSTEC through their respective secretariats. This could be followed up by such work as the drafting of the legal documents for the establishment of Special Economic Zones for consideration and adoption by the tsunami-affected countries. UNESCAP could also play a role in coordinating and consulting with WTO on granting special preferential treatment for LDC status and seeking GSP from developed nations.

(b) Establishing channels for private sector participation in development assistance

UNESCAP can act as a catalyst for eliciting recommendations and solutions from the private sector with regard to regional (cross-border) programmes that could assist in mitigating or alleviating the economic and social impact of the tsunami disaster. An example is the initiative to accord special status to companies operating in the disaster-affected regions so that they can be exempted from duties and taxes. UNESCAP could be the conduit for the implementation of such programmes within a new regional legal framework that it could help to establish.

(c) Establishing a monitoring system

UNESCAP should establish a system to monitor trade and investment issues in the tsunami-affected areas. Such a system would allow it to keep abreast of the progress of redevelopment within those areas and transmit such updates on a regular basis to other concerned agencies. UNESCAP should realize that, while there are numerous readily available data from international relief agencies operating in the tsunami-affected areas, such information will decline substantially once the short-term emergency relief operations are concluded and international interest has waned. It is recommended that as a first step, UNESCAP could initiate a benchmark exercise of surveying the current economic status of the affected regions. An update of the economic situation within the tsunami-affected areas could then be conducted on a biannual basis at least for the next five years.

(d) Establishing a convention for regional cooperation in disaster relief

Many developing Asian countries are prone to natural disasters. Apart from the tsunami, which is a rare event in the region, developing countries in Asia suffer from various kinds of natural disasters every year. UNESCAP could take the initiative to explore the establishment of a convention on regional cooperation in disaster relief, containing provisions for the granting of trade and investment privileges that would be automatically triggered in case of a disaster. Although an immediate decision to set up such a convention cannot be expected, the exercise of raising the suggestion may stimulate a more systematic discussion of a new framework that would facilitate the participation of public sector organizations and private sector enterprises and agencies in the longer-term rehabilitation efforts.

6. CONCLUSIONS

At this juncture in global development, where effective and timely humanitarian relief operations have the capacity to save thousands of lives despite the extreme difficulties involved, it is useful to ensure that the subsequent rehabilitation of the tsunami-affected countries is properly addressed. With new sophisticated tools and modern technology deployed in relief operations, it is perhaps appropriate that new mechanisms should be explored and deployed in the area of rehabilitation programmes on trade and investment. While it is recognized that there are pressing issues related to social and psychological needs, the need to provide for and ensure a long-term sustainable economic livelihood for tsunami survivors is paramount.

Priority areas for economic rehabilitation include the restoration of the business environment, both for the large number of self-employed farmers, fishermen and service operators and for the corporate sector. In the spirit of good governance, the role of government should be focused on providing a conducive legal and administrative environment for the private sector. Government and public agencies should not be tempted with the task of implementation. To the extent possible, it should be delegated to professional private sector entities.

In the same spirit, with regard to trade and investment cooperation, it is proposed that special economic zones be formed within the tsunami-affected areas. Such zones would be free from import and export duties, and companies operating in the zones (in particular, existing companies or operations that were damaged or destroyed by the tsunami) would be given investment incentives, including income tax holidays. In addition, exports from these special economic zones would be given special GSP status by the developed countries.

It is envisaged that private companies, especially TNCs, will want to contribute their expertise to the rehabilitation efforts. For example, such new ideas as the "Tsunami Rehabilitation Programme" along the lines of "Action against Child Labour" could be explored. Governments might wish to give special recognition to these private companies by according them a special company status to operate within the tsunami-affected areas with duty and tax privileges.

To ensure the successful implementation of the various initiatives, it is recommended that UNESCAP, as the largest Asian and Pacific regional organization of the United Nations, be tasked with the launching of these initiatives and to monitor economic performance in the tsunami-affected areas for the next five years.

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Policy Briefs

Thinking Ahead – Asia's Textiles and Clothing Trade in the Post-Quota Era*

QUOTA ELIMINATION: WINNERS AND LOSERS

The quota system that was the basis of the Multifibre Arrangement (MFA), and which had governed trade in textiles and clothing (T&C) for decades, was eliminated on 31 December 2004 in accordance with the terms of the World Trade Organization's (WTO) Agreement on Textiles and Clothing (ATC).[1] Under the MFA, T&C products from developing countries entered participating developed country markets (Canada, the European Union, Norway and the United States) through a quota system; that is, each developing country was assigned a quota maximum of T&C that it could export to a participating developed country. The MFA, which was basically a protectionist device used by developed countries, stood in contrast to the principles of the WTO multilateral trading system, as it violated the Most-Favoured-Nation (MFN) principle, it applied quantitative restrictions rather than tariffs, it discriminated against developing countries, and it was non-transparent.

The MFA quota system artificially repressed the exports of highly competitive countries that had the capacity to supply T&C in large quantities. At the same time, several smaller and poorer countries in Asia built up their T&C export-oriented sectors relying on the guaranteed exports provided under the MFA. Foreign direct investment, attracted by the underutilization of quotas in these countries, played a major role in the development of their T&C industries. T&C today constitute an important proportion of

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* This paper was prepared by Mr. Harish Iyer, former Economic Affairs Officer, Trade Policy Section, Trade and Investment Division, UNESCAP.

[1] The ATC provides for a gradual elimination of quotas in four phases (1 January of each of 1995, 1998, 2002, 2005) over 10 years. In each phase, a percentage of T&C products was placed under regular WTO rules; in the fourth and final phase the remaining 49 per cent of T&C products was incorporated.

the total exports of several countries in the region. For example, the T&C exports of Bangladesh and Cambodia make up approximately 85 per cent of total exports, the corresponding figures for Nepal and Sri Lanka being close to 55 per cent.

With the removal of quotas, T&C trade will to a much larger extent be determined by market forces. It is generally expected that the elimination of quota restrictions will open the way for the more competitive developing countries to build the expertise to handle all stages of the production chain. It has been suggested that the countries with the capacity to establish themselves as integrated suppliers, in particular China, but also India and perhaps a few others, will be the biggest winners in this respect. Smaller countries with more limited production bases, including Bangladesh, Cambodia, Nepal and Sri Lanka, could face severe adjustment problems. It is also important to note that women form an important proportion of the largely low-skill workforce in the T&C sector in developing countries, and the social costs of job loss and factory closure could be high.

Less pessimistic views on the post-quota era have also been put forward. Some have argued that the global growth of the T&C trade will allow at least some of the smaller suppliers to stay in business; it has also been pointed out that a number of smaller suppliers are already competing in non-quota markets. Furthermore, some mitigating factors could come into play which may prevent, or at least slow down, China and other large suppliers from dominating the global T&C industry. For one thing, with quotas no longer being an option, developed countries may turn to other means to protect their T&C industries, including the use of anti-dumping or safeguard measures, and more stringent environmental and labour standards. In addition, as part of the terms of China's accession to WTO, members of WTO have the right to impose safeguard measures specifically against textile imports from China until 2008 and under certain conditions. China itself, seemingly in a move to placate producers in developed countries and thereby thwart the possible imposition of protectionist measures, recently announced that it would tax its textile exports.

Nonetheless, the impact of the abolition of MFA on smaller countries could still prove to be severely damaging over time, and appropriate responses are called for in order to cushion the negative effects of quota elimination and to find appropriate solutions to the problem.

WHAT CAN BE DONE?

Responses at the national level…

Action will certainly be required at the national level, inter alia, to provide social safety nets, introduce education and training and programmes for labour relocation and re-employment, encourage product diversification and more generally assist the private sector in developing its capacity to compete internationally. These and other measures have been discussed extensively,[2] but the difficulties of implementing them should not be underestimated. Coping with the adjustment process could prove extremely challenging for many Governments operating in isolation, and the complex problems that will have to be faced certainly do not have simple solutions.

…could be complemented by support at the regional level…

The question is therefore posed as to whether the region can provide support for those countries adversely affected by the elimination of quotas. For example, could the larger developing countries in the region – notably China and India, the two countries expected to emerge as the biggest winners from the elimination of quotas – step in to assist the smaller ones, and thereby strengthen South-South cooperation? The provision of technical expertise is certainly one way in which the larger developing countries could assist.

The fact that tariffs on T&C products are among the highest imposed on manufactures[3] also points to tariff reduction as being an obvious measure that can be taken to boost trade in this sector and enhance cooperation between developing countries. Seeking market access through free trade agreements with larger developing countries could be one way for the smaller ones to maintain at least some segments of their T&C industries, though care should be taken to ensure that liberalization on a regional basis is complementary to the global trade liberalization process.

Thought might also be given to the feasibility of establishing a regional financial facility to assist those countries that have been adversely affected by the elimination of quotas. Through such a mechanism, the larger and more advanced developing countries, and perhaps developed countries in the region, could provide financial and technical support for those countries struggling to cope in the post-quota era. It goes without saying that the details of setting up such a scheme will cause much debate and raise many questions (for example: how will the scheme be funded? Should compensation only be available to least developed countries? What would be the criteria for compensation? Should the scheme be limited to the T&C sector or should it be part of a broader package encompassing all sectors?), but with the larger objective in mind, it is certainly worthy of consideration.

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2 See, for example, OECD (2004). CPD (2003) and Kelegama (2004) provide in-depth country-specific analysis for Bangladesh and Sri Lanka, respectively.

3 This sector has been subject to tariff peaks in both developed and developing countries. OECD (2004) reports that the average tariff applied by OECD countries on textiles is 9.4 per cent and on clothing products is 16.1 per cent (as opposed to 6.2 per cent on manufactured goods); in developing countries, the average tariff on textiles is 18.1 per cent and on clothing products 23 per cent (compared with 13.5 per cent for manufactured goods).

…and at the global level

Notwithstanding the importance of support at the regional level, particularly through South-South cooperation, the fact that MFA was a global mechanism in which several developed countries participated suggests that some response from the international community, and from this group of countries in particular, would not only be desirable, but perhaps even necessary. In April 2004, the International Monetary Fund's Executive Board approved the so-called Trade Integration Mechanism (TIM), designed to assist countries in overcoming balance of payments problems arising from trade liberalization, including from the abolition of the MFA, and in July 2004 Bangladesh became the first country to activate the mechanism. While TIM has yet to be fully tested and has raised some concern that, as a lending facility, it could increase debt burdens, it nevertheless represents recognition from the international community of the possibly severe adjustment costs that can arise from trade liberalization. Other financial mechanisms to assist countries experiencing adjustment challenges from the liberalization of trade could also be considered at the global level.

Developed countries could also provide support by further enhancing non-reciprocal preferential schemes, such as the Generalized System of Preferences (GSP) or the European Union's Everything But Arms Initiative (EBA). Some of these schemes already offer duty-free market access to least developed countries on a full range of products including T&C, but in other schemes, for example that of the United States, preferential treatment on T&C imports from developing countries in Asia is not offered. It has also been observed that utilization rates in these schemes have historically been low.[4] In the case of the European Union in particular, the main reason identified for low utilization rates has been highly restrictive rules of origin.[5] Non-reciprocal schemes could in general be made more effective by expanding the product coverage and the number of beneficiary countries, and simplifying rules of origin and other procedural matters. Consideration could be given to offering duty-free market access on T&C products not only to all least developed countries, but also to other developing countries, such as Sri Lanka, that will have difficulty coping with the elimination of quotas.

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4 For example, it has been estimated that average utilization rates of selected Asian least developed countries in certain categories of T&C have been lower than 40 per cent in recent years, in some cases below 30 per cent, in the European Union's GSP scheme (see UNCTAD, 2003).

5 It seems, however, that more flexible rules of origin will soon be introduced in the European Union's GSP scheme as part of general efforts to improve the scheme. In particular, it is proposed that regional cumulation be relaxed through elimination of the value added rule criterion, and cumulation across regions be introduced if requested (thus, for example, SAARC countries could cumulate origin from ASEAN). Other proposed changes aim to simplify and stabilize the scheme, encourage sustainable development and good governance, increase the product coverage, and introduce a clearer and simpler graduation process. Further information on the proposed changes can be found on the website of the European Commission's Directorate General for Trade: http://europa.eu.int/comm/trade.

Finally, it is worth exploring what response can be found within the context of the multilateral trading system. As the main global forum dealing with trade matters, WTO could be used by its members to discuss and agree on ways to provide support for those countries that will face adjustment difficulties in the post-quota era. CPD (2003), for example, has supported the case for transforming special and differential treatment measures in WTO from best endeavour clauses to binding commitments, and for increasing the commitment in WTO to providing technical assistance, particularly for least developed countries. In a submission by a number of countries to the WTO membership,[6] it was proposed that the WTO secretariat undertake a study identifying adjustment-related issues and costs, paying particular attention to the impact on least developed countries and other small and vulnerable economies that will lose from quota elimination, and that a work programme be established in the WTO to discuss and find solutions to problems identified by concerned parties. Turkey, a major T&C exporter, made a similar proposal.[7] There is still some way to go before a possible arrangement can found in the WTO context, but the debate will certainly continue as the realities of MFA abolition unfold.

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6 WTO document G/C/W/496/Rev.1, "Post-ATC adjustment related issues", submission by Bangladesh, the Dominican Republic, Fiji, Jamaica, Madagascar, Mauritius, Mongolia, Nepal, Sri Lanka and Uganda, 22 November 2004.

7 WTO document G/C/W/497, "Turkey's contribution to the debate on post-ATC related issues", 25 October 2004.

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Executive Summaries of Recent Studies in Trade and Investment Published by the Secretariat

Foreign Direct Investment in Central Asian and Caucasian Economies: Policies and Issues

Foreign direct investment (FDI) is widely acknowledged as playing a crucial role in the development process of developing economies, including economies in transition. As a result, FDI is being sought after by the Governments of these economies, which in need of external capital for development. While some of the economies in transition in Central Asia and the Caucacus have sizable deposits of oil, gas and minerals, which are major attractions to foreign investors, others are less endowed and have more difficulty in attracting FDI to their fledgling industrial and service sectors. But even in those countries that are well endowed with natural resources, there is a strong need to diversify their economies away from overdependence on those resources and to develop viable value-added manufacturing industries and services. FDI can play a major catalytic role in this process.

The process of attracting and promoting FDI is complex, in particular as most developing countries in the world are competing for similar types of FDI and some have natural competitive advantages owing to the size of their economies or other pull factors that enable them of attract FDI inflows. As a case in point, China attracts the bulk of FDI flows of the developing world. While countries might not be able to compete on the basis of natural competitive advantages, they could gain such advantages by creating an enabling investment climate, which goes beyond the mere enactment of an investment law and generous incentives. In countries that have been relatively successful in attracting investment, the institutional framework has played a significant role, usually in the form of a well functioning investment promotion agency with appropriate support in manpower, resources and authorities. Such agencies are not only essential in promoting and attracting FDI but also in facilitating the post-approval process. The facilitation of investment implementation and realization, though a critical aspect of the investment promotion climate and process, has often been overlooked, jeopardizing the country's future prospects for investment inflows.

In order to review and discuss thoroughly issues related to investment promotion and facilitation in Central Asian and Caucasian countries, UNESCAP organized a Regional Round Table on Foreign Direct Investment for Central Asia in Dushanbe in

April 2003. This activity was part of the implementation of the investment-related components of a United Nations Development Account project entitled, "Capacity-Building of UNESCAP Member States for Managing Globalization". At the Regional Round Table, best practices and successful experiences in FDI promotion from countries such as China, Malaysia, the Russian Federation and Turkey were discussed.

UNESCAP presented country studies on the investment climate based on fact-finding missions to five countries: Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan and Tajikistan. The meeting learned about the progress that various countries had made in improving their business and investment climate, but acknowledged that many problems remained and would have to be addressed in order to attract FDI more effectively.

UNESCAP also presented a paper entitled, "Policies and strategies for the promotion and attraction of foreign direct investment in less developed countries and economies in transition: an introduction", including conclusions and a set of recommendations for policies and strategies for the promotion and attraction of FDI.

These papers are presented in this monograph study in trade and investment. Information on the investment climate in the target countries is valid as at the end of 2002 and is by no means exhaustive. From this publication, however, the reader will be able to grasp fairly and comprehensively the business and investment policy, institutional and legal framework of the countries concerned as well as general concepts of investment promotion, attraction and implementation.

The publication and related materials are available online at:

<http://www.unescap.org/tid/publication/onlinepub.asp>

Trade and Investment Policies for the Development of the Information and Communication Technology Sector of the Greater Mekong Subregion

This study looks at trade and investment policies that help bridge the digital divide and facilitate integration into the global economy of the Greater Mekong Subregion (GMS) countries. It offers both regional and national perspectives on current and potential trade and investment in the information and communication technology (ICT) sector in these countries. Thailand has established itself among the top 15 traders of ICT goods in the world, and Viet Nam's trade in this sector is increasing. However, trade in ICT plays a very minor role in Cambodia, the Lao People's Democratic Republic, Myanmar and Yunnan Province of China.

The study reveals that comprehensive ICT policies have been formulated and implemented only in Thailand and Viet Nam, the two countries in GMS that have a ministry exclusively for ICT. Moreover, these two countries have recognized the role of trade and investment policies in promoting ICT production and trade.

In Cambodia, the Lao People's Democratic Republic and Myanmar, ICT use is largely confined to urban areas and high access costs constitute a major barrier. Among others, the small size of the economies and the dual role of Governments as providers and regulators of ICT have been identified as major constraints. In Myanmar, high costs also hinder the Government's ability to realize returns on its remarkable infrastructure investments. Viet Nam and Yunnan Province of China, however, have witnessed rapid increases in ICT use by allowing limited competition, despite the leading role the government plays in the telecommunication sector. Concrete measures to develop a more competitive telecommunication sector in the region are recommended.

As a result of the recent policy reforms initiated by Cambodia, the Lao People's Democratic Republic, Viet Nam and Yunnan Province of China, the environment has generally become more conducive for investment. This is also true for Thailand, which has a longer history of liberal trade and investment policies. Yet, there have been significant inter-country variations both in the amount of investment approved and the amount actually realized. Viet Nam has one of the highest per capita investment rates in the world. Despite major improvements in the investment climate, a number of

barriers of particular importance to investment in the ICT sector have been identified. This includes minimum capital requirements for foreign investment, hindering the entry of transnational small and medium-sized enterprises, as well as case-by-case exemptions from investment-related regulations, which are a potential source of non-transparent decision-making. The study underscores the need for initiating steps that would enable the GMS economies to find a place in the international production networks of both ICT goods and services. For most countries in GMS, except Thailand, such low-skill technologies as data entry are identified as real opportunities. At the same time, the importance of continuous skill upgrading, inter alia, through increased on-the-job training, is emphasized.

The study also analyses the implications of advancing the e-ASEAN framework and the Information Technology Agreement (ITA) under the World Trade Organization for the GMS countries. The loss due to the elimination of tariffs under ITA appears to be relatively modest. The greatest impact would be in Cambodia, where tariffs on ICT generated 5 per cent of total customs revenue in 2001. However, it is projected that, in all four countries tariff elimination would lead to a large increase in the available stock of ICT goods. An advancement of tariff elimination on ICT goods under the e-ASEAN Framework Agreement coupled with technical assistance in capacity-building from the more advanced ASEAN economies are considered to be promising policy options. Furthermore, regional cooperation is proposed in the areas of open-source software development, human resource development and accreditation schemes for ICT professionals.

The publication and related materials are available online at:

<http://www.unescap.org/tid/publication/t&ipub2336.asp>

Perspectives from the ESCAP Region After the Fifth WTO Ministerial Meeting: Ideas and Actions Following Cancún

The failure of the Fifth WTO Ministerial Meeting, held in Cancún, Mexico in September 2003 to advance the negotiations under the Doha Development Agenda (DDA) towards a conclusion created strong but short-lived concerns about the future of the multilateral trading system. Continuing its work on DDA (see Studies in Trade and Investment, no. 51), the UNESCAP secretariat moved swiftly to assist member countries in dealing with this temporary setback by organizing various activities focused on the current status and developments in DDA.

Among these activities, back-to-back dialogues held in Bangkok from 30 March to 1 April 2004 resulted in the issuance of No. 53 in the series of studies in trade and investment. This study provides the Asian and Pacific region's perspectives on the post-Cancún trading environment as well as its clear commitment to a successful conclusion of the DDA negotiations.

The study contains analytical papers that examine developments before, during and after the Cancun Ministerial Conference in the most relevant areas of the DDA negotiations, i.e., industrial product access, agriculture trade liberalization and special and differential treatment. Even though many commentators claimed that they had no major expectations for the Conference, it is important to understand which factors contributed to the breakdown of the Conference. The study identifies four groups of reasons: (a) tension and acrimony in the negotiations on agriculture, with an added North-South dimension from the emergence of G-21+ group of developing countries; (b) a refusal by the African, Caribbean and Pacific (ACP) group to start negotiations on any of the Singapore issues, even after concessions offered by the European Union; (c) the handling of the cotton subsidies initiative, which became a very controversial and divisive topic that contributed to North-South polarization; and (d) the Chairman's somewhat controversial decision to end the meeting prematurely. The sudden end of the Cancún Conference precluded the possibility of building on any possible agreements that had been negotiated prior to or during the Conference.

Special attention in the study is given to the issues surrounding market access for industrial product and agricultural trade liberalization at the Cancun Conference. The potential large gains for developing countries from easier access to the markets of both developed and developing countries for industrial products, while fully recognized in the Doha Declaration appeared not to be the main reason behind some of the proposals for tariff cuts discussed at the Cancun Conference. As a result, none of the proposals attracted general endorsement and the matter had to be left for further negotiations in Geneva.

Agriculture remains high on the agenda of all WTO members, but for most members in the ESCAP region, agriculture has an added developmental and poverty reduction value. The study gives a full account of the Cancun impasse in the negotiations on agriculture, outlining the different positions of the countries of the region. The proposals made by the Chairman of the Committee on Agriculture (March 2003) and the Chairman of the Conference at Cancún (September 2003) are carefully compared and contrasted.

Notwithstanding the apparent failure of the Cancún Conference to close with concrete results, the Conference did show the way forward, including a consensus to remove investment and competition issues from the negotiation agenda and a review of the approach taken towards SDT in the reduction of industrial and agricultural tariffs in developing countries.

The study also includes papers on the domestic impact and social costs of WTO accession for Bhutan, Cambodia and Nepal as well as an appraisal of the significance of the accession of Cambodia and Nepal to WTO as the first LDCs after the Uruguay Round.

Bhutan has opened its economy in the process of preparing for multilateral liberalization, which is evident from its increasing export/GDP ratio over time. However greater economic integration has also created challenges for the economy of Bhutan. Even though Bhutan has LDC status and would therefore be entitled to a number of concessions and benefits under SDT, it would also need to reciprocate in terms of reductions in tariff rates, liberalization of trade in services, or changes in its intellectual property protection regime. Given the constraints that the country faces, such as the small size of its domestic market, its isolated geographical location, and lack of skilled labour, unilateral trade liberalization on its own will not automatically spur economic growth. Bhutan would therefore benefit from further regional and multilateral trade and investment cooperation.

Cambodia and Nepal were the first LDCs to accede to WTO after the Uruguay Round. This study appraises their accession from two angles: one is the consideration of the national economic and social costs of implementing the accession package and its impact on the domestic economy and society in each country; another is a comparative analysis of the two countries' accession packages so as to derive lessons of a systemic nature that would be of relevance to other acceding countries in the region.

The study also contains country studies presenting the views and experiences of 14 UNESCAP member countries with regard to the outcome of the Fifth WTO Ministerial Conference. These include current WTO members (Bangladesh, Cambodia, India, Indonesia, Malaysia, Mongolia, Pakistan, Philippines, Thailand and Turkey) and countries that are observers (Bhutan, Lao People's Democratic Republic, Tonga and Vanuatu).

The publication and related materials are available online at:

<http://www.unescap.org/tid/publication/t&ipub2338.asp>

Harmonized Development of Legal and Regulatory Systems for E-commerce in Asia and the Pacific: Current Challenges and Capacity-Building Needs

E-commerce and ICT are now widely acknowledged by the international community as important instruments for economic development. E-commerce offers an important vehicle for local businesses to access international markets and reduce transaction costs, thus facilitating trade for developing and least developed countries (LDCs). As large companies begin to require their partners to communicate business information via electronic means, enterprises in countries that do not have these capabilities will be at a competitive disadvantage. A major obstacle to the development of ICT solutions has been the lack of a legislative foundation.

Various organizations have already developed model laws on e-commerce in response to increasing concerns that inappropriate legal and regulatory systems might constitute a serious impediment to e-commerce. Examples include the 1996 UNCITRAL Model Law on E-commerce and guidelines such as the OECD Guidelines on E-commerce. While many countries in Asia have used these model laws or guidelines as references when they design e-commerce legislation, the national e-commerce legal and regulatory systems throughout the region remain strikingly different. Such differences in development and application of e-commerce laws and regulations across the region could increase uncertainties and risks associated with electronic trading and commerce systems, thereby slowing their adoption, particularly by small and medium-sized enterprises.

UNESCAP Trade and Investment Study No. 54 is a compilation of eleven papers presented or prepared for the Regional Expert Conference on Harmonized Development of E-commerce Legal Systems in Asia-Pacific, held at the United Nations Conference Centre in Bangkok from 7 to 9 July 2004.

The first five papers provide an overview of e-commerce laws and regulations in the ESCAP region. In the first paper, Satola, Sreenivaasan and Pavlasova assess the legal environment for e-commerce in 23 countries in East Asia and the Pacific. Duggal then reviews the e-commerce legal frameworks in South Asia, highlighting specific areas in need of harmonization as well as the difficulties associated with the implementation of existing laws. In the third paper, Mambetalieva and Beklemishev present a comparative overview of the e-commerce legal and regulatory systems in the countries of Central Asia and the South Caucasus, followed by recommendations to policymakers stressing the importance of banking laws in relation to e-commerce. Part I of the publication concludes with an overview of the legal and regulatory e-commerce environment in selected Pacific island countries and a discussion of the e-ASEAN legal framework by Ahmadu and Quimbo, respectively.

Part two is a selection of five papers presented by experts during the conference. The first two papers in this section are country papers that discuss the status and challenges of e-commerce legal system development in Viet Nam and Singapore, two countries at different stages of development. In the third paper, Park reviews the history of information protection in the Republic of Korea and considers related legal issues in the private and public sectors in the light of the rapid development of Internet-based services, including e-commerce. Current legal issues in electronic contracting are then presented by Boss, followed by an overview of the current challenges of developing a legal infrastructure to make e-commerce more secure by Tan.

Part three focuses on capacity-building needs for the harmonized development of e-commerce legal systems in Asia and the Pacific. Amoussou-Guenou and Duval begin with a review of short country papers submitted by selected government officials and experts prior to the Conference and discuss the implications for capacity-building in the Asia-Pacific region. Lastly, the conclusions and recommendations of the expert round table on capacity-building needs for harmonized development of e-commerce legal and regulatory systems in Asia-Pacific, held during the last day of the Conference, suggest that, given the diversity of the region in terms of national economic and legal system development, a "harmonized development" strategy consisting in promoting grass- roots awareness and regional training of e-commerce legal professionals may constitute a more realistic and effective means of effecting harmonization and trade facilitation than a top-down strategy focusing on the harmonization of legal texts. Such training and capacity-building should be developed and delivered in a coordinated manner by relevant international organizations in cooperation with existing national legal training institutions throughout the region. A detailed regional capacity-building framework is proposed, to be implemented jointly by interested stakeholders.

The publication and related materials are available online at:

<http://www.unescap.org/tid/projects/ecom.asp>

GUIDELINES FOR AUTHORS

Articles should present issues and findings in an analytical yet non-technical manner. The *Review* emphasizes policy relevance and operational aspects of trade and investment, rather than theoretical and methodological issues.

Articles submitted to the journal should be original contributions and should not be under consideration by any other publication. Articles will be subject to refereeing, and efforts will be made to send reviewers' comments to authors within four weeks of submission.

Articles should be submitted in English. Each article should be between 4,000 and 7,000 words in length and should be accompanied by an executive summary of 400 to 450 words. Articles are expected to be clear, concise and easy to follow. The use of headings and subheadings is encouraged in order to provide the paper with structure.

Manuscripts must be typed double-spaced according to the following format:

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   Loungani, P., 2001. "How beneficial is foreign direct investment for developing countries?", *Finance and Development*, vol. 38, No. 2., pp. 1-21

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