



ECONOMIC INTEGRATION IN THE “HEART OF ASIA”: South Asia-Central Asia linkages

Ram Upendra Das
July 2013

July 1, 2013

Disclaimer: The views expressed in this Development Paper are those of the author(s) and should not necessarily be considered as reflecting the view or carrying the endorsement of the United Nations. Development Papers describe research in progress by the author(s) and are published to elicit comments and to further debate. This publication has been issued without formal editing.

For any further details, please contact:

Dr. Nagesh Kumar, Director
South and South-West Asia Office (SSWA)
Economic and Social Commission for Asia and the Pacific (ESCAP)
C-2 Qutab Institutional Area, New Delhi-110016, India
Email: sswa.escap@un.org

Foreword

The Development Papers Series of the ESCAP South and South-West Asia Office (ESCAP-SSWA) promotes and disseminates policy-relevant research on the development challenges facing South and South-West Asia. It features policy research conducted by ESCAP-SSWA and by outside experts from within the subregion and beyond. The objective is to foster an informed debate on policy challenges facing the subregion and to share development experiences and good practices.

This paper was prepared for ESCAP-SSWA by Dr. Ram Upendra Das, Senior Research Fellow, Research and Information System for Developing Countries (RIS).

The paper explores the potential and challenges to regional economic integration in the 'Heart of Asia', defined to include Afghanistan and neighbouring countries in Central and South Asia. The paper shows that the macroeconomic contexts of the two subregions are highly amenable to integration across a range of areas, especially through strengthening trade and investment linkages and that regional trade integration is a key opportunity for both subregions to foster synergy for mutual benefit, although many bottlenecks exist. It shows that Central Asian and South Asian integration would also greatly facilitate complementary export growth between the two subregions.

The paper puts forward three key recommendations for moving forward and enhancing integration between the two subregions: Greater trade integration through WTO accession and a Central Asia-South Asia FTA/CEPA; greater connectivity in transport, communications, infrastructure; and finally specific initiatives in targeted sectors such as banking and energy cooperation.

We hope that this paper will contribute to expanding the dialogue on the issue of regional economic integration which can provide huge potential benefits to South and South-West Asia for inclusive and sustainable development.

Nagesh Kumar
Director, ESCAP South and South-West Asia Office
and Chief Economist, ESCAP

Economic Integration in ‘Heart of Asia’

Focusing on South Asia-Central Asia Economic Linkages

Ram Upendra Das*

June 2013

*Dr. Ram Upendra Das is Professor and Senior Fellow at the Research and Information System for Developing Countries (RIS), New Delhi (Email: upendra900@gmail.com). This paper draws and builds upon another paper by the author entitled ‘Regional Economic Integration in Central Asia’ prepared for the UNESCAP and presented at the 2012 SPECA in Bangkok. The author gratefully acknowledges the discussions with Nagesh Kumar on the subject. Valuable comments received from two anonymous referees are also acknowledged as much as those of Matthew Hammill. Thanks are also due to Elvira, Anup and Sujata for their assistance. Usual disclaimer applies.

I. Background

One of the successful ways in which different regions in the world have tried to step-up their economic growth and development trajectories is through regional cooperation and integration. The economics of regional economic integration in the realms of trade, including both goods and services, and investments have unleashed dynamic paths of growth and development, as the experiences of various parts of the world suggest. The economics of neighbourhood and regional integration assume greater importance in regions that are particularly land-locked.

However, the regional economic integration process has thus far completely bypassed Central Asia-South Asia economic interactions. This is when both these regions need to integrate to address their developmental challenges and when both regions are quite amenable to regional economic integration. This assumes special importance in the context of what has come to be known since the Istanbul process as the *Heart of Asia* initiative. The term 'Heart of Asia' countries refers to Afghanistan and Afghanistan's near and extended neighbours, and does not denote a new geographical entity; wherein Afghanistan's crucial role is recognized as the land-bridge connecting South Asia, Central Asia, Eurasia/Europe and the Middle East.

Historically, the Central Asian region comprising Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan has literally been a crossroads for the movement of people, goods, capital and ideas across Europe on one hand and the East Asian region, on the other - via West Asia and South Asia. Central Asia has been at the centre of the well-known historic trade and transport network called the *Silk Route*.

Today, the Central Asian region is once again at a cross-road. It is independent and enormously endowed with natural, mineral and human resources but has fallen short of unlocking its true economic growth and development potential. However, this is not to deny that individual economies have shown different patterns. For instance, Kazakhstan has been doing better than Tajikistan or Kyrgyzstan.

The Central Asian region, given its typology and geography, appears quite amenable to regional integration; and its land-lockedness and locational advantages make it an ideal candidate for deeper regional economic integration. Despite its potential, the Central Asian region has so far not been able to undertake any regional integration initiatives that have had significant or lasting impacts either within the region or beyond, with other parts of the Asia-Pacific. The available studies and existing policy responses focusing this aspect have been far from satisfactory and have largely remained ineffective towards achieving the objectives of regional economic integration in Central Asia.

On the other hand, the South Asian region is still grappling with major developmental challenges such as poverty reduction, social development, energy security, and infrastructure development. Half its countries are Least Developed Countries (LDCs) and three are land-locked. The region also has a history of political turmoil that still impacts current political positions regarding development and integration processes.

Given the rich natural and human resource availability industrial base, services sector dynamism and macroeconomic resilience, the South Asian region offers complementary economic structures that are quite conducive for South Asia – Central Asia economic integration.

Whether this is possible or not is a question which is addressed in this paper, a question which has not received adequate attention by the existing literature. In doing so, this paper presents a brief profile of Central Asia in Section II and of South Asia in Section III. The present state of policy level interactions is assessed in Section IV and the potential for economic cooperation is analyzed in Section V. Some of the major constraints for greater Central and South Asian economic integration are presented in Section VI. Broad conclusions and policy recommendations are presented in Section VII.

II. Central Asia: A Brief Profile¹

It is observed that the Central Asian Republics (CARs) have tremendous scope for development through high saving and investment rates as well as through greater trade and FDI integration. This would be quite ably supported by reasonably good social indicators pertaining to health and education. The only worrying factor is high rates of inflation in the CARs. The macroeconomic context of the CARs suggests that these economies are quite amenable to regional economic integration that can help achieve their growth and developmental objectives. This effort would be further facilitated by through the availability of energy resources in these countries whereby generation and trade in energy would be possible with enormous developmental implications.

The trade structures of the CARs provide three important broad insights that impact CAR integration; a production-trade mismatch; a less diversified manufacturing base and adverse terms of trade due to the fact that exports are mainly consist of primary products whereas imports are largely in manufactured products.

The CARs have launched various initiatives of regional economic integration. These have entailed both bilateral as well as regional trade and economic cooperation initiatives, both within and outside the region. But a glaring absence is of a region-wide free trade agreement (FTA) among CARs.

The intra-Central Asia exports and imports as a proportion of total Central Asian exports and imports to world have been rather low at 4.7 and 5.6 per cent, respectively in 2010. An absence of a trade and economic cooperation agreement in CARs has, among other impacts, constrained regional trade integration. However, a key question is whether the low and weak intra-Central Asia trade links are due to a lack of trade complementarity or are constrained by other factors that deny the region the opportunity to tap its intra-trade potential.

The possible lack of complementarity for intra-Central Asia trade was tested firstly, with the help of the Cosine index of trade complementarities and secondly, with the help of an augmented gravity model approach through which trade potential for the intra-Central Asian trade was estimated, based on results obtained for each bilateral country-pair of the Central Asia region. This was further supplemented by the identification of items with trade potential among the Central Asian economies. These were done at SITC² 3-digit level disaggregation with the help of Revealed Comparative Advantage (RCA) Index, dynamic RCA and Intra-Industry Trade (IIT). These are further supplemented by assessing welfare and trade gains due to tariff liberalization under a proposed CAR FTA with trade facilitation measures estimated within a computable general equilibrium (CGE) framework.

The empirical estimations suggest the presence of trade complementarities among the CARs (see Das 2012, Table 1). The Cosine Index shows that country pairs with maximum potential for trade complementarities expressed as exports from one country to another are Kyrgyzstan-Kazakhstan, Kyrgyzstan-Tajikistan, Turkmenistan-Kyrgyzstan, Kazakhstan-Uzbekistan, and Turkmenistan-Kyrgyzstan.

The analysis based on an augmented gravity model also suggested that each of the bilateral pairs of the CARs displays enormous trade potential in future.³ Some pairs that show very high export potential to their respective partners at the three points of times chosen, i.e. 2020, 2025 and 2030 include Kazakhstan-Uzbekistan, Tajikistan-Turkmenistan, Turkmenistan-Kyrgyzstan, Uzbekistan-Kazakhstan and Tajikistan-Kyrgyzstan. It is also important to highlight that many of these pairs where very high potential for intra-Central Asia trade exists are in conformity with the results obtained with the help of the Cosine Index.

¹ This section is based on Das (2012).

² SITC – Standard International Trade Classification, UNCTAD

³ See Appendix I for details of the augmented gravity model methodology.

Convinced about the presence of trade complementarities, the gains from trade integration could be realized by implementing an FTA. To assess the effects of an FTA, CGE model simulations were conducted based on the latest GTAP 8 database released in 2012.⁴ The simulated potential welfare and trade gains of an FTA among the CARs were presented in a scenario of full tariff liberalization coupled with trade facilitation. Under this scenario, the welfare gains accruing to the CARs total 0.35 per cent of their GDP. The regional exports would be expected to rise by more than 1000 per cent. These are impressive and positive results, given that these gains are based on a static scenario and gains in a dynamic scenario would be expected to be far higher. Some sectors that show meaningful gains in terms of their intra-CARs exports include processed food, light manufacturing, mining and extraction and heavy manufacturing among others.

Having ascertained the presence of trade complementarities and potential gains for trade integration, including through an FTA among CARs, further analysis was undertaken to identify items, sectors or product groups where trade complementarities could be tapped. Firstly, based on the RCA there are a range of sectors wherein rich export potential exists from one Central Asian economy to another. This includes primary products, minerals and manufactured products from industries such as paper and paper board, iron and steel, electrical machinery, motor vehicle, clothing and other sectors. These sectors were consistent with the results obtained from the CGE simulation. Secondly, juxtaposing the observation on trade potential based on RCA index on the concept of dynamic comparative advantage, between 1995-2010, it was found that there are products at SITC 3- digit level for each country where there has been a gain in comparative advantage and another partner country lost its advantage over the same period under consideration in the same line of production or sector. These results illustrate the potential for exports from the sector-country which has gained comparative advantage directed to the sector-country which has lost comparative advantage over time. This also assists in identifying sectors and countries with trade complementarities in a dynamic setting. Such sectors include fruits and nuts (excluding oil nuts), fresh or dried; petroleum oils, oils from bitumin materials, crude; aluminum; copper; gold, non-monetary (excluding gold ores and concentrates); iron & steel bars, rods, angles, shapes & sections; textile yarn; other industrial machinery and parts; men's clothing of textile fabrics, not knitted; motor vehicles for the transport of persons; and others.

Thirdly, it is important to highlight that trade complementarities are not restricted to dissimilar trade and production structures. The concept of intra-industry trade explains that countries can trade in the same line of production. For each CAR, such items are identified and results show that many new products can be categorized as potentially tradeable items or sectors among CARs as compared to the analysis based on RCA.⁵ These include vegetables, oil seeds, crude fertilizers, inorganic chemicals, jewellery, polymers of ethylene, dyeing and tanning extracts, electrical circuits, non-alcoholic beverages, heating and cooling equipment, coffee and coffee substitutes, perfumery, cosmetics or toilet preparations, manufacturing of leathers, ferrous waste, aircraft and associated equipment, glassware and television receivers.

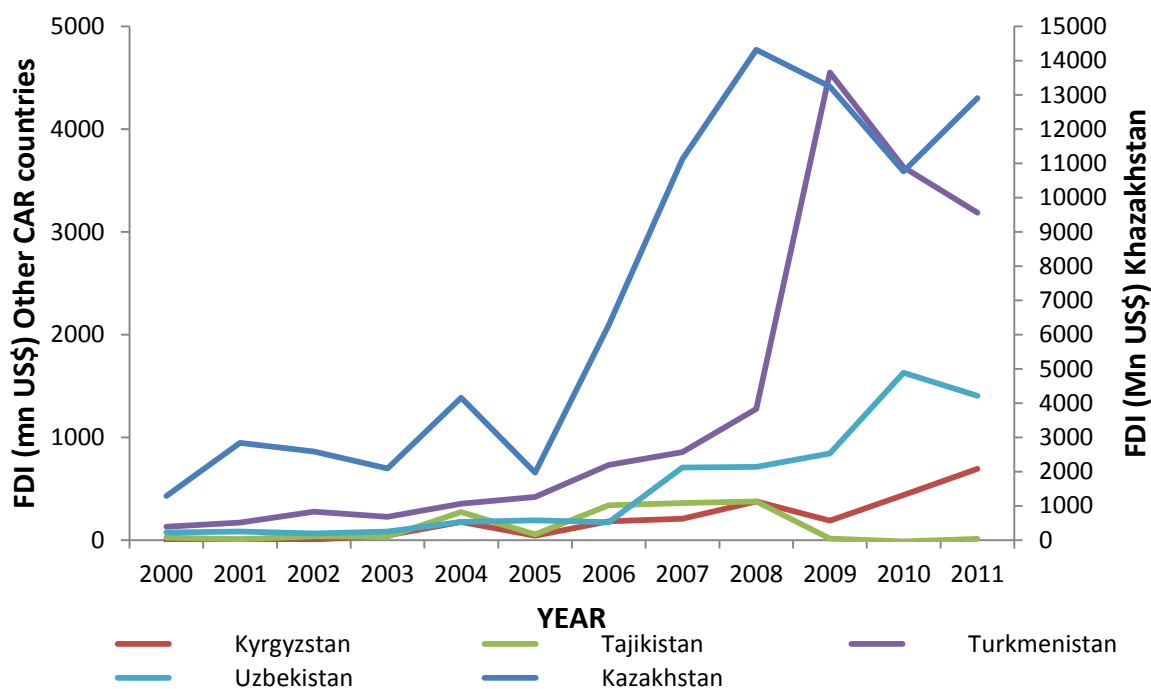
Having explored the potential for trade integration within Central Asia, this study further focuses on the broad trends in FDI inflows in the CARs and some of the specific FDI projects related to them, taking these as the basis for charting a course for Central Asian Investment Integration. Between 2000 and 2011, there are three noticeable features pertaining to the dynamics of FDI inflows in the Central Asian region. Firstly, different Central Asian Economies display asymmetric characteristics in terms of being recipients of FDI inflows (see Figure 1). Over the period, Kazakhstan FDI inflows have risen steeply from around US\$ 2 billion in 2000 to around US\$ 13 billion in 2011. On the other hand countries like Tajikistan and Kyrgyzstan have remained much weaker hosts of FDI with their FDI inflows still hovering around US\$1-2 billion. Secondly, it also shows that except for Kazakhstan and Turkmenistan, other CARs have remained relatively unattractive destinations for global FDI inflows.

⁴ GTAP (2012), *Global Trade Analysis Project 8 Database*.

⁵ Das (2012)

The dynamism of FDI inflows differs in different CARs (see Chart II). Since the volatility in FDI inflow on yearly basis was not clear in Chart I, we have plotted the log values of FDI inflows to the CARs as presented in Chart II. Quite clearly the trends suggest that in most of the CARs FDI inflows have been rather volatile.

Figure 1: Dynamics of FDI Inflows in Central Asia (2000-2011)



Source: Based on FDI annual flows data of UNCTADstat

However, more recently in 2011, the CARs have emerged as important hosts of FDI inflows among the transition economies and landlocked developing economies.⁶ Kazakhstan and Kyrgyzstan have also emerged as a source for outward FDI flows in 2011, however, only in relative terms in the comity of transition and landlocked developing economies.

It is interesting to note that the CARs feature quite prominently amongst the largest greenfield projects in landlocked developing countries in 2011, with Uzbekistan leading and followed by Kazakhstan and Turkmenistan. In terms of number of projects Kazakhstan leads with three projects followed by Uzbekistan and Turkmenistan with two each. In terms of the investment size of the projects Uzbekistan has attracted around US\$ 5 billion worth FDI whereas Kazakhstan has been able to attract three projects worth US\$ 4 billion. What also comes out clearly that the measure sources of these Greenfield projects in the CARs are primarily from countries like Russia, UK, Singapore, Canada and China. South Asia is conspicuous by its absence.⁷

Strengthening of trade-investment linkages is a pre-requisite for achieving effective regional economic integration, an aspect often neglected in FTAs, more so in the context of the CARs. The real gains from an FTA result from efficiency-seeking industrial restructuring, which also builds productive supply capacities in relatively lesser-developed economies. This is particularly important in the context of empirical findings that countries participating in regional trading blocs attract export-oriented production.⁸ In this context, in a dynamic scenario, vertical integration and horizontal specialization could be a focus with the help of cross-country investment flows that strengthen trade-

⁶ UNCTAD (2012) *World Investment Report*

⁷ UNCTAD (2012) *World Investment Report*

⁸ Kumar (1998)

investment linkages. This may essentially mean distribution of different stages of production in a particular industry regionally in an integrated manner such as in the vertical integration and specialization in the same stage of production with the help of product differentiation across the region, that is, the horizontal specialization. Vertical integration and horizontal specialization would be imperatives of investment cooperation within the ambit of the intra-Central Asia investment integration as well as between Central and South Asian economic integration process.

Studies have shown that the processes of vertical integration and horizontal specialization in many cases have been largely confined to sectors such as fruit processing, cotton and power generation. Based on the industrial structure and the service sector economies in the CARs as well as the analysis pertaining to identification of sectors and products for future trade integration, there are various potential opportunities for FDI integration to scale up the initiative pertaining to vertical integration and horizontal specialization, including those between Central and South Asia. Some of the sectors amenable for such endeavors would include dairy sector, sugar, fruits and vegetables, textiles and apparels, chemicals, automobiles, electronics, among others.⁹

Based on a significant body of existing literature and a close study of the Central Asian economies some of the sectors that can be identified for trade in services integration, including with South Asia may include Telecom and Information Technology; Professional Services; Construction and Related Engineering Services; Educational Services; Environmental Services; Health-related Services; Tourism and Travel -related Services; and Audio-Visual Services.¹⁰

III. South Asia: A Brief Profile

Unlike Central Asia, the South Asia region has had some experience with intra-regional economic integration processes. The South Asian Association for Regional Cooperation (SAARC) came into being when its Charter was formally adopted by its seven members on 8 December 1985. In the quarter century of its existence, SAARC has come a long way in shaping regional economic and development cooperation projects, and overcome various multi-faceted challenges. But the implementation of various flagship regional cooperation projects like the South Asia Free Trade Agreement (SAFTA) Treaty, the South Asian University, the SAARC Development Fund and the SAARC Food Bank are clear indicators of SAARC's emergence as an economic grouping.

The South Asian region has moved ahead in broadening the scope of trade cooperation in recent times, especially with the implementation of the SAFTA Treaty. Besides tariff reduction commitments, SAARC countries have also taken a number of initiatives which include, inter alia, reducing the items on sensitive lists, tackling non-tariff barriers (NTBs), enhancing customs cooperation, harmonization of standards and granting special and differential treatment to the LDCs. To realize the full potential of trade in services in the region, the SAARC Agreement on Trade in Services has now been signed (Thimpu, 2010), subsequent to a detailed regional study (Kumar, Das and De, 2008) on the subject. The negotiations for implementation are on-going and are expected to be completed soon.

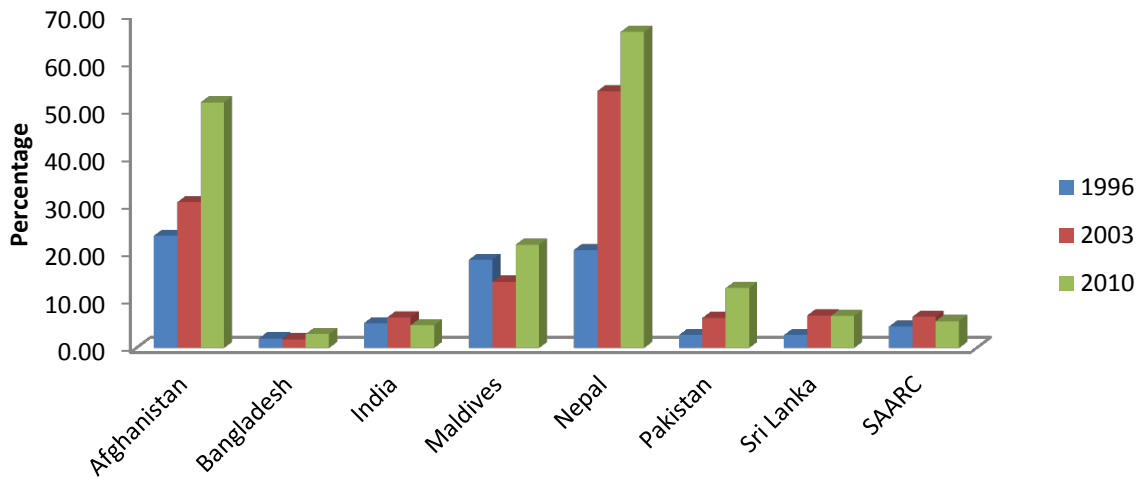
Intra-regional trade in South Asia has begun to grow and has doubled in absolute terms in recent years. The South Asian region has also remained attractive to individual South Asian countries as an export destination vis-à-vis the rest of the world. As evident from Figure 2, the share of intra-South Asia exports in total exports to world in 2010 was 66 percent in the case of Nepal, 51 percent for Afghanistan, 12 percent for Pakistan, 21 percent for Maldives and 7 percent for Sri Lanka, far above 6 percent for the South Asian region as a whole.

Similar figures in terms of South Asia's importance as an import source (Figure 3) are Nepal (56 percent), Afghanistan (31 percent), Sri Lanka (21 percent), Maldives (14 percent) and Bangladesh (14 percent).

⁹ Das (2012)

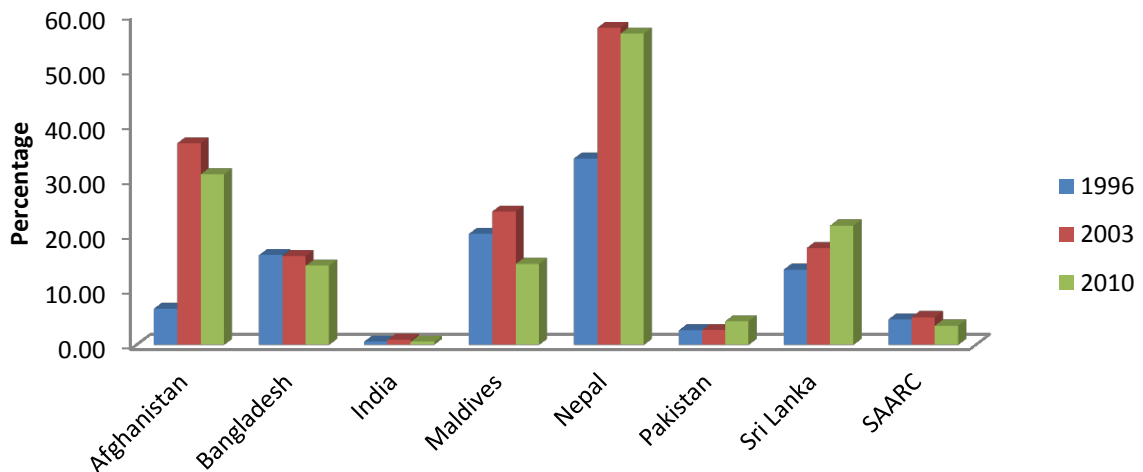
¹⁰ Das(2012)

Figure 2 Intra-SAARC exports (as percentage of total exports)



Source: Calculated from IMF, *Direction of Trade Statistics*, 2012.

Figure 3 Intra-SAARC imports (as a percentage of total imports)



Source: Calculated from IMF, *Direction of Trade Statistics*, 2012.

It is time that the region takes adequate cognizance of the economics of neighbourhood just as different regions across the world have adopted the strategy of regional economic integration to exploit their synergies for mutual benefit in a balanced and equitable manner. South Asia has emerged as one of the fastest growing regions in the world with an average rate of growth of 8 per cent sustained over the past five years with some recent declines posted due to global economic crisis. The region’s macroeconomic resilience is widely acknowledged in the wake of the crisis. With the help of various national and regional cooperation initiatives the region is also focusing on improving access to education, health, nutrition and basic amenities like safe drinking water and sanitation as the region faces development challenges. In this process, the countries of the South Asian region are committed to achieving inclusive growth and ensuring energy security. To sustain its dynamism, the region has to mobilize resources for development of physical and social infrastructure and focus on human development.

These challenges are of such a magnitude that national level policy initiatives may be necessary but not sufficient to address them. Realising this and quite often on account of shared history, cultural and linguistic similarities the world over, countries have embarked upon regional economic integration schemes. The South Asian region is no exception. Furthermore, the deepening of regional economic integration would assist the region to consolidate and sustain its dynamism and attack the menace of poverty more effectively besides strengthening the region's place in the international division of labour and in the emerging broader regional architecture in Asia.

A beginning needs to be made from economic complementarities for economic integration. It may be argued as to why the South Asian trade integration needs to be pursued with a greater degree of conviction as trade complementarities exist in both trade in goods and services. There can be various ways of assessing the existence or a lack of trade complementarities, especially in the South Asian region. Firstly, the fact that products are being exported by a country to the rest of the world but not to another country in the region, despite the fact that the same product is being imported by the latter from the rest of the world but not by the former, elucidates the existence of trade complementarities. Secondly, the South Asian region is characterized by informal trade flows that do not get recorded and do not get reflected in official statistics. This is nothing but a manifestation of 'natural trade complementarities' not only existing in the region but also being tapped. Thirdly, similarity in production structures in the region across countries could also offer opportunities for intra-industry trade which is taking place globally as well as in the region. These together help in arguing that the region has trade complementarities and innovative policy mechanisms are needed to tap them and further augment intra-South Asian trade.

The scope of trade in goods complementarities get widened if the constraint of similarity in production structures among the South Asian countries is converted into an opportunity by focusing on intra-industry trade. There are various sectors amenable to this kind of trade such as processed food, rubber products, plastics, pharmaceuticals, textiles, apparel, and light engineering goods. Augmenting intra-industry trade could be made possible by helping countries in reaping economies of scale, undertaking product differentiation – based on different raw materials, skills and technology – and creating industrial clusters. These sectors also need attention in terms of regional value chains.

In turn, this would help creating export supply capacities if investment that enhances intra-industry trade is facilitated. This is particularly important in the South Asian context as a set of trade barriers acts as a limiting factors on intra-regional trade at least as much as a lack of trade capabilities. Imports get limited due to limitation on the size of the importing country-market, whereas exports face a supply-capacity constraint. Strengthening trade-investment linkages in the realm of intra-industry trade thus assumes a greater importance. Efforts geared towards intra-regional intra-industry trade with the help of investment cooperation hence hold the key in South Asia as such a measure would help relieve both the size of the market constraint as well as export supply constraint.

Having studied the broad characteristics of the Central Asian and South Asian economies, it is important to assess the existing policy mechanisms for their economic integration, as by doing so it would be possible to get insights into the possible way forward in terms of Central- South Asian economic integration.

IV. Existing Policy Mechanisms for Cooperation between Central and South Asia

A closer study of the existing policy mechanism to promote economic integration between the Central and South Asian region suggests that a lot more needs to be done. One of the only existing important initiatives is that of the United Nations in the form of the United Nations Special Programme for the Economies of Central Asia (SPECA) jointly handled by the United Nations ESCAP and UNECE. This was launched in 1998 to strengthen cooperation in Central Asia and its integration with the global economy.

The 2012 SPECA Economic Forum was held in conjunction with the seventh session of the SPECA Governing Council in Bangkok on 27 and 28 November, 2012. The Economic Forum brought

together high-level representatives of SPECA member countries, observer countries, United Nations agencies, programmes and missions, international and regional organizations, multilateral financial institutions as well as the academic community and the private sector (Box I).

Box I: 2012 SPECA Economic Forum “Strengthening Regional Economic Cooperation and Integration in Central Asia by Sharing the Asian Experience”

Broad Conclusions

The 2012 SPECA Economic Forum was held on 27 and 28 November 2012 in Bangkok under the title “Strengthening Regional Economic Cooperation and Integration in Central Asia by Sharing the Asian Experience”. The meeting built on the work accomplished by two previous SPECA Economic Forums: the 2007 Economic Forum in Berlin which reviewed the European experience of regional economic cooperation and integration and the 2008 Economic Forum in Moscow, which discussed the experience of Eurasian economic cooperation and integration.

In his opening statement, the representative of Turkmenistan, the present Chair country of SPECA, expressed full support of his Government to all activities in this important regional framework, in particular to efforts to ensure the safe delivery of energy resources to world markets. The Executive Secretary of UNECE underlined the importance of careful study of Asian best practices in the field of regional economic cooperation and integration as well as increased attention to regional aspects of the post-2015 development agenda and implementation of the Rio+20 priorities.

The Executive Secretary of ESCAP pointed to the growing strategic importance of the Central Asian region. She called for a greater role of SPECA in promoting economic cooperation and integration processes in the Asia-Pacific region, which are far from being complete. The representatives of SPECA participating countries outlined those areas of regional economic cooperation which are considered to be a priority for their Governments. While describing the impressive economic progress by their countries they pointed to the role of regional economic cooperation in accelerating this progress and making it sustainable.

The Economic Forum heard keynote statements on Asian regional cooperation and integration processes, in particular the experiences of SAARC and APEC and also on evolving integration in the framework of the Euro-Asian Economic Commission and on activities of the Eurasian Development Bank. The presentations on Eurasian economic integration not only emphasized the successes of this process but also its open nature. Participants highlighted the relevance of the Asian experience for Central Asia and emphasized the need to develop closer cooperation among regional organizations and arrangements, which could play a key role in improving intraregional connectivity in the broader Asia-Pacific region. A particularly important aspect of regional cooperation and integration – its role in strengthening the stability and security of the region – was highlighted during the third session of the Economic Forum. The particular role of strengthened economic cooperation between Afghanistan and its Central Asian neighbours for the success of the “transition decade” in Afghanistan was emphasized by the speakers.

Representatives of international financial institutions presented their views on regional economic cooperation and integration in Central Asia. The representative of ADB introduced the CAREC strategy till 2020 and described the main directions of CAREC activities in the field of trade, transport and energy as well as activities of the CAREC Institute. The representative of the International Monetary Fund presented a detailed analysis of economic processes in Central Asia, comparing them with similar processes in other regions of the world. He highlighted the contradiction between the impressive economic growth of the countries of the region and the modest gains in intraregional trade and investment. The presentation by the representative of the UNDP focused on two global initiatives, the work on the post-2015 development agenda and the initiative of the United Nations Secretary-General on sustainable energy for all. She called on SPECA to catalyze efforts to better integrate the needs and priorities of the Central Asian region into the post-2015 development agenda and the implementation of other initiatives.

The Economic Forum heard in depth analyses by two distinguished researchers on regional cooperation and integration processes in Central Asia, highlighting the potential benefits of strengthened regional cooperation for the sustainability of economic growth of these countries and the much-needed diversification of their economies. The concluding session of the Economic Forum focused on the role of regional economic cooperation in the successful achievement of UN development goals and in the implementation of priorities set by UN summits. Participants heard convincing arguments in favour of better integration of the special needs and priorities of SPECA countries in the post-2015 development agenda. Regional cooperation would help SPECA countries to implement the Rio+20 priorities too. A more intensive discussion of regional aspects of these issues within the SPECA framework was supported by participants. The 2012 SPECA Economic Forum continued the tradition of previous such meetings of discussing strategic issues of regional economic cooperation in Central Asia. I would like to thank ESCAP and UNECE for the preparation of this important event, thank our speakers for their excellent presentation and thank the representatives of SPECA countries for their active participation in these discussions. I trust that they return to their capitals with a wealth of ideas that will further enrich and facilitate the joint thinking of SPECA countries on key issues of regional economic cooperation and integration in Central Asia.

Source: Excerpted from the Report of 2012 SPECA Economic Forum, Bangkok, Thailand, 27-28 November 2012

SPECA is doing a commendable job as a sole crusader to integrate the Central Asia economies. In 2012 SPECA made important progress in terms of deepening economic integration in Central Asia as

well as trying to allow Central Asian regions to economically integrate with some parts of South Asia, although not in a comprehensive way. In this regard, it provides a useful framework and forum for information sharing, generating well-informed debate on developmental issues at a high level. It also tries to draw upon the best practices elsewhere. Its focus on Afghanistan to connect with its extended neighbourhood also deserves special mention as much as its dialogue with major funding agencies across the globe. However, while the forum is so very important, it is time that it moves towards actual implementation of various projects. SPECA needs to be viewed in conjunction with the 'Heart of Asia' initiative, yet another remarkable move but still not acknowledged in the mainstream discussion on related subjects (see Box II).

Box II: HEART OF ASIA' MINISTERIAL CONFERENCE – KABUL (2012)

Confidence Building Measures (CBMs) on Economic and Social Issues

We, the Foreign Ministers of the 'Heart of Asia' countries, joined in Kabul by ministers and senior representatives of supporting countries and regional and international organisations;

Reaffirming our commitment to the principles stipulated in the *Istanbul Process on Regional Security and Cooperation for a Secure and Stable Afghanistan* document;

Agreeing that the Istanbul Process provides a new agenda for regional cooperation in the 'Heart of Asia' by placing Afghanistan at its centre and engaging the 'Heart of Asia' countries in sincere and result-oriented cooperation for a peaceful and stable Afghanistan, as well as a secure and prosperous region as a whole;

Clarifying that the term 'Heart of Asia' countries refers to Afghanistan and Afghanistan's near and extended neighbours, and that it does not denote a new geographical entity;

Taking note of Afghanistan's crucial role as the land-bridge in the 'Heart of Asia', connecting South Asia, Central Asia, Eurasia/Europe and the Middle East;

Welcoming the central and impartial role of the United Nations, in line with the Security Council resolutions, in support of regional cooperation, including the Istanbul Process;

Recognizing the important role of existing regional organisations, and *emphasizing* that the role of regional organisations should be supported in the interest of expanded economic cooperation and integration in the region, improved security and greater people-to-people relations, and *calling for* greater synergies to be created among these regional organisations;

Welcoming the successful conclusion of the 5th meeting of the Regional Economic Cooperation Conference on Afghanistan (RECCA V) held on 26-27 March 2012 in Dushanbe, and the valuable role of the Republic of Tajikistan in hosting this event, and *agreeing* that working towards implementation of the regional projects identified in the RECCA V Declaration will also be important steps towards greater confidence building in the region;

Welcoming the upcoming Tokyo Conference on Afghanistan to be held on 8 July 2012 at the invitation of the Governments of Japan and the Islamic Republic of Afghanistan, and *calling for* continued international support to Afghanistan's sustainable economic development during the Transformation Decade on the basis of mutual commitments between Afghanistan and the international community, and in this context, *appreciating* the initiative by the Republic of India to organise *the Delhi Investment Summit on Afghanistan*, a conference of regional and international investors focusing on Afghanistan, to be held on 28 June 2012 in New Delhi, and other such initiatives that could usefully contribute to the deliberations at the Tokyo Conference;

Hereby declare as follows:

Implementation of Confidence Building Measures (CBMs)

We emphasise the importance of comprehensive implementation of all the CBMs contained in the Istanbul Process document. However, recognizing the need for a sustained and incremental approach at this stage, we initially decide on the following CBMs for implementation, covering the areas of political and security, economic cooperation and education fields. With a view to implementation of the above CBMs, we welcome the following decisions by the Heart of Asia countries to participate in the implementation of specific CBMs and, in particular, take note of the willingness of countries to play a lead role in this process:

Chambers of Commerce CBM: Afghanistan, Azerbaijan, India, Iran, Kazakhstan, Kyrgyzstan, Pakistan, Russia, Tajikistan, Turkey and Turkmenistan decide to participate in implementation, and India expresses willingness to lead the CBM implementation. We also welcome the readiness of Germany, the United Kingdom, and the United States to support the implementation of this CBM;

Commercial Opportunities CBM: Afghanistan, Azerbaijan, India, Iran, Kyrgyzstan, Pakistan, Russia, Tajikistan, Turkey, and the United Arab Emirates decide to participate in the implementation, and India expresses willingness to lead the implementation of this CBM, in conjunction with the Chambers of Commerce CBM. We also welcome the readiness of Australia, Canada, the European Union, and the United States to support the implementation of this CBM;

Regional Infrastructure CBM: Afghanistan, Azerbaijan, India, Iran, Kazakhstan, Kyrgyzstan, Pakistan, Russia, Tajikistan, Turkey and Turkmenistan decide to participate in the implementation, and Turkmenistan and Azerbaijan express willingness to lead the CBM implementation. We also welcome the readiness of Germany and the United States to support the implementation of this CBM;

Education CBM: Afghanistan, Azerbaijan, India, Iran, Kazakhstan, Kyrgyzstan, Pakistan, Russia, Tajikistan, Turkey and Turkmenistan decide to participate in implementation, and Iran expresses willingness to lead the CBM implementation. We also welcome the readiness of Australia and the United States to support the implementation of this CBM.

Source: Excerpted from Kabul Conference Declaration 14 June 2012

The 'Heart of Asia' Ministerial Conference was convened on 14 June 2012 in Kabul, Afghanistan, as the first follow-up ministerial meeting of the Istanbul Process. The conference was attended by 14 ministerial and high-level delegations from the 'Heart of Asia' countries, 14 ministerial and high-level delegations from the supporting countries, and 11 high-level delegations from regional and international organisations. The Declaration included both economic and non-economic dimensions of cooperation. The concept of the *Heart of Asia* is very clearly explained in terms of Afghanistan's crucial role as the land-bridge in the 'Heart of Asia', connecting South Asia, Central Asia, Eurasia/Europe and the Middle East.

Assessing this process, firstly, it is important to highlight that the present status of cooperation incorporates few clear and comprehensive cooperation mechanisms between Central Asia and South Asia despite the wider definition of *Heart of Asia*. At best, the focus is on Afghanistan and her neighbours while the confidence-building measures (CBM) too do not exclusively focus on Central-South Asia cooperation. In this sense, the present study may help by filling an important gap in the existing initiatives. Secondly, India's role in the CBM on commercial linkages is acknowledged but that too falls short of any formalized and structured Central-South Asia economic cooperation initiatives. Thirdly, apart from United Nations agencies providing support to these processes, there are several other countries as stakeholders that have not really been active in the process, which gives an impression of diffused efforts. Fourth, while the role of regional organisations is outlined, apart from Afghanistan's membership in some of these organisations and somewhat relatively more active roles of the United Nations agencies, few institutionalised mechanisms have so far been developed. Fifth, while the existing efforts are noteworthy, they still lack in terms of concrete action and implementation 'plans'.

The third 'Heart of Asia' Ministerial Conference in the framework of the Istanbul Process, which was launched on 2 November 2011 in Istanbul, Turkey, took place on 26 April 2013 in Almaty, Kazakhstan. Again, the Conference was attended by 14 ministerial and high-level delegations from the 'Heart of Asia' countries, 16 ministerial and high-level delegations from supporting countries of the Istanbul Process, as well as 12 high-level delegations from international and regional organizations (Box III).

The 2013 Conference understandably emphasizes implementation, however yet again falls short of taking concrete measures. This may be due to three factors: (i) a wide-ranging broad and ambitious agenda (ii) absence of institutionalized implementation mechanisms and (iii) a lack of adequate funding. These factors also effectively deny the opportunity for a more concrete emphasis on Central-South Asia economic integration. While infrastructure projects have been identified, they have not taken off as yet in any meaningful manner. Similarly, while the role of regional organizations has been acknowledged; their exact roles remain undefined. The issue of creating a funding mechanism through launching a 'Trust Fund' is still at a stage of study and deliberations, however, in 2013 this issue was emphasized with a sense of urgency.

The next Ministerial Meeting of the Istanbul Process and the fourth Heart of Asia Ministerial Conference will be held in China in 2014 with a possibility of reconvening on the margins of the United Nations General Assembly in New York in September 2013.

Box III: HEART OF ASIA' MINISTERIAL CONFERENCE – ALMATY (2013)*Economic Cooperation Issues*

Our shared interests are best served by cooperation, rather than competition, in the 'Heart of Asia'. We will therefore use the **Istanbul Process** to build a common platform of shared regional interests, as well as a secure and prosperous 'Heart of Asia' region where Afghanistan has a crucial role as a land-bridge, connecting South Asia, Central Asia, Eurasia, and the Middle East.

Lack of infrastructure: The absence of infrastructure and established systems to underpin interaction, exchange and economic activity between and among regional countries poses a strategic impediment to the vision of connectivity in the region that the Istanbul Process promotes. To mitigate this problem, we reiterate our call for greater confidence building among countries of the region, and accelerated implementation of measures that would facilitate travel and harmonize trade and transit procedures, as well as other forms of legitimate interaction among countries. In particular, the timely implementation of large-scale infrastructure projects to facilitate trade and transit in energy and goods must be prioritized.

Afghanistan: We welcome Afghanistan's commitment to enhance its economic role at the regional level, including its potential to serve as a crossroads of trade and transit of goods, services, energy and people. In this context, we support the completion of infrastructure projects which connect Afghanistan with its neighbours and the surrounding region, including energy transit projects, transport projects, new railway and road networks, and border and customs cooperation and harmonization programs. As Afghanistan's economy normalizes and prospers, we also see significant opportunities for investment, notably in the areas of mining and natural resources, agriculture, and the services industry among others. The utilization of these opportunities will not only make Afghanistan's stability irreversible, but will also contribute to regional prosperity in general.

Role of Regional Organizations: We reiterate our understanding that the Istanbul Process does not substitute already existing formats for regional cooperation but rather seeks to add value by cooperating with them and complementing and bringing coherence to their work when necessary. The Istanbul Process can also contribute to enhancing cooperation through identifying and supporting existing initiatives of regional organizations, particularly those with relevance to Afghanistan. We welcome the strong commitment by all regional organizations to provide synergy with relevant international and regional organizations and fora in the process of implementation of our common goals. In this context, organizations such as the CAREC, CICA, CIS, CSTO, ECO, EEU, OIC, OSCE, RECCA, SAARC, SCO, UNSPECA, can play a valuable role.

Trade, Commerce and Investment Opportunities CBM (TCI-CBM): We welcome and adopt the implementation plan and thank the Republic of India for leading the TCI-CBM group, as well as the participating states of the CBM for actively supporting the development of the implementation plan. We welcome the plan's focus on highlighting Afghanistan's role in the context of the region's future prosperity, and encourage the activities envisaged in the plan aimed at highlighting the commercial and investment opportunities in today's Afghanistan; we strongly believe that promoting the involvement of regional countries in utilizing the opportunities in Afghanistan will contribute to greater regional cooperation and prosperity. In this context, we welcome initiatives like the Delhi Investment Summit of June, 2012 that seek to harness these opportunities for regional cooperation towards Afghanistan and the region's prosperity and stability. We welcome the efforts of Afghanistan to transform itself from an aid-based to a trade-driven economy and believe that capacity building of relevant Afghan institutions, including Chambers of Commerce, development and smooth functioning of trade and transit infrastructure linking Afghanistan to the rest of the region, and provision of better market access to Afghanistan would help the country to sustain its economy during the period of transition and the decade of transformation.

Source: Excerpts from Almaty Conference Declaration, 26 April 2013

Having assessed the existing policy mechanism that provide some opportunities to help integrate Central and South Asian regions it is important to highlight the magnitude and nature of potential for these regions to integrate, so that the need for a more concerted effort for economic integration between Central and South Asian region gets amplified.

V. Potential for Central Asia-South Asia Trade Integration

Using the gravity model approach an attempt was made to predict the potential for trade integration between the Central and South Asia regions. The results presented in Table 1 amply demonstrate that any FTA between the two regions would be not only trade-augmenting but also that trade cooperation between the two regions would yield much larger trade volumes and percentage increases on the current volume as compared to when central Asia adopts trade integration strongly only within the Central Asia region (Appendix I).

Table 1: Potential for Intra-Central Asia and Central-South Asia Trade Integration

| <i>X to</i> →/ <i>M from</i> ↓ | | | | | | |
|---|---|------|------|--------------------|------|-------|
| | VALUE (US\$ BN) | | | % CHANGE OVER 2010 | | |
| YEAR | 2020 | 2025 | 2030 | 2020 | 2025 | 2030 |
| | CENTRAL ASIA -CENTRAL ASIA | | | | | |
| Central Asia's Exports to Central Asia | 26 | 41 | 63 | 2470 | 4029 | 6161 |
| | CENTRAL ASIA -SOUTH ASIA | | | | | |
| Central Asia's Exports to South Asia | 6 | 9 | 12 | 545 | 787 | 1060 |
| South Asia's Exports to Central Asia | 7 | 11 | 17 | 2032 | 3423 | 5221 |
| | CENTRAL ASIA -CENTRAL ASIA and CENTRAL ASIA - SOUTH ASIA | | | | | |
| Central Asia's Trade with Central and South Asia Combined | 39 | 61 | 91 | 5147 | 8338 | 12542 |
| <i>Notes:</i> | | | | | | |
| Central Asia Export to Central Asia 2010 Billion \$ | | | | | | 2.35 |
| Central Asia Exports to South Asia 2010 Billion \$ | | | | | | 0.94 |
| South Asia's Exports to Central Asia 2010 Billion \$ | | | | | | 0.32 |
| Central Asia's Trade with Central and South Asia Combined 2010 Billion \$ | | | | | | 3.61 |

Source: Author's calculations.

Some interesting results of a possible FTA between Central Asia and South Asia countries are given in Table 2. These results are also under the scenario of full tariff liberalisation and trade facilitation (Appendix II). It may be noted that the welfare gains to the CARs would amount to 0.76 per cent of their GDP, in contrast to their welfare gains emanating just from an FTA among the CARs. South Asia too has positive welfare gains as a proportion of GDP; however, the value is far less. This can be explained on account of enormously high denominator of South Asia GDP, which is high due to India's GDP.

What is more, regional exports of CARs would rise by 187 per cent and South Asia regional exports would rise by 133 per cent in a static framework for the year 2010. These are substantive gains when the 'region' becomes as an integrated Central and South Asian region in terms of trade. Some of the sectors where exports' gains would lie for the CARs include some new sectors like Textiles and Clothing, Livestock and Meat products and services sectors alongside Processed Food, Light Manufacturing etc. It is evident that while the South Asian region would gain in sectors such as livestock and Meat Products, Processed Food, Textiles and Clothing, Heavy Manufacturing and services sectors, the gains for the Central Asian region is much higher than what was observed in the case of an FTA among CARs alone.

In sum, Central Asian FTA and the Central Asia-South Asian FTA both are welfare and trade inducing however, these gains is manifold in the case of the latter due to expanded scope for harnessing trade complementarities.

Table 2: Central Asian – South Asian FTA: Potential Welfare and Trade Gains

| Full Tariff Liberalization with Trade Facilitation | | | |
|--|---|-----------------|------------|
| S. No. | Dimensions of Gains | Extent of Gains | |
| | | Central Asia | South Asia |
| 1. | Welfare Gains (% of GDP) | 0.76 | 0.08 |
| 2. | Regional Exports Increase (%) | 187.25 | 133.28 |
| 3. | Regional Exports Increase by Sectors (%) | | |
| 3.1 | <i>Livestock and Meat Products</i> | 17.96 | 11.19 |
| 3.2 | <i>Mining and Extraction</i> | 19.86 | 9.99 |
| 3.3 | <i>Processed Food</i> | 42.92 | 21.34 |
| 3.4 | <i>Textiles and Clothing</i> | 19.46 | 17.57 |
| 3.5 | <i>Light Manufacturing</i> | 17.23 | 15.55 |
| 3.6 | <i>Heavy Manufacturing</i> | 10.36 | 26.01 |
| 3.7 | <i>Utilities and Construction</i> | 19.68 | 11.58 |
| 3.8 | <i>Transport and Communication</i> | 19.91 | 10.02 |
| 3.9 | <i>Other Services</i> | 19.87 | 10.03 |

Source: Author's CGE simulation results based on GTAP 8 database (2012).

VI. Investment Cooperation: Horizontal Specialization and Vertical Integration

As it was highlighted earlier, the strengthening of trade-investment linkages is a pre-requisite for achieving effective regional economic integration, an aspect often neglected in several FTAs more so in the context of the CARs, which was also highlighted earlier. This kind of linkage helps in improving export supply capabilities of the smaller countries and in the second round there are favorable trade effects. The real gains from an FTA result from efficiency-seeking industrial restructuring, which also builds productive capacities in relatively lesser-developed economies (Box IV). This is particularly important in the context of empirical findings that countries participating in regional trading blocs attract export-oriented production (Kumar, 1998).

The trade-investment linkages also run in both the directions. While a free trade agreement can spur investment flows in terms of efficiency-seeking regional restructuring, it is the trade-creating joint ventures that ultimately have a decisive impact on regional trade flows. The trade-creating joint ventures are in a position to take advantage of the regional freer trade agreement. In this context, in a dynamic scenario, vertical integration and horizontal specialization could be focused upon with the help of cross-country investment flows that strengthen trade-investment linkages. This may essentially mean distribution of different stages of production in a particular industry regionally in an integrated manner that is, vertical integration, and specialization in the same stage of production with the help of product differentiation across the region, that is, horizontal specialization (Das, 2004). This is the basis of the argument for the imperative of investment cooperation within the ambit of the intra-Central Asia investment integration as well as between Central and South Asian economic integration process.

A close study of the processes of vertical integration and horizontal specialization has shown that such initiatives have been largely confined to sectors such as fruit processing, cotton and power generation (See also Swinnen, 2005). Based on the industrial structure and the service sector economies in the CARs as well as the analysis pertaining to identification of sector/products for future trade integration both within CARs and with South Asia, it is easy to identify potential areas for FDI integration to scale up the initiative pertaining to vertical integration and horizontal specialization. Some of the sectors amenable for such endeavors would include the dairy sector, sugar, fruits and vegetables, textiles and apparels, chemicals, automobiles, electronics, among others.

Box IV: Efficiency-seeking Industrial Restructuring: Facilitating Product Mandate

Rationale

A number of quantitative studies conducted in inter-country contexts have also found strong association between membership in RTAs and FDI inflows. However, market extending (or enlargement) effect is only one and a relatively minor effect of RTAs. It is argued here that a more important effect of RTAs is strengthening of overall competitiveness of the region forming it through extensive industrial restructuring or rationalization across the region. This process of efficiency seeking industrial restructuring is accomplished by intra-regional FDI. The efficiency-seeking industrial restructuring is facilitated by liberalization of trade and investment regimes as a part of regional trading arrangements that enables free movement of goods across borders facilitating internal restructuring by removing the need to maintain horizontal national operations for multinational enterprises (MNEs). Therefore, MNEs restructure their operations by assigning the responsibility for serving specific regional or even global markets in particular product lines to certain affiliates. This strategy is sometimes called product mandating and results from the efficiency seeking restructuring or specialization within the MNE. The EU integration as also facilitated industrial restructuring of European businesses by adopting a statute of a European Company (*Societas Europaea*, S.E.) and through another legal instrument called the European Economic Cooperation Agreement (EECA). The latter is a form of cooperation between two or more firms which become a single body corporate with the aim of furthering the business activities of the participating firms.

Global Experiences

IBM has reorganized its operations in pan-European basis with IBM UK looking after PCs; IBM Germany, mainframe computers and manufacturing industry; IBM France, telecommunications, and IBM Italy, mid-range machines. Thus, this type of restructuring enables the enterprise to exploit the economies of scale and specialization. The location for specific product mandates is chosen on the basis of the advantages a particular country has for the particular activity. These could include factor availability and their prices, agglomeration economies and other locational advantages. Quantitative studies conducted in the inter-country contexts have also found strong evidence of the role of RTAs in shaping the patterns of export-oriented investments made by US and Japanese MNEs across countries to exploit the potential of efficiency-seeking industrial restructuring. The studies on the existing RTAs have shown that in the deeper type of integration, the biggest beneficiaries are relatively poorer or lesser developed economies because of migration of industry to them helping their economy converge with those of more developed ones. It is evident that poorest economies of EU, viz. Spain, Portugal, Greece and Ireland have rapidly converged with more developed economies of the region such as Germany, France or the UK. Although resource transfers have also played a role, investment restructuring (such as relocation of production to low wage locations within the EU) has played an important role bringing about this convergence. It is also clear that investment liberalization becomes a key to facilitate the process of industrial restructuring. The barriers to investment flows may not allow the full benefits to be reaped from the regional trade liberalization.

South Asian Experiences

India's emerging FTAs with Asian countries such as Sri Lanka, Thailand, Singapore, South Korea have already led to a significant trend of industrial restructuring. A typical example is an investment made by an Indian tyre company, CEAT to set up a large export-oriented tyre plant in Sri Lanka to cater to its growing markets in Pakistan, Middle East and other countries, taking advantage of abundant supply of natural rubber in the country. As a result of the growing trend of investments made by Indian companies to exploit the potential of the India-Sri Lanka FTA, India has emerged as the third largest source of FDI in Sri Lanka. UNCTAD's *World Investment Report 2003* has highlighted how Sri Lanka attracted Indian investments of US\$ 145 million in a very short period making India as the third largest source of investments for the island. Because of the investments in building supply capabilities in Sri Lanka facilitated by the India-Sri Lanka FTA, the trade deficit of Sri Lanka has come down to less than half. This success has prompted Sri Lanka to seek to expand the scope of the India-Sri Lanka FTA to cover investments and services in a comprehensive economic partnership agreement (CEPA). Similarly the India-Nepal trade and transit treaty giving unilateral duty free access to Nepali products to Indian market has also led to some industrial restructuring. For instance, Colgate-Palmolive India Ltd. (a subsidiary of Colgate-Palmolive, Inc.) has set up a venture with authorized capital of Rs 540 million in Nepal for production of 12000 tonnes of toothpaste per annum and tooth powder to feed their markets for the product in North India. As a result tooth paste exports from Nepal to India have grown from US\$ 11 million in 1997-98 to about US\$ 61 million in 1998/9, making tooth paste one of the most important item of Nepal's exports to India. Other companies like Hindustan Lever have followed suit. Dabur India, a domestic Indian group has invested in a fruit processing plant to produce and package fruit juices for the Indian market. Dabur's principal focus is ayurvedic and herbal medicinal preparations. It has also started using its Nepal venture for these preparations. Dabur Nepal was apparently contributing as much as 15 per cent of Nepal's exports to India. Presently all the fruit juices sold in North India are packaged at its Nepal plant. Kodak Nepal, a venture of Kodak India and Eastman Kodak, USA was planning to service the North Indian market from its Nepalese base. Subsequently however, this process of industrial restructuring between India and Nepal was disrupted because of the political turmoil in the country. It is expected that with the peace returning to Nepal with the revival of the democratic process, the process will be restored again.

Source: Kumar (2007)

VII. Constraints to Central –South Asian Economic Integration

There are significant barriers to trade and investment integration in Central Asia and between Central and South Asia pertaining to trade policy, connectivity, banking infrastructure etc. These barriers have been identified on the basis of secondary material available (see also RIS, 2005; Pomfret, 2006; ADB, 2006; EC, 2007; McGlinchey and Johnson, 2005, and European Investment Bank, 2012).

- (i) **Trade-related Barriers:** The more significant trade barriers pertaining to trade policy in the CARs include a complex tariff schedule and relatively high tariffs (Kazakhstan and Uzbekistan); escalation of tariffs (all the CARs); frequent and unpredictable changes in the tariff schedule (Kazakhstan, Tajikistan, and Uzbekistan); high implicit tariffs in the form of taxes that are levied on imported goods but not on domestically produced goods or have higher rates for imported goods than for domestically produced goods (Kazakhstan, and Uzbekistan); explicit export taxes (Kazakhstan); and prohibition and licensing of exports and imports of certain commodities (all the CARs). Uzbekistan appears to continue using restrictions on access to foreign exchange in regulating imports and imposes relatively tight restrictions on cross border movements of people and transport equipment in an apparent effort to restrict imports from neighbouring countries. Similar observations could be made in South Asia with respect to countries like India, Pakistan, Sri Lanka, especially in the realm of non-tariff barriers.
- (ii) **Trade Facilitation and Procedural Bottlenecks:** Trade facilitating customs procedures and rules are at differing levels of evolution in the CARs and South Asia and they lack harmonization across countries, acting as a major bottleneck for intra- and extra-regional trade linkages. These not only include customs valuation and definitional issues but also procedural delays, complex documentation and inefficient clearances.
- (iii) **Accession to WTO:** A lack of WTO membership for the four non-member states of CARs, except Kyrgyzstan is a significant constraint on trade flows as WTO-consistency in various rules makes trade regimes more harmonized and streamlined.
- (iv) **Connectivity:** Other significant barriers to trade in Central Asia and between Central and South Asia are high transport costs and long and unpredictable transport delays for international shipments. This is not only because of the landlocked and remote location of the CARs and their difficult topography, but also due to deficiencies of their transport networks, high costs and low quality of transport and logistics services in the region, and difficulties with movements of goods and transport equipment across borders and through the territories of the CARs and neighbouring countries. This is also true of South Asian countries. Air connectivity is yet another area which constrains trade and investment linkages restricting business-to-business contacts, educational services, health services, tourism linkages etc. This is particularly true of the linkages between the Central and South Asian regions. Telecommunications linkages also at times act as constraint, especially vis-a-vis South Asia. It has been found that internet regulatory policy varies across the CARs acting as a major constraint in smooth electronic connectivity, so very vital for intra and extra-regional trade and investment linkages.
- (v) **Banking Infrastructure:** The importance of the banking sector for trade and investment integration at the regional and inter-regional levels economic growth and development cannot be overemphasized. The Central Asian region has been making transition from the erstwhile Soviet-era to a more market –based economic and banking system. In the CARs, the under-provision of banking services in many areas is constraining development of the private sector and in particular small and medium-sized enterprises and this has remained an area of concern for augmenting trade and investment both within the region and outside. Managing credit quality, de-leveraging and developing a stable source of funding are important challenges for banks in the region, together with structural transformation and diversification in the banking sector. Several areas of trade finance and credit guarantee and insurance facilities remain underdeveloped. Overall, it may be stated that the lack of adequate financial intermediation is acting as a major constraint on trade-related and FDI-inducing trusted business environment,

having deleterious implications for regional and inter-regional economic integration. This is important in the context of possible integration with the South Asian region.

- (vi) **Investment Climate:** The investment climate remains unpredictable in most of the CARs. It is characterized by confusing laws and regulations, often enforced arbitrarily. Problems for investments have been identified in the realms of land property rights that have not yet been fully established in most of the countries. Policy reforms focusing on privatization and restructuring of the larger economic entities are far from complete. Moreover, registration and licensing procedures are time-consuming and need rationalization. Some of the South Asian countries too are under-developed in this respect.
- (vii) **Language Barriers:** A lack of adequate knowledge of one of the most important business languages i.e. English acts as a barrier in Central Asia. This has important implications for their extra-regional trade and investment linkages, especially when the focus is on Central Asia-South Asia integration. While common language within the Central Asian region is an advantage for intra-Central Asia integration, a lack of adequate knowledge of the English language could still act as a barrier when intra-regional integration is viewed in terms of its linkages with the global economy. In other words, intra-regional integration need not to be considered as an endeavour confined just to the region but needs to be viewed alongside its business linkages with other parts of Asia-pacific and even the rest of the world.
- (viii) **Institutional Constraints:** The assessment of the existing policy mechanisms earlier to economically integrate Central and South Asian regions shows that important fora like the UN-supported SPECA and the Heart of Asia are in place and have received attention at high levels of policy discourse. However, a more formal policy framework which focuses on integrating the two regions in the realms of trade in goods, trade in services, investment and other dimensions of cooperation is missing and possibly acts as a major institutional constraint on harnessing the potentials for economic integration between the two regions.

VIII. Broad Conclusions and Policy Recommendations

The present study explored ways and means of making the Central and South Asian regions more integrated through strengthening trade and investment linkages. The macroeconomic contexts of the two regions suggest that these economies are quite amenable to regional economic integration that can help achieve their growth and developmental objectives.

It is noticed that the CARs have launched various initiatives of regional economic integration. But a glaring absence is of a region-wide FTA which is amongst the CARs. The intra-Central Asia and intra-South Asia exports / imports as a proportion of their respective total exports / imports to world have been rather low. It appears that an absence of a trade and economic cooperation agreement in CARs has among other factors constrained regional trade integration. However, in the case of South Asian country-wise trade integration, the region gives much better picture, also because South Asia has moved along FTA in goods and services.

Empirical estimations suggest the presence of trade complementarities among the CARs. The prospect of cooperation between the Central Asian and South Asian region has also been evaluated. There are substantive gains when the 'region' becomes an integrated Central *and* South Asian region by way of trade. Some of the sectors where exports' gains would lie for the CARs include some new sectors like Textiles and Clothing, Livestock and Meat products and Services sectors. It is evident that while the South Asian region would gain in sectors such as livestock and Meat Products, Processed Food, Textiles and Clothing and services sectors, the gains for the Central Asian region are much higher than what was observed in the case of an FTA among CARs alone. In sum, the Central Asia-South Asian FTA is welfare and trade-inducing.

There are three notable features pertaining to the dynamics of FDI's inflows in the Central Asian region over time under consideration i.e. 2000-2011. Firstly, different Central Asian Economies display asymmetric natures towards hosting FDI inflows. Secondly, it shows that except for

Kazakhstan and Turkmenistan other CARs have remained as unattractive destination for global FDI inflows. Thirdly, the dynamism of FDI inflows differs in different CARs. The trends also suggest that in most of the CARs FDI inflows have been rather volatile. However, more recently in 2011, the CARs have emerged as important hosts of FDI inflows among the transition economies and landlocked developing economies. Kazakhstan and Kyrgyzstan have also emerged as a source for outward FDI flows.

A close study of the processes of vertical integration and horizontal specialization studies have shown that such initiatives have been largely confined to sectors such as fruit processing, cotton and power generation. Based on the industrial structure and the service sector economies in the CARs as well as the analysis pertaining to identification of sector/products for future trade integration both within CARs and with South Asia, the study identifies potentials for FDI integration to scale up the initiative pertaining to vertical integration and horizontal specialization. Some of the sectors amenable for such endeavors would include dairy sector, sugar, fruits and vegetables, textiles and apparels, chemicals, automobiles, electronics, among others.

Some of the sectors that can be identified for trade in services integration between the regions may include Telecom and Information Technology; Professional Services; Construction and Related Engineering Services; Educational Services; Environmental Services; Health-related Services; Tourism and Travel -related Services; and Audio-Visual Services. These are important sectors for intra-regional as well as inter-regional integration.

The study points out that there are significant barriers to trade and investment integration between Central Asia and South Asia. The study identifies these barriers on the basis of secondary material available. These relate to Trade-related Barriers; Trade Facilitation and Procedural Bottlenecks; Accession to WTO; Connectivity; Banking Infrastructure; Investment Climate; and Language Barriers and institutional constraints. While a common language within the Central Asian region is an advantage for intra-Central Asia integration, a lack of adequate knowledge of the English language could still act as a barrier in the context of inter-regional integration. In other words, intra-regional integration need not to be considered as an endeavour confined just to the region but needs to be viewed alongside its business linkages with other parts of Asia-pacific and even the rest of the world.

Against this backdrop, some of the preliminary broad policy recommendations that can be made are given below. These are by no means exhaustive and do not intend to address all the constraints on regional integration.

A. Accession to WTO: Since one of the prime benefits of joining the WTO is to have a uniform WTO-consistent policy framework that helps augment trade and provides for a reasonably good framework for regional trade negotiations, it is recommended that those countries that are not members of WTO should accede to the organization at the earliest opportunity.

B. Central Asia-South Asia FTA/CEPA: As per the findings of the study, the welfare gains and prospects for increase in regional exports would be far greater for both the Central and South Asian regions due to an expanded scope for tapping trade complementarities, and so it is recommended that a Central Asia-South Asia FTA be evolved. This could be further developed with the addition of a CEPA between the two regions. This would cover **Trade in Goods, Trade in Services, Investment and Trade Facilitation**, among other areas of cooperation.

C. Connectivity: A separate Central Asia-South Asia Connectivity Programme could be launched. In order to study various modes of connectivity i.e. road, air, pipeline, telecommunication etc. an Expert Group may be constituted with a mandate to study the feasibility and funding possibilities of such endeavours.

D. Banking: Given that the banking infrastructure is relatively more developed in South Asia especially countries like India, Pakistan, Sri Lanka and Bangladesh a programme to impart capacity building by South Asian countries may be launched. In addition, a sensitization programme for South Asian businesses of the existing banking practices and constraints in Central Asian region may also be launched. This would help addressing the banking relating operational level business constraints for the South Asian private sector.

E. Energy Cooperation: Since the Central Asian countries are rich in energy resources and the South Asian region is energy-deficient, a formal Energy Dialogue between the two regions should be initiated at the level of Energy Ministers.

F. Language: A programme to help the Central Asian countries learn globally-business-friendly English language may be launched in which a pool of high quality English language teachers from the South Asian region could be tapped in a cost-efficient way.

References

ADB (2006), 'Central Asia: Increasing Gains from Trade through Regional Cooperation in Trade Policy, Transport, and Customs Transit' (accessed from <http://www.adb.org/Documents/Reports/CA-Trade-Policy/ca-trade-policy.pdf>).

Das, Ram Upendra (2012), 'Regional Economic Integration in Central Asia', commissioned by UNESCAP and presented at 2012 SPECA Economic Forum, Bangkok.

Das, Ram Upendra (2004), 'Industrial Restructuring and Export Competitiveness of the Textiles and Clothing Sector in SAARC in the context of MFA phase out', RIS Discussion Paper # 85, New Delhi.

EIB (2012), 'Banking in the Eastern Neighbours and Central Asia: Challenges and Opportunities' prepared for ENCA Banking Sector Roundtable hosted by the EIB's Economics Department in Luxembourg, European Investment Bank, May.

Kumar, Nagesh (2007), "Investment Provisions in Regional Trading Arrangements in Asia: Relevance, Emerging Trends, and Policy Implications" RIS *Discussion Paper* # 125, New Delhi.

Kumar, Nagesh (1998), "Multinational Enterprises, Regional Economic Integration, and Export-Platform Production in the Host Countries: An Empirical Analysis for the US and Japanese Corporations", *Weltwirtschaftliches Archiv*, Vol. 134 (3), pp. 450-483.

Kumar, Nagesh, Ram Upendra Das and Prabir De, (2008), *SAARC Regional Study: Potential for Trade in Services under SAFTA*, New Delhi: RIS.

McGlinchey, E. and Erica Johnson (2005), 'Aiding the Internet in Central Asia', presented at the Post-Soviet Conference at the Mershon Center, Ohio State University, October.

Pomfret, R. (2006), 'Trade Barriers in Central Asia,' paper prepared for the Asian Development Bank, January.

Appendix I: Augmented Gravity Model: Empirical Strategy and Methodology

Model

The focus of our study was to estimate or predict the intra-regional trade potential of the Central Asian economies. We adopted the gravity model framework to estimate and project trade potential among the Central Asian economies.

As we are aware, the basic gravity model proposed by Tinbergen is given by the equation:

$$EX_{ijt} = C(GDP_i GDP_j / D_{ijt})$$

Where EX_{ijt} is bilateral exports of country i (reporter) to country j (partner), economic mass is proxied by each country's respective GDP, the distance, denoted by D_{ijt} , between countries is taken as an indication of the level of trade impediment. The higher is the respective GDP size, the greater is the possibility of bilateral trade to take place; however, it is inversely related to the bilateral physical distance. Furthermore, this process is impeded by trade costs (e.g., tariffs, lack of trade facilitating infrastructure etc.).

The econometric estimation of this equation could be undertaken by taking logs, adding some reduced form coefficients, and including an error term, giving the familiar empirical gravity model:

$$\ln EX_{ij} = \alpha_{ij} + \beta_1 \ln GDP_i + \beta_2 \ln GDP_j + \beta_3 \ln D_{ij} + \mu_{ij}$$

$$\beta_1, \beta_2 > 0; \beta_3 < 0$$

In our study an augmented gravity model was used to assess the effect of trade facilitation and trade cost elements on bilateral trade of the Central Asian countries in log-log form:

$$\ln EX_{ijt} = \alpha_{ijt} + \beta_1 \ln GDP_{it} + \beta_2 \ln GDP_{jt} + \beta_3 \ln D_{ijt} + \beta_4 \ln ER_{ijt} + \beta_5 \ln FDI_{it} + \beta_6 \ln GDPDEF_{it} + \beta_7 \ln EI_{it} + \beta_8 \ln EI_{jt} + \beta_9 \ln MI_{it} + \beta_{10} \ln MI_{jt} + \beta_{11} RTA_{ijt} + \sum_h \delta_h P_{ijh} + \mu_{ijt}$$

We have augmented the basic gravity model by including various relevant independent variables that are expected to determine export performance of Central Asian countries over time t . These include bilateral exchange rate (ER_{ijt}); FDI inflows as percent of GDP in the reporter / exporting countries (FDI_{it}); GDP deflator of the reporter ($GDPDEF_{it}$); export facilitating infrastructure of reporter and partner countries (EI_{it} , EI_{jt}); import facilitating infrastructure of reporter and partner countries (MI_{it} , MI_{jt}); regional trade agreement between trading pairs (RTA_{ijt}). The variable RTA_{ijt} is taken as a dummy which takes the value 1 if there exists a regional /bilateral trade agreement between bilateral pairs and zero otherwise.

Our model also includes dummy variables for trading partners sharing a common border, common official language, common colony and also a dummy for having a colony ever before. The sum of these dummy variables is denoted by $\sum_h \delta_h P_{ijh}$ wherein P_{ijh} takes the value one when a certain condition is satisfied and zero, otherwise. Some variables are by definition time-invariant in a gravity type model specification.

Econometric Estimation

We have used panel data estimation with a cross-section of import partners of each Central Asian country for two points of time i.e. 2010 and 2011. Depending on the data availability and trade linkages of each country the number of bilateral pairs varies, country-by-country. We have taken the year as the panel identifier. As is well known, panel data structure has two dimensions: (a) a cross-

sectional unit of observation, which in this case is country I and (b) a temporal reference, t , in this case the year. The error term has two dimensions, one for the country and one for the time period. Even though time is nested within the cross-section it is important to note that the cross-sections may be nested within time. Therefore, we took time as the panel variable.

Our panel was a balanced panel. Country dummy is not included because it would create multicollinearity problem. Country-pair dummies are also not included because our data covers only two years and because some of our key independent variables are time-invariant.

Given the time-invariant properties of some of the variables and due to the fact that we have a short panel data set whereby we have only two years but several bilateral pairs, we have used the random effects model (REM). Since individual effects (α_{ij}) are included in the regression we treated them as random rather than fixed because it is more appropriate when we are estimating trade flows for a randomly drawn sample from a larger population. We also performed the Hausman Test to check whether to use the fixed or random effects model. However, since the Hausman test has poor properties empirically and often fails to give sensible results, it is advised more recently that the economic rationale should govern the choice of this option which we have done. In order to control for heteroskedasticity it is recommended to always use the option robust to ensure that the covariance estimator can handle heteroskedasticity of unknown form. Hence, we have used random effects with the option robust standard errors. Additionally, we use Breusch-Pagan Lagrange Multiplier (BPLM) for heteroskedasticity as a whole in the model. For autocorrelation the DW Test was applied.

Data and Measurement of Variables

The empirical analysis is done for the case of bilateral trade between each Central Asian economy as reporter country and its trading partners worldwide as partner countries. The number of observations therefore varies country by country depending on trading partners. As a measure of bilateral trade, reporter country's export to partner country is taken for the latest two years available. The latest data on exports, which is our dependent variable, is taken from IMF Direction of Trade Statistics. The latest data on reporter and partner's GDP, data on reporter's FDI (as % of GDP) and reporter's GDP Deflator have been taken from World Bank WDI 2012. The bilateral cross-country exchange rate data was taken from UNCTAD for respective years. The CEPII Database provided the statistics for the variables such as distance, contiguity, common language and colony. The dummy variable for RTA was constructed taking the value 1 if there exists any Regional Trade Agreement between the bilateral pairs of country and 0 otherwise, obtained from UNESCAP. The data on export and import facilitating infrastructure of both the reporter and partner countries have been taken from the Ease of Doing Business database of the World Bank. Those bilateral pairs were dropped from the observations for which data was either unavailable or had zero value for any of the variables in any of the two time points.

Prediction: Potential for Intra-Central Asia Trade

After estimating the augmented gravity equation we tried to use the results to predict bilateral trade between each pair of Central Asian economies for three points of time viz. 2020, 2025 and 2030, excepting for a couple of pairs where data was unavailable. For this as the first step, we used the time series data to predict the values of the independent variables for these three points of time. The second step included using these predicted independent variables to obtain the potential trade between bilateral pairs of Central Asian economies for these three years based on the coefficients of independent variables obtained through panel data estimation outlined above. Since some of our independent variables were time-invariant in nature we retained their values while making predictions for potential trade. The same was used to predict trade between Central and South Asian Region.

Appendix II: Computable General Equilibrium (CGE) Simulations

Reduction or elimination of tariff barriers is a pre-requisite under any regional trade agreement in order to step up bilateral and overall regional trade flows in the region under consideration. Considering that trade flows are a function not only of tariff reduction or elimination, but also of trade facilitation measures that may include simplification of customs clearance procedures, mutual recognition agreements for standards, technical cooperation and improvement in trade facilitation infrastructure, it was imperative to factor in both tariff liberalisation and trade facilitation while making any assessment of the possible trade and welfare gains.

Thus, this exercise included full tariff liberalization along with import-augmenting technical change denoting trade facilitation effects. This was done on the latest GTAP 8 database. Regional-aggregation included East Asia, South Asia, North America, EU (25), Central Asia and Rest of the World. In terms of sectoral aggregation, 57 sectors were mapped in terms of 10 sectors with five sectors capturing the manufacturing sector as a whole. Due to livelihood sensitivities the agricultural sector was excluded.

Trade facilitation measures were formulated in our simulation as an “import-augmenting technical change” to estimate the impacts. In the model, a positive “import-augmenting technical change” or an improvement in efficiency of importing products lowers the market price (domestic price) of imported products. Specifically, we investigate the effects of 10 per cent exogenous change in this efficiency improvement. The solution method was adopted as 1-Step Johansen and the parameters were taken as default.

The CGE modelling simulations were undertaken with trade liberalization and trade facilitation scenarios together for regional trade cooperation between Central Asia and South Asia in a static framework for the year 2010.