TRADE AND INVESTMENT PROSPECTS OF THE IOR-ARC IN THE NEW MILLENNIUM

New Economic Frontier of the Region

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Priyadarshi Dash

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1

IOR-ARC at 15

1.1 Background

The Indian Ocean Rim Association for Regional Cooperation (IOR-ARC) was established in 1997 with select littoral states on the coast of the Indian Ocean as its members. At present, the grouping has 19 members, 5 dialogue partners and 2 observers. The grouping aims to promote mutually beneficial economic cooperation through open regionalism based on consensus, and an evolutionary and non-intrusive approach. As per the IOR-ARC Charter, the work programmes of the Association are undertaken by the member states on a voluntary basis.[1] Before its formal launch in 1997, there existed several sub-regional structures for diplomatic and economic engagements in the IOR-ARC region. Even though it covered four different geographical regions, such as South Asia, South-East Asia, Middle East and Africa, the countries had strong political and economic reasons for vigorously pushing the IOR-ARC agenda in the mid-1990s. Against the backdrop of the post-Apartheid liberation fervour, the perceived need for asserting 'South Leadership' among the three leading countries-India, Australia and South Africa, the importance of effective use of maritime resources, fusion of 'Look East' policy of India with 'Look West' policy of Australia, South Africa's search for a regional identity, frustration with slow progress in the existing regional groupings and fears of globalisation were some of those major factors that inspired the leaders in the region to consider IOR-ARC as a means for promoting regional economic cooperation.

The idea of an IOR-ARC community was first mooted by the former Foreign Minister of South Africa and his counterpart in India in New Delhi in 1995. Soon after the visit, a meeting was held in Mauritius in March 1995 at the initiative of the governments of Australia, India, Kenya, Mauritius, Oman, Singapore and South Africa. In due course, the Charter of the IOR-ARC for regional cooperation was adopted at the Ministerial level meeting held in Mauritius during March 5-7, 1997. With regard to institutional mechanism, there exist two modes of interaction among the member states, i.e. Track I and Track II in

all major decisions. The official process is represented by the Council of Ministers (COM), the Committee of Senior Officials (CSO), the Indian Ocean Rim Business Forum (IORBF), Working Group on Trade and Investment (WGTI) and the Indian Ocean Rim Academic Group (IORAG). Economic and cultural activities are often exhibited through various events organised by the member countries from time to time. Trade fairs, exhibitions, films and staging of other cultural events are considered important channels for dissemination and sharing of information on the areas of mutual interest.[2] The secretariat has been the vital link in the institutional architecture of the IOR-ARC.

1.2 Progress on Earlier Initiatives

As per the provisions in the Charter, several initiatives were undertaken by the COM on diverse fields of trade, investment, services, science and technology (S&T), etc., among others. The Association has operated similar to the Asia-Pacific Economic Cooperation (APEC) from the beginning and indirectly embraced 'open regionalism' as its operational framework.[3] Initially trade liberalisation, trade facilitation and investment cooperation were identified as the priority areas for voluntary action by the member countries. Since modalities for comprehensive trade agreements between the members (e.g. PTAs, RTAs, etc.) were not clear in formative years, sectoral cooperation was given due emphasis for furthering regional integration. After having six Ministerial meetings and 12 meetings of the CSO, IORBF and IORAG, the grouping has achieved very little to make any significant dent in the priority areas of action.[4] On the other hand, the grouping seems to have gained adequate diplomatic mileage in harmonising differences of opinions on many fronts such as intensification of the existing framework of interaction among various stakeholders and enhanced understanding on financing of project-specific studies with funds earmarked in annual budgets and support from the IOR-ARC Special Fund. Given divergent views on the future of the grouping, it is imperative to assess the progress made by the regional caucus.

1.2.1 Appropriateness of the Strategy of 'Open Regionalism'

Several reasons are attributed to the slow progress[5] in the IOR-ARC objectives in adopting the strategy of open regionalism and unilateral liberalisation. Implicitly, it refers to the argument of a small country that special and differential treatment in a trading regime may help them in order to be at par with large economies in any regional economic arrangement. In other words, trade cooperation based on uniform voluntary action benefits large countries more than the smaller ones.[6] Although it was not stated clearly in governing principles of the IOR-ARC, trade promotion between the member states was probably considered as the way to realise the larger gains of regional cooperation.

In fact, trade flows within the region increased more than its global trade in the post-1997 period. As per an estimate, the intra-regional trade (IRT) potential in IOR-ARC turned out to be large for the region. However, the countries in the region still face the problem of peak tariff and lack a coherent trade policy regime. In order to foster regional trade integration within the existing framework of open regionalism, there is a need to rationalise the tariff structures across the region and orient the regional economies towards sectoral specialisation.[7] Moreover, the sectoral projects identified by the IORAG were in the areas of trade, investment, S&T, fisheries, maritime resources, etc. But it could not effectively address the regional dimension even though those sectors had special relevance to most members or groups in the region. Therefore it requires a proactive role of various constitutional forums of IOR-ARC like IORAG, IORBF and WGTI in identifying and commissioning of sector-specific projects and studies to meet the specific interests of the region.

1.2.2 Challenges Involving Governing Procedures and Operational Difficulties

As discussed in various forums of IOR-ARC, there are difficulties in implementation of the principles of the Charter with respect to membership, consultations and normal functioning of the Secretariat. The necessary structural mechanism to expedite or implement the relevant project proposals was not properly delineated at the early stage of the Association. As a result, the recommendations of most of these studies were not implemented in the initial years. In view of persistent procedural difficulties, it was considered imperative to establish the National Focal Points (NFPs) as envisaged in the Article 8 of the Charter at the earliest so as to plug loopholes in the process of implementation.[8] On trade policy information and infrastructure, the COM in Teheran felt the need to bring a wide range of issues including participation of the corporate sector (both public and private companies) for providing trade support services, packaging design consultants, freight forwarders and shippers, commercial banks and other financial institutions offering trade credits and guarantees, chambers of commerce, training institutions, investment promotion agency, small business development agencies, R&D organisations, overseas commercial representatives, enterprises and professional associations, and sector-specific export councils to augment regional trade. The Plan of Action also included the provision for national trade sector strategy, modern customs, quarantine and investment regimes, 21st country transport corridors, etc., among others.

1.2.3 Membership in Multiple Regional Groupings/RTAs

Before the creation of IOR-ARC, the membership issue[9] was debated widely among the various stakeholders and surfaced as a formidable

challenge for the IOR-ARC in the future.[10] At present, most members of the Association are part of several other groupings/RTAs such as ASEAN, GCC, SACU, SAARC, SADC, COMESA, EAC, BIMSTEC, etc. among others. Given the snail's pace of integration in IOR-ARC, the multiple RTA membership of the member states leads to a genuine fear of the weakening of voluntary action by the existing members.[11] In particular, the growing interest in COMESA-EAC-SADC single market worries the grouping especially from their African counterparts. At the same time, the mushrooming growth of RTAs within the region could be hailed as a positive step in the sense that the process of sub-regional cooperation may finally move towards greater regional integration. Since the region-wide integration initiatives are yet to assume momentum in the region, there exist clear manifestations of strong bilateral economic relations between the member countries. Moreover, several non-economic bilateral cooperation agreements have been implemented (or are under implementation) by the member countries. For example, India maintains deeper bilateral diplomatic relationships with African countries like Kenya, Madagascar and Mozambique ranging from cooperation in maritime security, defence, trade and overseas investment, which may feed positively into the IOR-ARC mechanism later. Likewise, other member countries of the IOR-ARC are actively engaged in bilateral relationships in diverse economic and non-economic spheres of cooperation.

1.3 Recent Developments in the Region

Apparently, the world economy may take more time to recover from the double dip recession during 2007-11 that has caused sharp decline in global output and employment affecting both developed and developing countries. As the magnitude of economic slowdown reached epidemic proportions spreading to many important parts of the world, the IOR-ARC region was not completely immune to the crisis spillovers. Despite the recession-induced adjustments that the regional economies have undertaken during the crisis period, the region has strong economic potential ranging from trade, investment, human resources, among others, which could be leveraged for higher growth and mutual benefit in the future. As member countries are placed at different levels of economic development and trade competitiveness, they stand to gain from comprehensive economic cooperation within the IOR-ARC framework. This may go beyond trade and investment cooperation. Considering the large potential of the region, the founders of the forum had great vision to bring in different activities through various institutional frameworks in order to promote deeper economic cooperation among the participating countries.

Despite having several institutional mechanisms which built into the organisational structure, the regional grouping could not make

significant headway in pushing its economic agenda on the forefront. The launch of IOR-ARC coincided with the Asian Crisis in 1997 when the economically vibrant economies within the region particularly in the East and the South-East were subject to severe economic turmoil. As a result, these economies failed to provide adequate support to the newly formed regional integration initiative. The region continued to remain volatile and faced a series of external shocks intermittently in the subsequent years. Although the region recovered from the Asian crisis in 1999, it had to grapple with the vagaries of global recession again in 2001.[12] With this failure of the regional caucus on economic front, the focus of discussion gradually shifted from economic issues to the political issues, particularly to the membership issue. This shift in focus resulted in a substantial enlargement of the group membership even though the achievements on economic agenda were far from the expectations.

The size of GDP of the region was US$ 2777.3 billion with the total population of 1970.4 million in 2009. Since the recovery from the last global recession of the millennium, the region expanded at the growth rate of 10.9 per cent per annum during the period 2003-08. The economic expansion of the region is either comparable or better than many RTAs in the world economy during the corresponding period. Macroeconomic fundamentals of the region are sound and show signs of effective management of the regional economies. The broad macro parameters of the regional economies including trade openness, savings and investment ratios, exchange rate variability, foreign exchange reserves, debt ratio, rate of inflation, etc., show healthy signs. The trade basket of the region is now highly diversified and shows sign of self-sufficiency in several products within the region. This reveals that the regional economies may rely upon the region for several products and take advantages of the synergies of the intra-regional market for mutual advantages.

Despite several encouraging features, the region continues to lag behind other RTAs around the globe in terms of level of intra-regional trade (IRT). The ratio of IRT to overall trade of the region is 'deceptively' high as compared to many RTAs in the world. The overall ratio of IRT is impressive because of high sub-regional trade flows between countries of the South-East Asia and Australia. Moreover, other countries in the region have strong trade linkages with South-East Asian countries too. But many of them have failed to capitalise on the potential of their sub-regions for promoting IRT. Some mechanisms need to be evolved to ensure that IRT of other sub-regions also become significant to make the overall performance of IOR-ARC vibrant.

However, it may be noted that structural problems are apparently strong to hinder the flow of trade within the region. In spite of these

challenges, the regional economies have large trade potentials to widen their economic linkages. According to a recent estimate, IRT potential of IOR-ARC could be up to the level of US$ 453 billion per annum. As regional countries are placed in different levels of economic development, their demand for and supply of products for trade would not be symmetrical thereby making the region a global hub for diversified products. The region not only produces a wide range of products including primary, resource-based, labour-intensive and various categories of technology-intensive goods but also demands them for internal consumption. The present state of the IOR-ARC is like a sleeping tiger, which has the potentiality to create lasting impact in the region and the world economy when awakens from its slumber. Trade wind is blowing in favour of the region. In the last Bengaluru Ministerial meeting in 2011, the members of the regional forum welcomed Seychelles which left the grouping in 2003 to rejoin the regional caucus. Further, the inclement global economic environment could prove conducive for the cause of regional economic cooperation. On the path to recovery from the present episode of global recession the member countries could re-engage themselves within the region in expanding intra-regional trade and investment. Possibly, the post-recovery regime could be the appropriate time for the re-integration of the region with new vigour.

The study is structured as following: Chapter 2 analyses the recent macroeconomic trends in the member states, particularly in the event of global economic slowdown during 2007-09 and the recovery period, and weighs the implications of those trends on economic performance of the IOR-ARC countries. Chapter 3 examines the trends and patterns in FDI inflows and outflows in the IOR-ARC countries with respect to different sectors, forms and destinations. Subsequently, Chapter 4 provides trade performance of the individual member countries, estimates of intra-and inter-regional trade potential, and current trade policies and future challenges of the region. Building on the economic strengths of regional cooperation in the region, Chapter 5 delineates the various emerging sectors of cooperation and the mechanisms for developing an enabling business environment in the IOR-ARC region. Last but not the least, Chapter 6 concludes and highlights the major policy imperatives for fostering the ongoing process of regional cooperation in the region.

2

Macroeconomic Performance

The IOR-ARC comprises a heterogeneous group of countries characterised by varying sizes of the economies, differences in resource endowments, level of openness, and trade and investment liberalisation. Many member countries are having surplus resources which could be productively invested in other resource deficit countries of the region. In view of the growing importance of reinvigorating economic activities towards regional integration, it is of vital interest to examine the pattern of macroeconomic developments in the member states and identify the areas of convergence with respect to GDP growth, prices, resources mobilisation and external sector performance.

2.1 Growth Performance

The combined GDP of the IOR-ARC region grew impressively at a CAGR of 6.5 per cent during the period 2004-07. All the four sub-regions in the IOR-ARC region witnessed an upsurge in economic activity in this boom period by registering an average growth rate of 5 per cent and above. In relative terms, South Asia and Middle East were the fastest growing sub-regions in the region with growth rates of 8.4 and 7.9 per cent, respectively, as shown in Table 2.1. Like other parts of the world, the countries in the region faced the brunt of the global economic meltdown in the period 2007-09 with growth rates falling sharply from 6.9 per cent in 2007 to 4.3 per cent in 2008 and (-) 7.3 per cent in 2009. Given the sluggish pace of recovery in the advanced economies, the medium-term growth projections for most countries in the region seem robust but protracted. Except South Asia, growth forecasts for other three sub-regions remain bleak over the period 2011-13 (Table 2.2). Even though negative output correction is widespread throughout the region, the South Asian countries are expected to maintain growth rates close to their pre-crisis levels over the recovery period.

As regards the structure of the economy, the IOR-ARC region is characterised by heavy dominance of large countries like India, Australia, Indonesia, South Africa and Thailand. In terms of 2009 figures, these countries together accounted for 74 per cent of the total regional output. India alone with a population of 1.2 billion has output share of 32 per cent in the total regional output. At the same time, the region is also home to a good number of small countries (mostly from Africa) like Kenya, Madagascar, Mauritius and Mozambique. The heterogeneous economic structure of the member countries is clearly reflected in their per capita income levels. Some countries such as Australia, Singapore and UAE are pretty rich with per capita income touching US$ 25,000 and above whereas for some other countries it is less than US$ 1000 (Table 2.1).

In line with the global trends in the 1990s and 2000s, most countries in the region have embraced a conscious policy of trade and investment liberalisation. Higher values of trade-GDP ratio corroborate the growing pace of opening up in the economies of the IOR-ARC region. Overall, trade openness is found comfortably higher except for Bangladesh, India and Tanzania. In fact, Malaysia, Singapore, Thailand and UAE could be considered as highly export-oriented economies in the region.

With regard to international liquidity, there was hardly any threat of external insolvency in the regional economies. Most of them had adequate level of reserve stock in 2009 despite a disproportionately higher pace of accumulation in select countries like India, Singapore and Thailand. Reserve levels in these three countries were to the tune of US$ 265.2 billion, US$ 187.8 billion and US$ 135.5 billion, respectively. While shares of the Middle East and Africa in global output remained more or less similar since 2003, the relative economic weight of the other two sub-regions, e.g. South Asia and South-East Asia, has significantly improved in the recent years. Their contributions to world GDP rose moderately from 4.4 per cent and 4.1 per cent in 2003 to 5.8 per cent and 4.4 per cent in 2010 respectively. It is expected that the share of South Asia will move up to 6.6 per cent in 2013. In terms of country shares, no other country except India noticed any significant change in its individual contribution to world GDP (Table 2.3).

With respect to the composition of output, there was evidence of increasing service orientation in the IOR-ARC countries. On the other hand, output from the rest three sectors, e.g. agriculture, industry and manufacturing, has not undergone any precipitous fall during the study period 2004-09. Services account for more than 50 per cent of national GDP for Australia, Bangladesh, India, Kenya, Madagascar, Mauritius, Singapore, South Africa and Sri Lanka. Industry particularly manufacturing continued to remain the lead production sector for Indonesia, Malaysia and Thailand. For most countries, the share of industrial output in national GDP varied in the range from 23 to 30 per cent (Table 2.4).

Table 2.1: Macroeconomic Performance in 2009

Country/region	GDP	PCY	Population	Reserves	Merchandise Exports	Merchandise Imports
(1)	(2)	(3)	(4)	(5)	(6)	(7)
Australia	548.1	25056.1	21.9	39.0	154.2	165.5
Bangladesh	78.2	482.3	162.2	10.2	15.1	21.8
India	885.4	766.4	1155.3	265.2	162.6	249.6
Indonesia	258.5	1124.1	230.0	63.6	119.5	91.7
Iran	158.1	2168.5	72.9	..	78.1	50.4
Kenya	18.0	451.9	39.8	3.8	4.4	10.2
Madagascar	5.0	254.6	19.6	1.1	1.1	3.3
Malaysia	137.1	4992.4	27.5	95.4	157.4	123.8
Mauritius	6.3	4917.3	1.3	2.2	1.9	3.7
Mozambique	8.5	370.7	22.9	2.1	2.1	3.8
Oman	..	..	2.8	12.2	27.7	18.0
Singapore	143.5	28765.0	5.0	187.8	269.8	245.8
South Africa	181.9	3688.6	49.3	35.2	62.6	73.2
Sri Lanka	25.0	1232.6	20.3	4.6	7.3	10.2
Tanzania	18.7	438.9	43.7	3.5	3.1	6.3
Thailand	173.9	2566.6	67.8	135.5	152.5	133.8
UAE	117.8	25606.8	4.6	36.1	175.0	140.0
Yemen	13.3	564.7	23.6	6.9	5.6	8.5

Source: World Bank (2011), *World Development Indicators 2011*, Washington D.C.
***Note*:** GDP in constant US$ billion, GDP per capita (PCY) in constant US$, population in million, reserves minus gold in US$ billion, merchandise exports and imports in US$ billion. Due to the lack of full information on all member countries in the region on key economic indicators, data reporting was restricted to 2009.

Table 2.2: Growth Performance and Outlook

(GDP Growth Rate, Per cent)

Country	2003	2004	2005	2006	2007	2008	2009	2010	2011P	2012P	2013P
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Australia	3.3	3.8	3.1	2.6	4.6	2.6	1.3	2.7	3.0	3.5	3.5
Bangladesh	5.8	6.1	6.3	6.5	6.3	6.0	5.8	6.0	6.3	6.6	6.9
India	6.9	8.1	9.2	9.7	9.9	6.2	6.8	10.4	8.2	7.8	8.2
Indonesia	4.8	5.0	5.7	5.5	6.3	6.0	4.6	6.1	6.2	6.5	6.7
Iran	7.2	5.1	4.7	5.8	7.8	1.0	0.1	1.0	0.0	3.0	3.5
Kenya	2.8	4.6	6.0	6.3	7.0	1.6	2.6	5.0	5.7	6.5	6.8
Madagascar	9.8	5.3	4.6	5.0	6.2	7.1	–3.7	–2.0	0.6	4.7	4.9
Malaysia	5.8	6.8	5.3	5.8	6.5	4.7	–1.7	7.2	5.5	5.2	5.1
Mauritius	4.3	5.5	1.5	4.5	5.9	5.5	3.0	4.0	4.1	4.2	4.3
Mozambique	6.5	7.9	8.4	8.7	7.3	6.8	6.3	7.0	7.5	7.8	7.9
Oman	0.3	3.4	4.0	5.5	6.7	12.9	1.1	4.2	4.4	4.1	4.3
Singapore	4.6	9.2	7.4	8.7	8.8	1.5	–0.8	14.5	5.2	4.4	4.3
South Africa	2.9	4.6	5.3	5.6	5.6	3.6	–1.7	2.8	3.5	3.8	4.2
Sri Lanka	5.9	5.4	6.2	7.7	6.8	6.0	3.8	9.1	7.0	6.5	6.5
Tanzania	6.9	7.8	7.4	7.0	6.9	7.3	6.7	6.5	6.4	6.6	7.4
Thailand	7.1	6.3	4.6	5.1	5.0	2.5	–2.3	7.8	4.0	4.5	4.7
UAE	16.4	10.1	8.6	8.8	6.6	5.3	–3.2	3.2	3.3	3.8	4.0
Yemen	3.7	4.0	5.6	3.2	3.3	3.6	3.9	8.0	3.4	4.0	4.3

Source: IMF (2011), *World Economic Outlook*, April 2011, Washington D.C.

Table 2.3: GDP Share of Member Countries in Gross World Product

(GWP Share PPP, Per cent)

Country	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Australia	1.3	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2	1.2
Bangladesh	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4
India	4	4.1	4.3	4.5	4.7	4.8	5.2	5.4	5.6	5.8	6
Indonesia	1.2	1.2	1.2	1.2	1.3	1.3	1.4	1.4	1.4	1.4	1.5
Iran	1.1	1.1	1.1	1.1	1.2	1.1	1.2	1.1	1.1	1.1	1.1
Kenya	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Madagascar	0	0	0	0	0	0	0	0	0	0	0
Malaysia	0.5	0.5	0.5	0.5	0.5	0.6	0.5	0.6	0.6	0.6	0.6
Mauritius	0	0	0	0	0	0	0	0	0	0	0
Mozambique	0	0	0	0	0	0	0	0	0	0	0
Oman	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Singapore	0.3	0.3	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
South Africa	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Sri Lanka	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.2
Tanzania	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Thailand	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
UAE	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Yemen	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1

***Source*:** World Bank (2011), *World Development Indicators 2011*.

Table 2.4: Sectoral Contributions to GDP

(Per cent of GDP)

Country	Agriculture			Industry			Manufacturing			Services		
	2004	2008	2009	2004	2008	2009	2004	2008	2009	2004	2008	2009
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Australia	3.5	2.5	..	26.1	29.1	..	12.5	10.5	..	70.4	68.4	..
Bangladesh	21.0	19.0	18.7	26.6	28.5	28.7	16.1	17.8	17.9	52.4	52.5	52.6
India	19.0	17.6	17.8	27.9	28.2	27.0	15.3	15.5	14.8	53.0	54.2	55.3
Indonesia	14.3	14.7	15.8	44.6	48.8	49.1	28.1	28.3	27.2	41.0	36.5	35.2
Iran	11.2	..	..	42.7	..	..	11.3	..	..	46.0	..	..
Kenya	28.0	21.0	22.6	18.2	15.1	15.3	11.2	8.9	8.7	53.7	63.9	62.1
Madagascar	28.8	24.8	29.1	15.9	16.2	16.0	14.2	14.3	14.1	55.3	59.0	54.9
Malaysia	9.3	10.2	9.5	48.5	48.1	44.3	30.4	26.3	25.5	42.2	41.7	46.2
Mauritius	6.4	4.4	4.3	29.1	29.2	29.1	21.0	20.1	19.4	64.4	66.4	66.6
Mozambique	27.4	30.5	31.5	27.4	23.7	23.6	17.7	14.0	13.6	45.2	45.9	44.9
Oman	1.9	..	..	55.1	..	..	8.3	..	..	43.0	..	..
Singapore	..	..	..	33.2	25.9	26.3	27.3	19.4	19.4	66.7	74.0	..
South Africa	3.1	3.2	3.0	31.3	32.5	31.1	19.2	16.5	15.1	65.6	64.3	65.8
Sri Lanka	12.5	13.4	12.6	28.6	29.4	29.7	18.7	18.0	18.1	58.8	57.2	57.7
Tanzania	33.3	29.7	28.8	22.3	23.1	24.3	8.7	8.6	9.5	44.3	47.2	46.9
Thailand	10.3	11.6	11.6	43.4	44.2	43.3	34.4	34.9	34.1	46.3	44.2	45.1
UAE	2.6	..	..	54.0	..	..	13.1	..	..	43.3	..	..
Yemen	..	..	..	..	..	..	..	..	..	..	..	..

Note: Manufacturing is included in industry.

Source: World Bank (2011), *World Development Indicators 2011*.

2.1.1 Inflation

Many countries in the region have faced the problem of high inflation in the past decade. Double-digit inflation prevailed in most parts of the 2000s in Indonesia, Iran, Kenya, Madagascar, Mozambique, Sri Lanka and Yemen. While the roots of the price rise after 2006 probably lied in global commodity price boom, there could be other domestic factors responsible for persistence of inflationary tendencies in the early 2000s. Although the incidence of inflation got moderated reasonably during the crisis years of 2007-09 in most of these high-inflation countries, it requires an in-depth analysis of the causes of escalating prices in the high-inflation countries (Table 2.5).

2.2 Emerging Resource Gap: Saving, Investment and FDI

Resource mobilisation occupies a crucial place in growth process of a country. In particular, the domestic savings-investment gap determines the extent of dependence on foreign savings and the modes and incentive structures for augmenting resource balance. The current pattern of resource flows in the IOR-ARC countries presents a mixed picture. Besides a few countries, many IOR-ARC countries suffer from adverse resource balance. Savings and investment rates have followed divergent paths across the region. Barring a few countries,

Table 2.5: Trends in Inflation

(CPI, Annual Per cent)

Country	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
Australia	4.5	4.4	3.0	2.8	2.3	2.7	3.5	2.3	4.4	1.8
Bangladesh	2.2	2.0	3.3	5.7	9.2	7.0	6.8	9.1	8.9	5.4
India	4.0	3.7	4.4	3.8	3.8	4.2	5.8	6.4	8.4	10.9
Indonesia	3.7	11.5	11.9	6.6	6.2	10.5	13.1	6.3	10.1	6.4
Iran	14.5	11.3	14.3	16.5	14.8	13.4	11.9	17.2	25.5	13.5
Kenya	10.0	5.7	2.0	9.8	11.6	10.3	14.5	9.8	26.2	9.2
Madagascar	11.9	6.9	15.9	–1.2	13.8	18.5	10.8	10.3	9.2	9.0
Malaysia	1.5	1.4	1.8	1.0	1.5	3.0	3.6	2.0	5.4	0.6
Mauritius	4.2	5.4	6.5	3.9	4.7	4.9	8.9	8.8	9.7	2.5
Mozambique	12.7	9.0	16.8	13.4	12.7	7.2	13.2	8.2	10.3	3.3
Oman	..	–0.8	–0.3	0.2	0.8	1.9	3.2	6.0	12.1	3.9
Singapore	1.4	1.0	–0.4	0.5	1.7	0.4	1.0	2.1	6.5	0.6
South Africa	5.3	5.7	9.2	5.9	1.4	3.4	4.6	7.1	11.5	7.1
Sri Lanka	6.2	14.2	9.6	6.3	7.6	11.6	10.0	15.8	22.5	3.5
Tanzania	5.9	5.1	5.3	5.3	4.7	5.0	7.3	7.0	10.3	12.1
Thailand	1.6	1.6	0.7	1.8	2.8	4.5	4.6	2.2	5.5	–0.8
UAE*	1.3	2.8	2.9	3.1	5.0	6.2	9.3	11.1	12.3	1.6
Yemen	4.6	11.9	12.2	10.8	12.5	11.8	10.8	7.9	19.0	3.7

Source: World Bank (2011), *World Development Indicators 2011.*

Note: * IMF (2012), *World Economic Outlook 2012.*

gross domestic savings as percentage of GDP seem to have varied within the expected range in the IOR-ARC region.[13] Compared to other countries, savings rates are found significantly higher for Malaysia, Singapore, Iran and Oman. However, savings rate is comparatively low for Bangladesh, Kenya, Madagascar, Mozambique, Sri Lanka, Tanzania and Thailand. It improved marginally for India, Indonesia, Madagascar, Sri Lanka, Tanzania, Australia and Thailand. On the whole, the region is quite dependent on foreign savings for capital formation. While access to foreign capital has become easier in recent years, the abysmally lower savings rates for Kenya, Madagascar and Mozambique is a matter of serious concern.[14] In fact, investment outpaced savings mobilisation for the IOR-ARC countries during 2004-09. On the other extreme, there are encouraging trends in domestic savings mobilisation in Bangladesh, Sri Lanka, South Africa and Tanzania (Table 2.6).

Investment trends in the IOR-ARC region were found at par with the prevailing savings rates. In general, investment rates increased for most member countries in the past five years (Table 2.6). Gross Fixed Capital Formation (GFCF) as percentage of GDP hovered around 25 per cent for most countries in the region. Countries like Kenya, Mozambique and South Africa, which faced lower savings rates in the early 2000s, have experienced modest rise in their saving rates in the latter period of the decade. From a holistic point of view,

Table 2.6: Saving and Investment in IOR-ARC Countries

(Per cent of GDP)

Country	Savings Ratio			Investment Ratio			GFCF			GFCF Private Sector		
	2004	2008	2009	2004	2008	2009	2004	2008	2009	2004	2008	2009
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Australia	22.9	25.7	..	25.4	27.5	..	24.7	27.1	..	..	..	..
Bangladesh	18.7	15.8	17.2	24.0	24.2	24.4	24.0	24.2	24.4	17.8	19.3	19.7
India	31.1	29.1	32.0	32.8	34.5	36.5	28.7	32.9	30.8	21.8	24.4	22.4
Indonesia	28.7	28.9	33.8	24.1	27.8	31.0	22.4	27.7	31.1	..	..	..
Iran	39.1	..	..	36.0	..	..	28.6	..	..	19.0	..	..
Kenya	10.8	6.1	7.8	17.1	20.3	20.9	16.3	19.7	20.1	7.5	15.3	14.5
Madagascar	8.5	9.9	8.9	23.4	40.3	32.6	23.4	40.3	32.6	13.4	33.2	29.4
Malaysia	43.4	42.3	36.0	23.0	19.3	14.5	21.0	19.5	20.1	10.7	10.8	9.6
Mauritius	22.0	12.5	10.8	24.4	27.2	21.4	21.6	24.6	26.2	15.0	20.4	19.5
Mozambique	7.7	1.6	2.2	18.6	15.7	21.0	18.6	15.7	21.0	8.0	4.1	7.9
Oman	38.1	51.1	..	25.6	29.7	..	..	..	..	..	..	..
Singapore	47.1	47.0	..	21.8	29.1	..	23.2	26.8	..	17.0	..	..
South Africa	17.8	18.9	18.6	18.1	22.0	19.4	16.0	22.5	22.6	11.7	14.6	13.4
Sri Lanka	15.9	13.9	18.0	24.7	27.6	24.5	22.6	25.3	23.8	20.2	19.3	17.4
Tanzania	15.2	10.3	17.9	21.7	26.7	29.8	21.2	26.3	29.3	14.2	18.3	20.5
Thailand	31.6	31.5	32.4	26.8	28.9	21.8	25.9	27.4	24.4	19.3	20.8	17.9
UAE	36.6	..	..	22.5	..	..	21.3	..	..	..	..	..
Yemen	..	..	..	..	..	..	..	..	..	9.3	..	..

Source: World Bank (2011), *World Development Indicators 2011*, Washington D.C.
Note: Reported variables are the following: Gross domestic savings, Gross capital formation, Gross fixed capital formation.

the region presents diverse investment regimes contingent upon varying initial conditions, disparity in level of development, access to foreign capital, incentives to the private sector and a set of other factors. Among many competing explanations on the investment-growth nexus, the available empirical evidence reveals inconclusive evidence particularly with reference to the direction of causality. In some cases, it was higher economic growth that led to higher savings and investment, thereby refuting the widely held proposition of investment-led growth (high investment leading to higher growth).[15] These conflicting strands on the link between resource mobilisation and growth were apparently noticed in some of the African member states of the IOR-ARC grouping. Devarajan, Easterly and Pack (2003) observed no direct relationship between low investment rates and weak growth performance in Africa. To them, low returns to scale (probably attributed to declined TFP), poor incentives created by distortions in foreign exchange markets and high budget deficits explain low saving propensity in the African countries.

Private sector investment was found robust in Bangladesh, India, Madagascar, Mauritius, Sri Lanka, Tanzania and Thailand. Financing investment remained a crucial policy challenge in the IOR-ARC region especially for the small African states that face pervasive resource gap. For instance, the rate of capital formation outpaced the rate of savings mobilisation in India, thereby raising the dependence on foreign savings. But, to a large extent, domestic investment in the country was financed by domestic savings.[16] Foreign investment not only bridges the saving-investment gap but also contributes to the growth of domestic capital stock. Based on a study on Malaysia, Anwar and Sun (2011) find that domestic stock of capital increases in response to increase in foreign investment. However, the rise in domestic capital stock has no positive effect on the stock of FDI in Malaysia.

In the recent years, IOR-ARC countries have invariably followed proactive investment policies with the aim of raising export competitiveness, encourage foreign competition and bridging the supply bottlenecks. In this paradigm, infrastructure investment has been given utmost priority in country development strategies.[17] For instance, the World Bank prescribes a significantly higher level of FDI inflows to support congenial growth environment in order to compensate for domestic resource constraints and to enable the countries to benefit from knowledge and technological spillovers. The current trends in FDI flows show increasing contribution of FDI to fixed capital formation in the IOR-ARC countries. For instance, FDI accounts for more than half of GFCF in two capital-scarce African economics such as Madagascar and Mozambique. FDI share in capital formation is also found higher for Singapore, Malaysia, Mauritius, Tanzania, and Australia (Table 2.7). While lower level of domestic savings explains the rise in FDI flows to the region, the reasons

for unusually higher proportion of FDI flows to Singapore may be different; probably due to mature financial markets.

2.3 External Sector

As highlighted below, four countries in the region, namely Malaysia, Singapore, Thailand and the UAE, have relatively open external sector in terms of trade in goods. But, the same does not hold for trade in services except for Singapore. Singapore with trade in services-to-GDP ratio of 95 per cent is an outlier in the grouping. For other member countries, the ratio has improved marginally over time with increasing activity in the services sectors (Table 2.8). External sector stability to a large extent is contingent upon the availability of liquid international reserves. Looking at the current pattern of import cover of reserves, no country in the region is found insolvent. While most countries held reserves at least for five months in 2009, it was relatively higher for India, Thailand, Malaysia and Yemen. Interestingly, reserve stock measured in terms of imports improved for the IOR-ARC countries in the post-crisis period. For instance, reserve level rose from 2.9 months to 5 months for Bangladesh, from 3.3 months to 4 months for Kenya, from 3.5 months to 5.8 months for Oman, from 2.7 months to 5.2 months for South Africa and from 2.8 months to 5.2 months in 2009 over the year 2004. Keeping other things constant, the rising levels of reserve stock substantiate the genuine fear of reserve loss in the region in periods of anticipated external shocks (Table 2.9).

Table 2.7: Share of FDI in Gross Fixed Capital Formation

(Per cent)

Country	1990	1995	2000	2005	2006	2007	2008	2009	2010
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Australia	10.7	14.2	16.5	–11.4	13.5	15.8	15.4	9.0	9.3
Bangladesh	0.1	1.3	5.5	6.0	5.3	4.0	5.6	3.2	3.7
India	0.3	2.2	3.3	2.9	6.6	6.2	9.7	8.2	4.5
Indonesia	3.4	7.7	–13.7	12.3	5.6	6.4	6.6	2.9	5.8
Iran	–1.7	0.0	0.7	5.9	2.8	2.3	1.6	3.7	4.0
Kenya	3.1	1.6	5.2	0.6	1.2	13.8	1.6	2.4	1.8
Madagascar	4.3	2.8	13.2	7.7	21.1	38.1	37.9	51.7	56.2
Malaysia	17.5	14.6	16.0	14.4	18.6	21.3	16.5	3.7	18.9
Mauritius	5.1	1.9	26.3	3.1	6.7	17.9	16.7	11.7	19.1
Mozambique	2.1	7.3	10.4	8.8	12.3	33.0	38.2	44.1	29.4
Oman	7.7	1.7	2.8	21.5	17.8	26.8	14.1	10.0	13.2
Singapore	46.8	41.1	58.1	60.0	95.6	92.5	16.4	29.9	71.3
South Africa	–0.4	5.2	4.5	16.0	–1.1	9.9	14.5	8.4	1.9
Sri Lanka	2.7	2.0	4.2	4.8	6.8	7.5	7.3	4.3	4.0
Tanzania	0.0	10.4	16.6	13.9	15.0	12.9	11.0	10.4	10.6
Thailand	7.5	3.0	12.6	15.8	16.4	17.4	11.3	7.7	7.3
UAE	–1.8	3.3	–3.2	42.7	38.9	21.0	16.8	4.6	4.9
Yemen	–23.8	–20.3	0.4	–8.8	30.1	19.0	27.7	2.8	–6.7

Source: UNCTAD (2011), *World Investment Report 2011*, Geneva.

Table 2.8: Trade Openness in Goods and Services

(Per cent of GDP)

Country	Goods			Services		
	2004	2008	2009	2004	2008	2009
Australia	31.8	37.3	34.6	9.2	9	..
Bangladesh	36	49.3	41.3	5.3	7.1	6
India	24.4	42.4	29.9	10.2	15.8	12.5
Indonesia	48.9	52.2	39.1	12.8	8.5	7.7
Iran	45.1	50.6	38.8	..	..	..
Kenya	45	53.5	49.8	15.5	17.1	16.1
Madagascar	61.2	56	51.1	24.3	..	..
Malaysia	185.8	160.7	145.7	29.2	27.3	29.1
Mauritius	74.6	75.6	66	38.8	47.9	44.8
Mozambique	62.1	67.5	60.4	13.8	15.4	17.1
Oman	89.7	100.9	99	15.8	12.8	15.9
Singapore	39.4	340.3	282.9	89.7	97.4	95.1
South Africa	45.5	65.6	47.6	9.2	10.8	9.4
Sri Lanka	66.4	55	41.8	16.6	12.3	10.5
Tanzania	32.8	49	44.2	16.4	17.6	16.7
Thailand	118.2	130.9	108.5	26.1	29.2	25.7
UAE	157.1	159.2	136.8	..	..	..
Yemen	58.1	67	53.5	10.3	13.2	12.8

Source: World Bank (2011), *World Development Indicators 2011*.

Table 2.9: Performance of the External Sector

Country	Reserves (Months of Imports)			Current Account Balance (Per cent of GDP)			Remittances (Per cent of GDP)		
	2004	2008	2009	2004	2008	2009	2004	2008	2009
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Australia	2.6	1.2	..	–6.3	–4.6	..	0.5	0.5	0.4
Bangladesh	2.9	2.6	5.0	–0.5	1.2	3.7	6.3	11.2	11.8
India	11.3	7.8	9.8	0.1	–2.5	–1.9	2.6	4.1	3.6
Indonesia	5.2	3.8	6.1	0.6	0.0	2.0	0.7	1.3	1.3
Iran	..	..	..	..	..	..	0.6	0.3	0.3
Kenya	3.3	2.7	4.0	–0.8	–6.6	–5.7	3.9	5.6	5.7
Madagascar	2.8	..	..	–9.1	..	..	0.3	0.1	0.1
Malaysia	6.2	5.6	7.2	12.1	17.5	16.5	0.6	0.6	0.6
Mauritius	5.4	3.1	5.0	–1.8	–10.5	–7.9	3.4	2.3	2.5
Mozambique	5.0	3.7	5.7	–10.7	–12.0	–12.0	1.0	1.2	1.1
Oman	3.5	4.6	5.8	3.6	8.3	–0.6	0.2	0.1	0.1
Singapore	5.4	4.5	5.9	17.6	18.6	17.9	..	..	..
South Africa	2.7	3.3	5.2	–3.1	–7.3	–4.0	0.2	0.3	0.3
Sri Lanka	2.8	1.9	5.2	–3.1	–9.5	–0.5	7.7	7.2	8.0
Tanzania	7.3	3.8	5.3	–3.8	–13.0	–8.5	0.1	0.1	0.1
Thailand	5.1	6.1	9.8	1.7	0.8	8.3	1.0	0.7	0.6
UAE	..	..	..	..	..	..	..	..	..
Yemen	10.7	7.0	7.4	1.6	–4.6	–9.7	9.2	5.2	4.4

Source: World Bank (2011), *World Development Indicators 2011*.

Most countries in the region had current account deficits during the period 2004-09. In 2009, it was found unusually high for Mozambique (–12 per cent), Yemen (–9.7 per cent), Tanzania (–8.5 per cent), Mauritius (–7.9 per cent) and Kenya (–5.7 per cent). Some of these countries had adverse current account from 2004 through 2009 whereas for some others it turned negative due to the global economic slowdown during 2007-09. Remittance flows contribute to higher income for domestic residents and raise social welfare. On an average, remittance flows to the IOR-ARC countries have remained modest and healthy. For Bangladesh, Kenya, Sri Lanka and Yemen, remittances are found higher compared to other countries in the region.

Given different resource endowments and varying country sizes, the IOR-ARC region is broadly characterised by heterogeneous macroeconomic regimes and absence of synchronisation in regional business cycles. With varying paces of growth, the regional economies witnessed significantly higher growth during the global boom period of 2003-08 which was largely fuelled by rising investment. This also marked a tremendous improvement in macroeconomic parameters such as investment rate, trade openness, price management, reserve stock and so on. Global as well as intra-regional trade expanded at a faster pace in this period. Despite differences in initial conditions the observed trends show a healthy convergence of growth rates in the region. Unlikely, most regional economies suffer from pervasive resource gap implying in turn heavy dependence on foreign investment for capital formation. Although the incidence of high inflation prevails in most economies, no such country in the region faces the immediate threat of external insolvency and macroeconomic instability. Member countries have invariably followed proactive investment policies with an aim to raise export competitiveness, encourage foreign competition and bridge supply bottlenecks. The recovery process from the economic downturn caused by the global economic recession is yet to assume momentum and the growth forecasts for most countries look pessimistic. In order to sustain economic upturn, the governments in the region need to undertake suitable policy measures to raise domestic savings, push comprehensive economic reforms and maintain buoyant investment climate so as to aid the on-going regional integration process.

Given differential access to natural resources and varying sizes of the economies, IOR- ARC countries present diverse macroeconomic regimes. The evolution of some leading indicators in the past decade reveals that macroeconomic regimes in the IOR-ARC region could be broadly characterised as growth-led market-oriented with random episodes of uncertainty and instability. Most of these countries have experienced significantly high growth during the global boom spanning over the period 2003-08. In this phase, economies gained momentum on several fronts marked by rising trade, increased cross-

border capital flows, stable remittance flows, healthy reserve stock, and so on. However, this tranquility didn't last for long due to the perverse impact of the global economic recession during 2007-09. Although the severity of the crisis was modest for most member countries, there were serious disruptions in the growth enabling environment. No IOR-ARC state was spared from the crisis-led downturn in the economy. Barring the negative spillover effects of the global slowdown, IOR-ARC economies faced high inflation for most parts of the 2000s. While the roots of the price rise after 2006 probably lied in global commodity price boom, it is believed that there could be other domestic factors responsible for persistence of inflationary tendencies in the region in this period. In view of pervasive resource gap, the long-run growth prospect of the IOR-ARC economies depends to a great extent on steady flows of foreign capital and sound domestic and external impulses.

3

Foreign Direct Investment

Foreign Direct Investment (FDI) flows to countries bridge domestic resource gap and contribute to productive capacity in the host economies.[18] There are competing views on the factors that explain FDI flows between countries. Recent trends in FDI flows suggest a healthy growth in South-South FDI flows which has not only enhanced the level and quality of access to international capital but also raised scope for maximising returns to capital for each additional unit of capital deployed in production. Moreover, FDI flows not only improve liquidity position of the recipient country but also support the country in accessing technology which has cascading effects on the economy. It is observed that outward FDI from the region to the world is mostly concentrated in services, Greenfield projects and manufacturing sectors. These sectors also happen to be critical for the IOR region. With better coordination and improved policy environment, regional OFDI can be mobilised within the region creating regional public goods and building infrastructure. Moreover, FDI is increasingly becoming a crucial component of regional economic cooperation in most parts of the world. IOR-ARC being a large regional grouping represents substantial fraction of global FDI flows. In that perspective, the current chapter examines the trends and patterns in FDI inflows and outflows in the region and assesses the potential for regional cooperation in the field of investment promotion among the member countries.

3.1 Trends in FDI Flows

The current trends in FDI flows to/from the IOR-ARC countries show substantial growth in investment activity in the region during 2005-08. Economic literature is indicative of the fact that FDI flows coincide with the size of the market.[19] In fact, high degree of openness provides exporting firms more exposure in terms of learning about the foreign markets and relevant regulations and standards, and marketing

their products globally.[20] Some markets in the region are attractive destinations for FDI inflows for similar reasons. FDI inflows to the region are mainly concentrated in four countries, namely Australia, India, Singapore and the UAE. These countries together account for more than 70 per cent of total FDI inflows to the region. However, inflows to other countries in the region seem to have grown in the past few years. For example, inward FDI in Kenya, Mauritius, Madagascar, Mozambique and South Africa whose individual shares constitute less than 1 per cent of total regional flows increases by 101.5 per cent, 83.7 per cent, 73.9 per cent, 55.4 per cent and 43.4 per cent, respectively. On the other hand, Singapore and the UAE with respective shares of 15 per cent and 7.5 per cent in regional total in the period 2007-09 register negative growth in inward FDI flows. In both share and growth terms, India and Australia are found to be the most preferred destinations for direct investments in the region. Growing by 43.7 per cent and 32.6 per cent per annum during 2005-08, the shares of both the countries in regional FDI inflows improved remarkably from 18.9 per cent and 13 per cent in 2004-06 to 27.1 per cent and 23.6 per cent in 2007-09 respectively. The next tier of countries that witnessed moderate to average growth in inward direct investments are Yemen (39.3 per cent), Oman (34.5 per cent), Sri Lanka (21.3 per cent), Indonesia (11.7 per cent) and Tanzania (11.5 per cent). More or less, similar trend prevailed for inward FDI stock in the region. Like inward flows, growth in FDI outflows is found exorbitantly high for Australia (139.4 per cent), Thailand (80.4 per cent), Mozambique (74.8 per cent), Bangladesh (53.4 per cent), Kenya (49 per cent), Malaysia (45.6 per cent) and India (37.6 per cent). Australia held the highest share (28.6 per cent) in the total outward direct investments from the region during 2007-09 followed by India (21.3 per cent), Malaysia (14.4 per cent), UAE (13.9 per cent) and Singapore (10.6 per cent) (Table 3.1). Interestingly, the same set of countries dominates both inward and outbound FDI flows in the region.

3.2 Forms of FDI

With regard to forms of FDI flows, IOR-ARC countries have made significant presence in both cross-border mergers and acquisitions (M&As) and greenfield investments. Prior to the global financial crisis in 2007 the region as a whole registered impressive growth both as source and destination for cross-border M&As and greenfield investments. In 2006, the value of M&As in the IOR-ARC countries rose by 78.2 per cent whereas the number of M&As in those countries grew by 32.9 per cent. As destination, the value of M&As in IOR-ARC countries increased by 198.8 per cent in 2007. On the other hand, the region has performed well as the source for greenfield investments than as the destination. In terms of the number of deals, there have been consistent rise in both M&As and greenfield projects over the past few years. FDI flows, both inward and outward, have declined in

Table 3.1: Trends in Inward and Outward FDI Flows/Stocks

Country	Inward							
	Flow				Stock			
	Actual 2009 (US$ Million)	Share 2004-06	Share 2007-09	CAGR 2004-06/ 2007-09	Actual 2009 (US$ Million)	Share 2004-06	Share 2007-09	CAGR 2004-06/ 2007-09
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Australia	22572	18.9	27.1	32.6	328090	33.5	26.6	7.4
Bangladesh	716	0.8	0.6	5.6	5139	0.4	0.4	10.1
India	34613	13.0	23.6	43.7	163959	6.2	10.3	37.2
Indonesia	4877	5.8	5.0	11.7	72841	4.5	5.8	25.5
Iran	3016	2.9	1.5	–6.2	23984	1.9	1.7	11.3
Kenya	141	0.0	0.2	101.5	2129	0.1	0.2	21.3
Madagascar	543	0.2	0.6	73.9	3496	0.1	0.2	87.8
Malaysia	1381	5.7	4.1	5.3	74643	5.8	5.9	16.7
Mauritius	257	0.1	0.2	83.7	1889	0.1	0.1	24.4
Mozambique	881	0.2	0.4	55.4	4689	0.3	0.3	14.2
Oman	2211	1.2	1.9	34.5	13268	0.5	0.9	40.6
Singapore	16809	25.2	15.0	–1.1	343599	24.7	26.0	17.9
South Africa	5696	2.7	4.8	43.4	125085	9.4	7.9	9.5
Sri Lanka	404	0.4	0.4	21.3	4687	0.3	0.3	18.3
Tanzania	645	0.5	0.5	11.5	7266	0.6	0.5	11.0
Thailand	5949	9.0	6.1	3.3	99000	7.8	7.5	14.5
UAE	4003	13.0	7.5	–1.8	73422	3.6	5.2	31.1
Yemen	129	0.4	0.6	39.3	4525	0.2	0.3	43.6
	Outward							
	Flow				Stock			
	Actual 2009 (US$ Million)	Share 2004-06	Share 2007-09	CAGR 2004-06/ 2007-09	Actual 2009 (US$ Million)	Share 2004-06	Share 2007-09	CAGR 2004-06/ 2007-09
Australia	1	0.0	0.0	0.0	1	0.0	0.0	0.0
Bangladesh	66	0.1	0.1	9.3	442	0.0	0.0	24.0
Indonesia	18426	4.3	28.6	139.4	343632	49.0	38.5	9.4
IOR	2723	14.8	13.9	25.2	53524	2.5	5.8	57.3
Iran	15	0.0	0.0	53.4	91	0.0	0.0	–1.0
Kenya	14897	17.0	21.3	37.6	77207	3.1	7.7	60.4
Madagascar	2949	8.1	5.7	13.7	30183	2.9	3.3	23.8
Malaysia	356	0.8	0.4	4.6	2209	0.2	0.2	34.2
Mauritius	46	0.0	0.1	49.0	289	0.0	0.0	19.2
Mozambique	1	0.0	0.0	0.0	6	0.0	0.0	0.0
Oman	8038	9.7	14.4	45.6	75618	4.9	8.4	41.7
Singapore	38	0.1	0.1	18.2	375	0.0	0.0	17.6
South Africa	3	0.0	0.0	74.8	3	0.0	0.0	47.5
Sri Lanka	406	0.5	0.4	20.2	1239	0.2	0.2	12.5
Tanzania	20	0.1	0.1	23.3	334	0.0	0.0	21.9
Thailand	5979	35.8	10.6	–14.9	213110	27.2	26.6	17.6
UAE	1584	7.3	0.6	–44.6	64309	8.9	7.5	12.1
Yemen	3818	1.4	3.9	80.4	16303	1.1	1.6	36.5

Source: UNCTAD (2011), *World Investment Report 2011*, Geneva.

the crisis years of 2007-09. With moderate recovery in the year 2010, the investment prospects in the region may ease in subsequent periods. The leading IOR-ARC countries that invested heavily in M&As abroad were Australia, India, Singapore and UAE in 2005-07. And, during the same period all these countries except UAE have emerged as leading destinations for M&As (Tables 3.2 and 3.3).

Table 3.2: Trends in Cross-Border M&As, 2005-10

Source												
	Value of Deals (US$ Million)						No. of Deals					
Country	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Australia	26 602	31 949	43 439	18 454	–2 981	15 323	209	246	363	153	58	107
Bangladesh	-	-	-	-	-	1	-	-	-	-	-	3
India	1 877	6 715	29 083	13 482	291	26 421	98	134	175	163	56	139
Indonesia	290	– 85	826	913	–2 590	893	5	1	5	11	9	13
Kenya	12	-	-	18	-	-	2	4	4	3	1	2
Malaysia	1 946	2 664	3 654	9 751	3 277	2 306	120	117	123	113	63	86
Mauritius	– 265	232	89	206	191	– 50	14	12	6	6	10	5
Mozambique	-	-	-	-	-	-	-	-	-	-	-	–1
Oman	6	5	79	601	893	– 529	1	4	2	7	5	7
Singapore	5 706	5 566	23 916	6 992	2 762	7 851	134	100	129	78	74	134
South Africa	1 604	10 046	8 541	2 817	1 491	1 488	26	22	38	22	29	33
Sri Lanka	-	-	12	6	-	-	-	2	2	2	-	1
Thailand	– 203	88	54	1 416	872	2 864	10	9	11	17	16	21
UAE	7 481	23 117	15 611	5 983	14 831	–2 157	22	42	56	68	36	15
Yemen	-	-	-	-	-	-	-	-	-	-	-	1
Destination												
	Value of Deals (US$ Million)						No. of Deals					
Country	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Australia	2 070	10 508	44 222	33 530	22 206	26 530	180	229	252	306	283	305
Bangladesh	-	330	4	-	9	10	1	1	1	1	1	2
India	526	4 424	4 405	10 427	6 049	5 537	94	130	147	136	104	115
Indonesia	6 171	388	1 706	2 070	1 332	1 667	30	24	40	54	35	60
Iran	-	-	-	695	-	-	-	-	-	3	-	-
Kenya	32	2	396	-	-	-	3	2	2	5	-	1
Madagascar	-	1	-	-	-	-	-	3	-	1	-	-
Malaysia	1 141	2 509	6 976	2 781	354	3 441	92	67	91	80	75	59
Mauritius	– 25	268	-	26	27	203	3	4	2	5	5	9
Mozambique	-	34	2	-	-	35	-	5	2	-	-	4
Oman	116	1	621	10	-	386	1	2	9	2	2	2
Singapore	3 933	2 908	7 426	14 240	9 693	4 578	96	91	103	89	62	76
South Africa	5 092	–1 336	4 301	6 676	4 215	3 943	24	34	41	37	22	27
Sri Lanka	5	4	6	370	36	9	-	2	4	5	8	5
Tanzania	-	-	-	-	2	60	-	4	2	2	3	1
Thailand	– 632	3 771	2 372	142	346	457	29	36	31	41	12	18
UAE	61	53	856	1 225	300	376	12	13	18	27	13	18
Yemen	-	716	144	-	-	20	-	1	1	-	-	1

Source: UNCTAD (2011), *World Investment Report 2011*, Geneva.

Table 3.3: Trends in Greenfield Investments, 2005-10

Country	Value of Deals (US$ Million)						No. of Deals					
	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Australia	14322	18988	17597	29919	16156	9049	145	159	154	208	164	172
Bangladesh	208	20	-	14	24	50	4	3	-	3	2	6
India	11232	28192	23928	35666	20651	17314	191	297	215	358	267	339
Indonesia	4554	633	1659	390	1039	400	9	5	9	5	10	14
Iran	264	860	6076	1643	5197	503	7	7	7	9	16	13
Kenya	24	42	18	590	216	3517	4	3	2	26	26	17
Madagascar	-	27	-	-	-	-	-	2	-	-	-	-
Malaysia	6481	4996	25314	18121	13544	20566	73	71	73	135	114	75
Mauritius	2	-	36	314	2392	1028	1	-	2	5	8	8
Oman	-	-	95	91	3177	39	-	-	4	6	3	4
Singapore	6861	11105	14141	18127	11216	7683	84	100	92	177	119	106
South Africa	2212	1926	3589	4452	9608	4953	32	41	29	65	50	61
Sri Lanka	477	4760	7	26	65	36	5	4	1	3	4	3
Tanzania	-	-	-	9	32	49	-	-	-	1	2	3
Thailand	975	2366	2881	7951	7898	3193	19	36	29	47	51	38
UAE	28897	81296	57365	105523	27613	23217	102	210	145	266	229	211
Yemen	-	-	-	54	-	1	-	-	-	4	-	1
Destination												
Country	**Value of Deals (US$ Million)**						**No. of Deals**					
	2005	2006	2007	2008	2009	2010	2005	2006	2007	2008	2009	2010
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
Australia	6 847	3 815	20 937	27 362	15 200	37 107	115	135	178	240	254	322
Bangladesh	1 942	511	169	510	574	2 447	7	12	5	13	17	30
India	27 224	86 738	51 564	74 335	50 022	45 358	591	984	695	972	745	747
Indonesia	12 747	12 467	18 266	36 731	27 317	11 659	76	98	82	136	118	124
Iran	1 205	977	8 284	7 798	8 807	2 532	10	9	17	20	15	11
Kenya	546	81	354	437	3 708	1 549	13	12	8	19	29	35
Madagascar	336	246	3 331	1 273	474	-	4	3	3	4	3	-
Malaysia	4 091	4 497	9 912	20 168	12 088	12 750	92	125	172	214	158	187
Mauritius	80	3	538	294	58	54	5	1	4	14	5	5
Mozambique	-	595	2 103	11 607	1 557	3 192	-	5	5	23	10	16
Oman	2 958	3 216	2 349	13 792	6 266	4 226	13	37	16	55	42	38
Singapore	5 825	11 767	22 939	10 478	9 596	13 603	156	197	254	304	311	321
South Africa	3 467	4 947	5 148	11 873	7 509	5 891	62	76	59	120	109	95
Sri Lanka	249	547	602	1 085	1 682	716	12	11	15	22	23	26
Tanzania	1 520	263	315	2 090	726	994	11	7	6	17	11	23
Thailand	6 048	4 291	7 173	12 369	7 036	7 696	120	112	123	331	276	209
UAE	23 715	17 057	16 762	34 241	13 160	10 835	229	290	293	490	401	309
Yemen	2 144	308	190	4 010	952	1 049	3	3	4	10	5	6

Source: UNCTAD (2011), *World Investment Report 2011*, Geneva.

3.3 Sectoral FDI Flows

A look at the structure of FDI flows suggests that the IOR-ARC countries are increasingly witnessing service orientation in their economies. The proportion of FDI allocation to services in both inward and outward FDI flows is found higher in all leading countries like India, Mauritius, Singapore, Thailand, Australia, and Sri Lanka. In contrast, manufacturing and minerals attract highest shares in FDI inflows to other countries. For instance, FDI in manufacturing amounts to 54.5 per cent of total overseas inward direct investments in Indonesia. On the other hand, mineral sector accounts for 91 and 41.4 per cent of FDI inflows to Mozambique and Oman. From the available data, it is evident

Table 3.4: Sectoral FDI in IOR-ARC Countries

(Per cent)

Country	Latest Reported Year	Inward						Outward					
		Agr.	Min.	Mnf	Serv	Cons	Others	Agr.	Min.	Mnf	Serv	Cons	Others
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)
Flow													
Indonesia	2006	5.6	1.9	54.5	14.0	15.2	8.9	..	..	..	..	..	..
India	2010	..	6.2	6.6	25.3	4.1	28.6	..	..	..	..	..	..
Mozambique	2007	1.7	90.9	3.4	2.9	0.2	0.9	..	..	..	..	..	..
Mauritius	2007	..	..	..	83.9	..	16.1	..	..	1.3	1.7	0.0	2.9
Singapore	2007	0.0	0.1	28.9	69.7	0.0	1.3	..	..	..	..	..	..
Thailand	2006	0.0	1.6	33.0	57.9	0.4	7.2	..	..	..	..	..	..
Stock													
Australia	2008	0.2	25.4	18.8	45.0	3.3	7.3	..	8.1	21.9	61.1	0.4	8.5
Sri Lanka	2009	5.9	1.6	25.3	67.1	..	..	..	11.5	44.3	40.5	2.1	1.6
Oman	2007	..	41.4	18.5	25.8	..	14.4	..	..	..	..	..	..
Singapore	2006	..	..	31.6	68.0	0.3	0.1	..	..	22.9	74.3	0.5	2.3

Source: RIS estimation based on Trade Policy Reviews of various countries in the region.

Notes:Agr: for agricultural sector, Min: for mining sector, Mnf: for manufacturing sector; Serv: for services sector and Cons: for construction. Share of each cell represents the share in the total inward/outward FDI of respective country in the reporting year.

Table 3.5: Structure of Inward/Outward FDI in Agriculture

(Per cent)

Sector	Australia	Indonesia	Sri Lanka	Mozambique	Singapore
(1)	(2)	(3)	(4)	(5)	(6)
Flow					
Agriculture and agri-industry	0.0			1.5	
Fisheries and aquaculture				0.2	
Agriculture		5.0			
Agriculture, fishery and forestry					0.0
Fishery		0.6			
Forestry		0.0			0.0
Stock					
Agriculture, forestry and fishing	0.2				
Food, beverages, and tobacco			5.9		

Source: RIS estimation based on Trade Policy Reports of various countries in the region.

Note: Each cell denotes the total inward/outward FDI of respective country in the reporting year.

that the outward FDI has been mainly targeted in the services sectors (Table 3.4). Agriculture accounts for negligible share in total FDI flows to the region. Barring Sri Lanka and Indonesia for which it constituted 5.9 per cent and 5.6 per cent, direct investment in agriculture for the rest members is less than 1 per cent of total direct investment in the region (Table 3.5). Within manufacturing, FDI inflows are mainly targeted into the sectors like chemicals, textiles, paper and printing industry, food, and wood and wood products.

Besides these broad sectors, the sub-sectors that attract FDI inflows to the region includes automobile industry, electrical appliances, leather goods and footwear industry, machinery and transport equipment, metal and non-metallic, metal, machinery and electronics industry, fabricated metal products and equipments, and rubber and plastics industry.[21] Some countries such as Australia, Singapore and Mauritius have made substantial investments in manufacturing outside the region (Table 3.6). There have been steady inflows of FDI into diversified services sectors in the IOR-ARC countries. It includes banking, insurance and other financial services, tourism, telecommunication, transport and communications, computer software and hardware, wholesale, retail, hotels and restaurants, housing and real estate, transport, storage and communication, and trade, commerce and repair. For some countries, FDI inflows are heavily concentrated in certain sectors. For example, direct investments in tourism constitute 60 per cent of the total inward FDI to Mauritius in 2007. Likewise, investment in trade, commerce and repair accounts for 27 per cent of total FDI in Singapore and Thailand. Further, finance and insurance accounts for 38 per cent of total investments in Singapore in 2007. Australia and Singapore have been the two leading source countries for outbound FDI in the region. OFDI from these two countries is concentrated in the finance and insurance sector (Table 3.7).

To sum up, several countries in the region suffered from low domestic savings in the 2000s and are found heavily reliant on FDI for capital formation. Although savings rate improved moderately for a few economies in the subsequent years, it largely fell short of the potential investment requirements in many of the IOR-ARC member states during 2004-09. This resource gap created space for inward FDI in response to deliberate investment promotion measures as well as strong country fundamentals.

Regional economies are found equally competitive in inward as well as outbound FDI flows. FDI flows to the regional economies peaked up during 2005-08. However, it exhibits a skewed pattern with a few economies having significantly higher proportion in the total regional FDI inflows. At the same time, upward momentum in FDI inflows is also noticed for select small economies, mainly from the African region. Besides emerging as the preferred destinations

Table 3.6: Structure of Inward/Outward FDI in Manufacturing

(Per cent)

Sector	AUS	IDN	IND	LKA	MOZ	MUS	OMN	SGP	THA
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Inward: Flow									
Automobile industry			5.1						
Chemicals		9.1	1.5						2.9
Construction materials									0.0
Electrical appliances									6.8
Food		6.5							1.2
Industry	0.0				3.4				
Leather goods and footwear industry		0.2							
Machinery and transport equipment									9.6
Manufacturing								28.9	
Metal and non-metallic									2.6
Metal, machinery and electronic industry		19.2							
Motor vehicles and other equipment		2.8							
Non-mineral metals		5.7							
Others		0.2							7.1
Paper and printing industry		8.8							
Petroleum products									2.2
Precision instruments		0.0							
Rubber and plastic industry		0.6							
Textiles		1.0							0.6
Wood		0.4							
Inward: Stock									
Chemical, petroleum, rubber, plastic products				7.2					
Fabricated metal products, equipments				2.7					
Manufacture products n.e.s.				3.6					
Manufacturing	18.8						18.5	31.6	
Paper products, publishing and printing				0.8					
Textiles and clothing, leather products				9.8					
Wood and wood products				1.2					
Outwards and Flow									
Chemicals									1.5
Construction materials									0.0
Electrical appliances									3.8
Food and sugar									2.3
Machinery and transport equipment									3.6
Manufacturing						1.3			
Metal and non-metallic									1.6
Others									7.7
Petroleum products									1.1
Textiles									0.3
Outwards and Stock									
Manufacturing	44.3							22.9	0.0

Source: RIS estimation based on Trade Policy Reports of various countries in the region.

Note: Each cell denotes share in the total inward/outward FDI of respective country in the reporting year.

Table 3.7: Structure of Inward/Outward FDI in Services

(Per cent)

Sector	AUS	IDN	IND	LKA	MOZ	MUS	OMN	SGP	THA
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Inward: Flow									
Banking and insurance	0.0				0.0	23.5			
Telecommunication						0.3			
Tourism					2.4	60.1			
Transport and communications					0.4				
Computer software and hardware			3.0						
Financial & insurance								12.2	6.8
Hotel and restaurants		1.6							
Housing and real estate			4.3						
Investment									11.7
Other services		2.8						19.5	4.4
Real estate and business activities		0.3						11.5	8.3
Services, other than telecommunications			12.6						
Telecommunications			5.4						
Trade/commerce/ repair		7.2						26.5	26.7
Transportation, storage, and communication		2.1							
Inward: Stock									
Accommodation, cafes, and restaurants	0.2								
Finance and insurance	13.5						16.1	37.6	
Information & communication								1.1	
Other Services	1.6								
Professional, technical & support services								3.0	
Real estate, rental & leasing	8.6						4.4	2.8	
Services				67.1					
Trade							5.3		
Transport, storage and communication	6.6							5.6	
Wholesale & retail trade, hotels & restaurants	14.5							18.0	
Outward: Flow									
Banking						0.0			
Tourism						1.7			
Financial institutions									6.7
Investment									7.0
Other services									2.6
Real estate									1.1
Trade									43.7
Outward: Stock									
Finance and insurance	27.9							51.4	
Information & communication								5.8	
Other Services	1.8								
Professional, technical & support services								1.6	
Real estate, rental & leasing	4.1							4.1	
Transport, storage and communication	3.7							4.8	
Wholesale & retail trade, hotels & restaurants	3.0							6.6	0.0

Source: RIS estimation based on Trade Policy Reports of various countries in the region

Note: Each cell denotes share in the total inward/outward FDI of respective country in the reporting year.

for overseas direct investments, many of these economies invest outside the region also. While the member countries have presence in both forms of FDI flows, i.e. cross-border M&As and greenfield investments, the region has performed well as a destination for M&As and as a source for greenfield investments. Although FDI inflows are mostly channelled to manufacturing, a drastic shift is noticed in direct investments into the services sectors. The healthy trends in FDI inflows and outflows suggest an overall improvement in the investment climate in the region. At the same time, it has thrown the challenge of diverting the outbound FDI originating from the region to productive investments within the region. It will not only plug the pervasive resource gap but also contribute to the regional processes of production specialisation and fragmentation. As some member states like Singapore, Malaysia, Thailand and other South-East Asian economies are considered as hubs for production assembling and exports, it requires a calibrated approach by the member states to streamline their investment policies and initiate proper regional mechanisms for managing the regional investable resources within the region itself. With an overall improvement in the investment climate the region is gradually emerging as a preferred destination for FDI flows originating elsewhere.

4

Regional Trade: Policy, Potential and Performance

Trade has been the driving force in the context of regional economic cooperation. It involves a slew of policy reforms in the member countries including tariff liberalisation, harmonisation of regulations pertaining to non-tariff barriers, standards, technical barriers to trade, sanitary and phyto-sanitary measures, trade facilitation measures and policies relating to dispute settlements, arbitration, etc., among others. Trade performance could be better assessed by examining the trends in inter- and intra-regional export and import flows among the member countries. In fact, there are several approaches to measure success of a region in exploiting its trade potential. As the IOR-ARC region comprises of a number of developing and Less Developed Economies of different sizes, it is obvious to expect differences in the trade policy environment in the member states with regard to the trade structure, trade potential and nature of trade barriers. Given these policy dichotomies, it is imperative to conduct a detailed study of the level and direction of trade flows in the IOR-ARC region. The current chapter covers all those complex issues relating to trade in the region.

4.1 Trade Performance

During the last two decades, the structure of trade in the IOR-ARC grouping has undergone a considerable change. Trade flows of the region appeared to be strong before the inception of the IOR-ARC in 1997.[22] In 1996, just before the formation of the IOR-ARC, total IRT of the current members of the region was estimated to be US$ 217 billion. In the aftermath of the formal formation of the grouping, the growth in region's trade remained flat over the period 1997-2002. The region experienced steady growth in intra-regional and global trade since 2003 (Table 4.1). Overall, the level of regional trade has increased by more than four times in 2012 over the trade level in 2003 (Figure 4.1). In contrast, their total trade to the rest of the world increased by less than three times and half-fold during the same period. This indicates

that IRT has increased more sharply than their overall trade. The region achieved this distinction in IRT despite that there is no formal arrangement between the member countries to promote trade. Since the inception of the IOR-ARC, the intra-group trade passed through a phase of dynamic trade engagement, where both exports and imports made a moderate growth due to several compelling factors. IRT ratio (percentage ratio of IRT to region's total trade to world) was stagnant during 1997-2002, hovering around less than 23 per cent per annum. In subsequent years, it gained momentum to reach the level of 29.1 per cent of its global trade in 2010. IRT ratio continued to post impressive performance during global buoyancy, and the same drive continued during the recent episode of 'Global Financial Crisis'. However, the impressive record of accomplishment of rising IRT was marred during the 'Euro-Zone Crisis'. Interestingly, the rising phase of IRT ratio has resumed in 2012, showing beginning of a new era in regional trade.

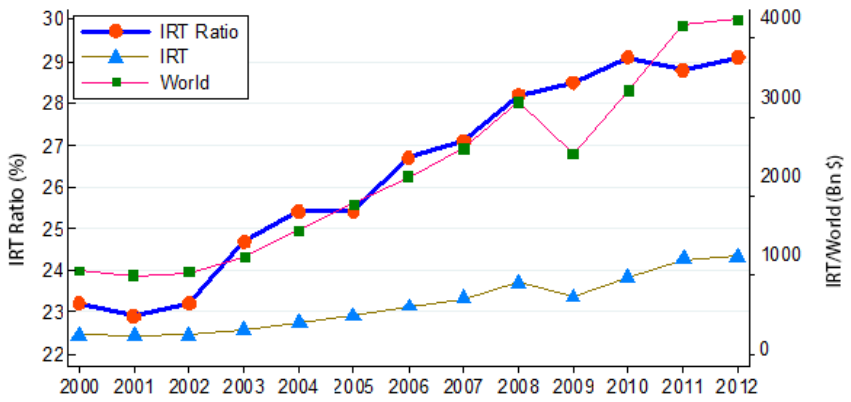
Table 4.1: IRT in the Region: Overall Situation

Variable	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
IRT (US$ Billion)	217	219	192	217	258	227	240	302	398	483	598	705	901	720	969	1199	1230
Total (DOTS) (US$ Billion)	970	979	902	971	1140	992	1036	1224	1564	1900	2241	2605	3193	2529	3329	4161	4232
IRT (per cent)	22.3	22.4	21.2	22.4	22.6	22.9	23.2	24.7	25.4	25.4	26.7	27.1	28.2	28.5	29.1	28.8	29.1

Source: IMF (2013), *Direction of Trade Statistics,* July, Washington DC.

Note: IRT refers to Intra-Region Trade.

Figure 4.1: Surging of Intra-Regional Trade Ratio in IOR-ARC



Source: IMF (2013), *Direction of Trade Statistics*, July.

It is often alleged that the IOR-ARC is a non-starter in its trade endeavour. This argument seems plausible when growth rate of region's IRT is lower than its overall trade with the world. In contrast, the current trade pattern of the region presents an impressive indication where growth in IRT outpacing the region's global trade. The IRT grew at the CAGR of 14.5 per cent whereas the region's overall trade with the world increased at the CAGR of 12.5 per cent during the period 1997/99-2005/07. The growth profile of regional trade continued during recession where intra-regional trade and overall trade of the region to the rest of the world grew at the CAGR of 13.5 per cent and 12.1 per cent per annum respectively during the period 2007/09-2010/12.

Further, trade flows within various sub-regions of the IOR-ARC region are lopsided. The region can be broadly divided into four sub-regions, namely Africa, Middle East, South Asia and South-East Asia including Australia. The speed of IRT flows between the four sub-regions has remained divergent since 1997. It is commonly perceived that the sub-regional trade may be stronger on account of regional contiguity which leads to cost advantage in terms of reduction in transaction costs. But IOR-ARC presents a different trade scenario. While the region's overall IRT ratio[23] is comparable with various successful Regional Trading Arrangements (RTAs) in the developing world, the trade flows within various sub-regions have been asymmetrical (Table 4.2). Taking into account the size of intra sub-regional trade flows, East Asia is at the top followed by the Middle East, Africa and South Asia. These sub-regions not only differ in their levels of IRT ratios but also in their speed.

Table 4.2: Intra-Sub-Regional Trade

(US$ Billion)

From	To	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
AFRIC	AFRIC	15.5	4.0	5.1	4.5	4.4	4.1	4.5	4.4	4.4	3.9	3.9
AFRIC	EASIA	5.4	4.4	5.4	5.1	5.4	5.4	5.5	5.5	5.5	5.8	5.5
AFRIC	MEAST	4.4	2.2	2.4	3.5	3.3	2.7	2.9	3.7	4.0	5.5	5.4
AFRIC	SASIA	5.4	2.3	2.4	1.8	1.8	1.8	1.9	2.1	2.8	2.9	2.9
EASIA	AFRIC	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.6	0.6	0.6	0.6
EASIA	EASIA	19.5	18.6	19.2	20.3	19.7	20.1	21.6	21.8	22.2	23.1	22.9
EASIA	MEAST	1.6	1.5	1.5	1.7	1.9	1.7	1.9	1.9	2.1	2.2	2.2
EASIA	SASIA	1.5	1.8	1.8	1.7	1.8	1.8	2.0	2.3	2.5	2.6	2.8
MEAST	AFRIC	1.0	0.9	0.7	1.9	1.9	1.5	1.4	1.7	1.5	2.1	2.1
MEAST	EASIA	8.8	8.1	9.1	9.5	8.7	8.4	8.1	8.1	7.9	8.6	8.2
MEAST	MEAST	5.6	7.4	8.4	5.8	6.8	7.8	6.4	5.2	5.3	5.3	5.3
MEAST	SASIA	4.0	4.4	5.3	3.7	4.2	4.0	4.2	5.8	5.5	5.7	6.1
SASIA	AFRIC	1.5	2.2	2.6	1.9	1.0	2.3	2.1	2.0	2.0	1.2	1.2
SASIA	EASIA	9.6	9.7	9.8	9.1	10.7	9.5	10.5	10.6	10.2	11.7	11.3
SASIA	MEAST	5.2	5.0	6.0	4.5	4.5	4.6	5.5	6.6	6.2	5.8	5.8
SASIA	SASIA	3.0	3.4	2.8	2.7	2.9	3.3	3.7	3.4	3.2	2.9	2.9

Source: IMF (2010), *Direction of Trade Statistics,* April. Washington DC.

Note: Results for the period 2008-12 are not included in the table for global double-dip recession. IRT refers to Intra-region Trade. AFRIC refers to Africa, EASIA to East Asia, MEAST to Middle East and SASIA to South Asia.

Recent trends in the IRT ratio indicate a steady rise in IRT for East Asia, stagnancy for the Middle East and decline for South Asia and Africa. The results show that some of the extra-sub-regions are becoming more attractive for trade than the sub-region itself. For example, intra-sub-regional trade ratios of South Asia and Africa are low but their corresponding ratios with extra-sub-regions like East Asia and Middle East are strong and significant. Among the sub-regions, East Asia and the Middle East are emerging as the most vibrant sub-regions in the IOR-ARC region. It is worth noting that the low IRT ratio in South Asia and Africa is due to the presence of large country-syndrome. Since large countries like India and South Africa are part of these two regions, the IRT ratio is bound to be low. However, for achieving better trade flows within the sub-regions, more comprehensive policies are required.

4.2 Regional Tariff Regimes and Recent Trade Policy Developments

4.2.1 Overview of Trade Policies in the Region

The pace of regional economic cooperation depends on commitments to trade policy harmonisation with respect to tariff, non-tariff barriers (NTBs), customs and other trade measures. In addition to unilateral liberalisation the degree of harmonisation across the grouping on tariff and other policy measures agreed upon by the member states matters most. From that angle, the progress made in the IOR-ARC mandates and targets has been very slow after more than a decade of its formation. While there could be numerous explanations for the inertia in the grouping's activities, the participation of the member states in other overlapping RTAs/FTAs across the IOR-ARC geographical space has been identified as the major potential disincentive to this process. Many of these member states are part of different RTAs and economic groupings and have shown various levels of commitments in trade, investment, services and other areas of mutual interest. The region as a whole presents diverse practices and regulations for trade, investment, services and other economic activities pertaining to country-specific priorities and stipulations. Overall, individual countries have undertaken significant liberalisation in their trading regimes; most of those are reflected in adherence to commitments to RTAs/forums like APEC, GCC, BIMSTEC, SACU and COMESA. Despite substantial progress in promoting trade reforms, regional economies maintain certain specific trade regulations and standards in the form of import prohibitions on sensitive products, products of specific national interests, security concerns, and for those products with conflicting rules of origin, and sanitary and phytosanitary conditions. The same applies to investment and services too. In that perspective, this section attempts to present the recent developments in trade and investment scenario in the region with an aim to expedite

the implementation process, and chart out the future roadmap for deepening economic cooperation in the region.

4.2.1.1 Tariff Structure

Over time, MFN applied rates has been invariably lowered for most counties in the region. In fact, the applied rates are almost zero for most products in Singapore. In general, the average level of protection is found higher for agricultural products than non-agricultural goods. Tariff bands have, more or less, converged downward across the region. The level of tariff protection in some of the regional economies is not only high as compared with other countries of the world, but also highly diversified among the regional economies. The region has witnessed two parallel trends in its tariff structure: (a) the level of tariff is not uniform and (b) the absence of sectoral tariff harmonisation. Based on the current tariff policies prevailing in the regional economies, the tariff regime in the IOR-ARC could be classified into three distinct tariff regimes: (i) liberal, (ii) moderate and (iii) restrictive.[24]

The IOR-ARC region is not only witnessing diversified tariff regimes but also facing the problem of peak tariffs. Peak tariff is a major concern for member countries as it serves as an instrument of protection to domestic producers against competitive imports from the region. The regional countries are pursuing more restrictive regime in so far as the management of peak tariffs is concerned. There are certain exceptional cases where countries with high average tariff may not be having restrictive peak tariff policy.

The evidence of positive tariff escalation exists for most tariff lines in a number of IOR-ARC countries. It increases with the degree of processing of goods. Higher tariff rates are associated with higher stages of processing. Textiles and clothing is the most commonly affected sector due to tariff escalation. One broad direction that emerges from the current tariff regimes in the region is the tendency to align MFN applied rates at par with the commitments made under various PTAs/RTAs by the individual member countries. While reduction in applied rates may benefit countries other than the preferential trading members of IOR-ARC countries, it has widened the gap between bound and applied rates. This may create uncertainty over the applied rates, thereby affecting trade between nations.

4.2.1.2 Anti-Dumping and Countervailing Measures

Anti-dumping and countervailing measures are quite steady in the IOR-ARC countries. Some of the regional countries have formal legislation and regulations for anti-dumping, safeguard and countervailing measures. The nature and number of initiations vary across the regional countries. In Australia, most initiations are on products

originating from Asia. Initiations are on products such as pineapple fruit, steel items and polynyl chloride.[25] India is one of the active users of anti-dumping measures among the regional economies. Over the period since the inception of the WTO in 1995 till June 30, 2010 India accounts for 436 out of 2,433 anti-dumping measures adopted by the WTO members constituting 17.9 per cent of total initiations.[26] These measures are undertaken against products like chemicals and chemical products, plastics and rubber and thereof, base metals, and textiles and clothing. Similarly, Indonesia has initiated a number of anti-dumping cases against base metals and chemicals. Some countries in the region such as Mauritius, Madagascar, Mozambique, Oman,[27] Sri Lanka and Tanzania do not have any legislation or regulatory framework as such on anti-dumping allegations. Thailand, being a highly export-oriented economy, has not initiated any anti-dumping case since 2005. Interestingly, UAE has not taken any anti-dumping, countervailing and safeguard actions since becoming the member of the WTO in 1996. With respect to services trade, Singapore believes in transparent conduct of the anti-dumping investigations, and is interested in tightening the Anti-dumping Agreement to help strengthen its provisions. There have been a few cases of anti-dumping against exports from the IOR-ARC countries.

4.2.1.3 Investment Regime

Investment policy forms an integral part of any trade agreement involving two or more countries. More importantly, policies relating to FDI provide information on priority sectors and sectoral caps if it exists. Most countries in the IOR-ARC region have recognised the growing importance of liberal investment regime and have introduced necessary policy measures for attracting FDI inflows. These include relaxing norms, restricting flows into different sectors, providing tax concessions, signing Bilateral Investment Treaties (BITs) and Double Taxation Treaties (DTTs), streamlining appraisal and documentation procedures, and so on. As the nature of fiscal incentives remain largely similar for most regional economies, the divergence in investment regimes could be explained by sectoral restrictions existing in individual member states. For instance, in Australia, foreign investment is restricted to sensitive sectors such as airports, banking, residential real estate, telecommunications, transport and natural resources. In the region, India is considered as one of the promising destinations for foreign investment. The Government of India has undertaken several policy reforms for attracting FDI to the fast growing sectors of the economy. In Indonesia, foreign investment is closed in forestry & plantation and communication sectors. For some regional countries, local participation (up to a prescribed limit) in the host countries is considered mandatory for approval of the foreign-originated investment projects. For instance, in Malaysia, the *Bumiputera* (local participation) requirement apply to sectors like banking and insurance, manufacturing

such as fabrics and apparel of *batik*, and integrated Portland cement, agriculture, defence, energy, telecommunications and water.

Among other policies, the Government of Mauritius has merged several overlapping incentives towards a uniform low-tax regime and target at the promotion of projects. Regulated activities in Mauritius include banking services, global business, internet services provider and freeport activities. Oman has recently emphasised on promoting private investment in order to achieve economic diversification away from oil towards agriculture, fisheries, manufacturing and services. At the same time, restrictions do exist for sectors such as real estate brokerage services, employment placement services, investigation and security services, tourist guide services, internal waterway transportation services, taxi transportation services, etc. Singapore is considered as a leading destination for FDI in the region because of its better infrastructure and sophisticated financial sector. It has emerged as a regional hub for high-end manufacturing and product development, and for coordination of regional procurement, production, marketing, assembling and distribution operations. While most sectors are open to foreign investment, it is prohibited in broadcasting, domestic news media, retail banking, legal and other professional services, property ownership, and sectors in which government-linked companies have a significant presence. Foreign investment is not permitted in money lending and retail trade where investment is lower than US$ 1 million, and coastal fishing among others.

In terms of foreign investment inflows, Bangladesh lags behind its potential due to poor investment climate, poor governance, infrastructure bottlenecks, labour quality and trade policy-related impediments. Reservations exist for public investment in arms and ammunitions, other military equipment and machinery, nuclear power, security printing and minting, and afforestation and mechanised extraction within the boundary of the reserved forests. There is no change in the investment regime in Madagascar. Besides the overall legislation governing foreign investment, there are specific frameworks for large-scale mining investments and industrial free zone regime. In Tanzania, the government has identified several sectors as the lead and priority sectors. The lead sectors cover economic infrastructure such as construction of roads, bridges, railways, airports and installation of electricity, telecommunications, water services, etc., and export processing zones. And, the priority sectors include agriculture and livestock, aviation, commercial bridges, commercial, development and micro-finance banks, export-oriented projects, special development areas, HRD, manufacturing, natural resources, fisheries, rehabilitation and expansion, tourism and tour operators, and radio and television broadcasting.

4.2.2 Trends in Tariff Liberalisation

The purpose of tariff regime is not only to protect domestic industries against intrusion of foreign imports into the domestic economy but also to fulfil wider development dimensions. Until the 1970s, most of the regional economies were protected against the external competition and pursued the Import Substitution Industrialisation (ISI) as a key economic strategy. Trade liberalisation started gradually in the region after seeing the growth of the Asian Tigers in the East. It took almost two decades for the South Asian sub-region to switch over to the alternative policy paradigm. Many member countries even began their reform process at a very late stage. As countries differ in terms of timing and sequencing of trade liberalisation, the pace of tariff liberalisation differs significantly across the region.

The level of tariff protection in some of the regional economies is not only high as compared with other countries of the world, but also highly diversified. The region has witnessed two parallel trends in its tariff structure – (a) the level of tariffs is not uniform among regional economies, and (b) there is no harmonisation among the regional economies so far as the level of protection across broad trade sectors is concerned. IOR-ARC region has large resource endowments, and it differs significantly across the sub-regions. As countries differ in level of economic development and resource endowments, there exist divergences in their tariff structures. Since trade policies are mostly guided by domestic compulsions, countries very often formulate tariff policies consistent with the existing industrial policies; a country prefers to lower its level of tariff protection where it is more competitive. The divergence in tariff structures among regional countries highlight the nature of regional competitiveness among the member countries.

The IOR-ARC member countries have divergent trade regimes (Table 4.3). It is difficult to regionalise countries in terms of homogeneous tariff regimes within the IOR-ARC. Using thumb rule, the regional economies are grouped into restrictive, moderate and liberal tariff regimes.[28] Based on 2008 data, five of the member countries fall under the liberal tariff regime (Australia, Mauritius, Oman, Singapore and United Arab Emirates), eight of them fall under moderate tariff regime (India, Indonesia, Malaysia, Mozambique, Sri Lanka, South Africa, Thailand and Yemen) and five of them fall under restrictive tariff regime (Bangladesh, Iran, Kenya, Madagascar and Tanzania).

It may be noted that some of the member countries have made marked improvement in undertaking significant tariff liberalisation by slashing their average tariff rates during the last decade. India reduced its average tariff from 32.9 per cent in 1999 to 11.5 per cent in 2008, Iran from 66.2 per cent in 2000 to 25.6 per cent in 2008, Mauritius

from 25.9 per cent in 1997 to 2.8 per cent in 2008, and Tanzania from 24.2 per cent to 12.3 per cent in 2008. Experiences of these countries indicate that other member countries can liberalise their tariff regime unilaterally to make the IOR-ARC region a barrier-free trading space. In the absence of uniformity in the trade policy regime in the region and contiguity of countries with similar trade policy regimes, it would be difficult to form any regional or sub-regional trading arrangement within the IOR-ARC. There are countries like Singapore where average tariff is close to zero, and no more advantage could be accrued to partner countries if they wish to make any trading arrangement with the country. Therefore, some other strategies may be adopted to foster trade and industrial activities in the region without taking the regional route.

The IOR-ARC is not only witnessing diversified tariff regimes, but also facing the problem of peak tariffs. Peak tariffs are becoming a major concern for member countries as this policy is used to protect domestic producers as against competitive imports from within the region. Countries managing with low average tariff may not be always those which are handling their peak tariff policies well. The experiences of most of the developed countries are falling under this category. For regional trade flow to flourish, countries with high tariff along with low peak tariff may be a better option than having low average tariff with high peak tariffs. As bilateral trade flow is low in the region, the coverage of export basket of most of the countries in the region is small. In case an importing regional country imposes peak tariff

Table 4.3: Regional Trade Regimes During 1997-2010: Average Simple Tariff

(Per cent)

Country	1997	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	Recent
Australia	5.2	4.4	4.1	4.2	4.2	4.2	3.5	3.4	3.4	3.4	3.4	2.8	2.8
Bangladesh	..	21.6	..	20.7	19.5	18.4	15.3	15.3	14.6	14.7	..	..	14.7
India	30.1	..	32.3	..	..	29.1	18.3	..	16.5	11.7	12.4	..	12.4
Indonesia	..	8.4	6.9	6.9	6.9	6.9	6.9	6.9	6.9	..	6.8	..	6.8
Iran	..	66.2	..	..	27.0	22.0	..	..	26.2	25.9	..	..	25.9
Kenya	..	15.5	19.1	..	..	16.7	12.8	12.6	12.6	12.5	12.5	12.6	12.6
Madagascar	..	..	4.6	..	..	..	12.3	13.3	12.4	12.4	..	..	12.4
Malaysia	10.2	..	8.3	8.3	8.3	..	7.3	7.1	7.1	6.8	6.9	..	6.9
Mauritius	28.7	..	..	18.4	..	..	6.0	3.0	3.1	3.0	1.1	..	1.1
Mozambique	15.7	..	13.8	12.1	12.1	..	12.1	12.1	10.3	..	10.0	..	10.0
Oman	4.7	..	..	7.6	..	..	5.0	5.0	5.2	5.2	5.2	..	5.2
Singapore	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
South Africa	6.4	..	7.7	..	..	7.9	7.6	7.5	7.7	7.4	7.6	7.5	7.5
Sri Lanka	19.4	9.2	9.2	..	..	10.0	10.8	10.6	10.9	..	10.3	..	10.3
Tanzania	24.2	16.3	..	..	13.6	..	12.8	12.6	12.6	12.5	12.5	12.6	12.6
Thailand	..	18.3	15.9	..	15.2	..	11.8	11.8	8.8	8.8	8.8	..	8.8
UAE	..	..	..	..	5.1	..	4.9	4.8	4.7	4.7	4.7	..	4.7
Yemen	..	12.8	..	..	..	..	..	6.9	..	..	6.9	..	6.9

Source: Trains Wits Online, Downloaded in October 2011, ITC, Geneva.

Note: Estimation is based on tariff lines reported at 6-digit HS for selected years.

against products which are of export interest to a regional country, the exporting country may not compete with domestic suppliers despite having price competitiveness. This would likely constrain the regional flow of trade.

Many countries in the region have been maintaining international tariff peak which is a major impediment to expand IRT. The trends in international tariff peak are declining in the regional economies during the period 1997-2009. Despite substantial tariff liberalisation in the 2000s, many member countries still have a large number of peak tariff lines. For instance, it is the highest for Iran with peak tariff constituting 54 per cent of total tariff lines in 2008 (Table 4.4). Economies having more than 40 per cent of its tariff lines as peak tariff include Bangladesh, Kenya, Madagascar, Sri Lanka and Tanzania. Except Sri Lanka, the rest of the countries mentioned above have restrictive tariff regimes.

The region has embraced liberalisation since its inception in 1997, but this process was intensified since 2005. This may be due to the WTO Agreement reached in the Sixth Hong Kong Ministerial Conference in 2005. This Agreement has a significant impact on many IOR-ARC countries leading to a swift change in the policy regime in terms of decline in the ratio of international peak lines to total tariff lines. In 2005, international peak ratio declined significantly in

Table 4.4: Share of International Peaks in Total Tariff Lines, 1997-2009

(Per cent)

Country	1997	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Recent
Australia	10.6	10.6	4.1	4.1	3.9	3.9	3.9	3.9	3.9	3.7	3.7	3.7	3.7
Bangladesh	..	55.0	54.8	..	52.7	53.1	52.2	42.1	42.1	42.1	41.8	..	41.8
India	89.6	89.8	..	93.9	..	..	94.0	18.3	..	18.5	13.2	12.0	12.0
Indonesia	..	30.6	12.3	3.6	3.5	3.4	10.5	10.5	10.5	17.5	..	15.9	15.9
Iran	..	..	67.5	..	..	47.0	47.5	..	..	55.2	54.0	..	54.0
Kenya	..	..	26.4	39.8	..	..	39.0	41.0	40.8	40.8	40.6	40.5	40.5
Madagascar	..	..	..	5.7	..	..	..	35.9	43.5	41.7	42.4	..	42.4
Malaysia	27.1	..	..	27.6	27.6	27.7	..	23.4	29.2	32.3	22.1	22.2	22.2
Mauritius	56.9	..	..	..	31.1	..	..	15.0	6.6	7.1	13.4	6.4	6.4
Mozambique	34.9	..	..	34.8	35.0	35.0	..	34.9	34.9	34.9	..	33.3	33.3
Oman	0.0	..	..	..	0.9	..	..	0.2	0.3	0.6	0.6	0.6	0.6
Singapore	..	..	..	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
South Africa	20.8	16.0	..	32.7	..	..	20.7	19.8	19.8	20.4	29.9	20.3	20.3
Sri Lanka	44.7	..	21.0	20.9	..	..	22.0	22.4	21.8	22.8	..	45.5	45.5
Tanzania	68.8	..	59.9	..	..	39.1	..	41.0	40.8	40.8	40.6	40.5	40.5
Thailand	..	..	45.8	52.3	..	49.0	..	26.4	26.4	20.2	20.2	20.0	20.0
UAE	..	..	..	..	..	0.5	..	0.3	0.3	0.2	0.2	0.2	0.2
Yemen	..	..	12.9	..	..	..	..	..	4.0	..	..	4.5	4.5

Source: Trains Wits Online, Downloaded in October 2011, ITC, Geneva.

Note: Estimation is based on tariff lines reported at 6-digit HS for selected years.

countries like Bangladesh, India, Malaysia, Mauritius, South Africa and Thailand in comparison to 2004. The year 2005 was a watershed for reforms in the policy regime for international tariff peaks. The liberalisation process continued during 2005-09. Between 2005 and 2009, some other countries also undertook significant reforms in rationalising their number of international tariff peaks.

For many countries, the number of tariff lines under peak tariff is relatively lower than other countries in the region. For example, the share of peak tariff lines is found significantly lower for Singapore, Mauritius, Oman, UAE and Yemen. Although the number of peak tariff varied marginally in the past decade, a distinct pattern in management of peak tariff was observed for select countries in the region. Peak tariff lines became gradually higher in countries such as Indonesia, Iran, South Africa and Sri Lanka. Interestingly, India witnessed a structural change in its peak tariff lines after 2004. It fell sharply from 94 per cent in 2004 to 18.3 per cent in 2005 and to 12 per cent in 2009. There were cases where reversal of tariff liberalisation policy was noticed. In case of Sri Lanka, the ratio of peak tariff increased from 22.8 per cent in 2007 to 45.5 per cent in 2009.

Average international peak tariff varies significantly across the member countries. Countries having small number of peak tariff are not the same as having low level of average peak tariff (Table 4.5). In case of Oman and UAE, the ratio of international peak tariff is low compared to other member countries in the region but their average

Table 4.5: Average International Peak Tariffs, 1997-2009

(Per cent)

Country	1997	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	Recent
Australia	26.6	21.3	25.0	25.0	25.0	25.0	25.0	17.5	17.5	17.5	17.5	17.5	17.5
Bangladesh	..	33.2	32.9	..	33.1	29.8	28.0	25.6	25.6	25.0	25.0	..	25.0
India	32.8	35.3	..	33.8	..	..	31.2	38.9	..	39.2	41.0	42.5	42.5
Indonesia	..	28.4	28.4	47.1	46.6	47.3	54.6	54.6	54.6	24.5	..	24.7	24.7
Iran	..	..	94.5	..	..	49.4	40.6	..	..	43.1	43.0	..	43.0
Kenya	..	..	33.4	33.5	..	..	29.4	25.9	25.8	25.9	25.7	25.7	25.7
Madagascar	..	..	..	20.0	..	..	..	23.8	20.0	20.0	20.0	..	20.0
Malaysia	41.2	..	..	41.4	41.4	41.4	..	29.7	29.5	28.2	27.6	27.7	27.7
Mauritius	46.6	..	..	..	57.3	..	..	39.8	30.0	30.0	23.2	18.3	18.3
Mozambique	35.0	..	..	30.0	25.0	25.0	..	25.1	25.0	20.0	..	20.0	20.0
Oman	..	..	..	..	96.6	..	..	100.0	100.0	100.0	100.0	100.0	100.0
Singapore	..	..	..	..	..	..	..	..	..	..	..	..	..
South Africa	25.3	24.2	..	24.9	..	..	26.7	26.1	26.1	26.3	22.2	26.2	26.2
Sri Lanka	34.0	..	25.6	25.6	..	..	28.7	28.4	28.4	29.6	..	22.1	22.1
Tanzania	30.6	..	23.3	..	..	25.0	..	25.9	25.8	25.9	25.7	25.7	25.7
Thailand	..	..	32.2	27.9	..	27.4	..	32.1	32.1	33.1	33.1	33.0	33.0
UAE	..	..	..	..	..	79.5	..	52.8	52.8	52.9	52.9	52.9	52.9
Yemen	..	..	26.5	..	..	..	..	..	25.0	..	..	25.0	25.0

Source: Trains Wits Online, Downloaded in October 2011, ITC, Geneva.

Note: Estimation is based on tariff lines reported at 6-digit HS for selected years.

tariff peaks are high compared to others in the region. With regard to the peak tariff levels, it is found substantially higher for Oman (100 per cent). Among others, peak tariff rates are above 40 per cent in the UAE, Iran and India. Surprisingly, peak tariff levels have remained steady for most regional economies except Australia, Indonesia, Mauritius, Mozambique and Sri Lanka which experienced a modest decline over the last decade. The year 2005 marked a turning point when average peak tariff declined significantly for several countries in the region. In India, peak tariff rates increased during 2005-09. Overall, the incidence of peak tariff on trade in the IOR-ARC countries has not entirely mitigated. Even though it is low for some member countries, there is hardly any visible decline in the level of peak tariff. This seems inconsistent with the pace of tariff liberalisation taking place in the region. Therefore, the member countries need to rationalise their peak tariff structure in tandem with other trade reform measures in order to ensure faster harmonisation of trade policy in the region.

4.2.3 Trade Facilitation

Transaction costs of IRT increase significantly because of constraints involved in documentation and custom procedures. Lack of common standards in the region is a major hindrance to growth of IRT. Different member countries adopt varying standards for the same type of products, which are traded within the region. There is a need to harmonise the conformity assessment procedures and evolve common standards or mutual recognition of reciprocal standards with respect to product rating, packaging, labelling, etc., to boost trade within the region. Harmonisation of standards could be instrumental not only in achieving scale economies and cost reduction but also in bringing about innovations and promote international division of labour. Regional experience shows that there is a considerable level of asymmetry between countries in levels of transaction costs and procedures relating to exports and imports. Trends in container costs, documentation procedures and time involved in clearance of various procedures indicate that container cost is high for many regional countries and such costs have increased during 2006-11(Table 4.6). As regards exporting/importing procedures, the complexities in documentation and time taken for clearances are streamlined during the period.

Container cost has been high in many African member countries such as Kenya, Madagascar, South Africa, Tanzania, etc. But such costs are relatively low in some countries in South-East Asia and the Middle East. Except Thailand, other member countries have observed significant escalation of container costs in the recent years. Countries witnessing low rise in container costs include Thailand, Kenya, Yemen, Mauritius, Bangladesh, etc. On the other hand, sharp increase in such costs is noticed in countries like Madagascar, Iran, South Africa and Tanzania.

Table 4.6: Structure of Impediments to Trade

Countries	Cost to Trade (US$ per container)				Number of Documents				Time for Trade (Days)			
	Exports		Imports		Exports		Imports		Exports		Imports	
	2006	2011	2006	2011	2006	2011	2006	2011	2006	2011	2006	2011
Australia	795	1060	945	1119	5	6	10	5	12	9	12	8
Bangladesh	902	985	1287	1390	6	6	8	8	35	25	57	31
India	864	1055	1244	1025	8	8	9	9	27	17	41	20
Indonesia	546	704	675	660	5	5	6	6	25	20	27	27
Iran	860	1090	1330	1735	7	7	8	8	26	25	39	32
Kenya	1980	2055	2325	2190	7	8	12	7	45	26	62	24
Madagascar	982	1197	1282	1555	8	4	11	9	48	21	48	24
Malaysia	432	450	385	450	7	7	7	7	18	18	14	14
Mauritius	683	737	683	689	5	5	7	6	16	13	16	13
Mozambique	1055	1100	1185	1475	7	7	10	10	27	23	38	30
Oman	665	766	647	890	9	9	9	9	18	14	23	17
Singapore	416	456	367	439	4	4	4	4	5	5	4	4
South Africa	1087	1531	1195	1807	8	8	9	9	30	30	35	35
Sri Lanka	647	715	639	745	7	8	9	6	25	21	26	19
Tanzania	822	1262	917	1475	7	5	13	7	30	24	51	31
Thailand	848	625	1042	795	9	4	12	3	24	14	22	13
UAE	462	521	462	542	7	4	8	5	12	7	12	7
Yemen	1129	1129	1475	1475	6	6	9	9	33	27	28	25

Source: World Bank (2011), *Doing Business Online,* October.

As mentioned above, the regional economies have introduced comprehensive liberalisation in the trading procedures. These measures have resulted in convergence of a plethora of trade procedures and logistics. Of these, the measures undertaken to address the issue of time taken for export/import clearance have been quite effective and successful. Thailand and Singapore have emerged as the most ideal countries in the region where the number of documents required is found to be the lowest for exports and imports. For other regional countries, it differs widely from 10 in Mozambique to 3 in Thailand in 2011.

Time taken for customs clearance has declined for all countries in the region during 2006-11. The decline is prominently noticed in countries like Kenya (48 to 26) and Madagascar (48 to 21) between 2006 and 2011. Clearance time has been the lowest for exports and imports in Singapore in the whole region. This has been low in countries like the UAE, Australia, Mauritius, Thailand, Oman, etc. Despite liberalisation, clearance time has been low for countries like Tanzania, Bangladesh, Iran, Kenya, Yemen and South Africa, etc., among others. The following measures are suggested for reforms in the custom clearance procedures:

- Enhancing trade facilitation in customs by simplification and harmonisation of customs procedures.
- Promoting transparency, consistency and uniformity in the classification of goods traded between the member countries.
- Evolving transparent, consistent and uniform valuation methods and rulings.
- Facilitating greater use of information technology in the customs clearance procedure and exchange of experience and expertise. Developing databases of standards and conformity assessment procedures in relation to the regulatory requirements of member countries for easy access by the regulatory bodies as well as exporters in the participating countries.
- Evolving technical cooperation in capacity building through setting up an accreditation mechanism against various international standards, and also facilitating the building up of the systems in certification bodies with a view to their seeking accreditation against these standards.
- Organising awareness and training programmes for the member countries with a view to utilise the available expertise within this region.
- Setting up of an Expert Group on Standards and Quality Control, which would meet once in six months for experience sharing with regard to problems with importing countries, testing issues, standardisation and conformity assessment issues and latest development in related fields.
- Developing online links between the member countries with regard to certificate of origin, quality and test certificates, etc.

4.2.4 Apprehension Regarding Economic Feasibility of an FTA/PTA

Discussions in the preceding sections present some insights on the economic feasibility of an FTA/PTA in the IOR-ARC region. The countries in the region are already into the regional process and assumed membership in several forums prior or after joining IOR-ARC. Many of them are part of several FTAs, Custom Unions, Bilateral FTAs, etc. In these trading arrangements, the member countries have made commitments to various schemes of trade, investment and sectoral liberalisation. In that case, the possibility of adopting an 'existing commitment plus' approach may be difficult. For example, the region has three custom unions (SACU, GCC and ASEAN) where each of them maintain common border tariff. Member countries in a Custom Union cannot offer a better treatment to another country/RTA outside the caucus and in that case, all countries of the Custom Union have to agree on revision in the common border tariff. Therefore, harmonisation of tariff among Custom Unions may be a difficult task to realise. At the same time, FTA within the region is difficult because of large variation in the level of tariff across the

IOR-ARC member countries. According to the recent information, average simple tariff rates at the country level vary from 0 per cent to nearly 26 per cent. In case of an FTA, gains from liberalisation would be low for the countries having high tariff. The possibility of asymmetric gains from an FTA may minimise its relevance as a policy option. In the present context, the formation of an FTA/PTA cannot be considered as a viable policy alternative for the IOR-ARC countries to have economic cooperation among themselves. Member countries may consider 'open regionalism' as an alternative to foster cooperation in diversified sectors including trade and investment. Many regions have gained from sectoral cooperation in the framework of 'open regionalism' as compared to alternative option of an FTA/PTA.

To sum up, trade policy regime in the region indicates that trade liberalisation is underway in all the member countries in diversified sectors. While many of these liberalisation initiatives are unilateral in nature, others are implemented as part of their engagement in various regional and sub-regional initiatives. Despite these developments, there are asymmetries in the level of trade liberalisation across member countries. The region has several custom unions and regional arrangements, covering almost all countries of the region. Considering their commitments to these RTAs/CUs, economic feasibility for an FTA/PTA for the region as a whole is not feasible. The region can take advantage from the existing complementarities in several sectors including trade, production, technology, etc., among others. Trade liberalisation in the framework of 'open regionalism' could help the member countries to take advantages from the synergies of the region. Unilateral liberalisation with sectoral cooperation could be the key approach to promote regional cooperation in the IOR-ARC region. The empirical estimates suggest that the region has large trade and investment potential which could be the basis for sectoral cooperation. Realisation of such opportunities is linked to the manner in which the NTBs and trade facilitation issues are handled in the regional forum.

4.3 Trade Potential of the Region

As per the empirical estimates, the total export potential[29] in the IOR-ARC region turns out to be US$ 453.1 billion. This estimation is based on modified trade creation effect.[30] Apparently, it is larger for two sub-regions, e.g. South-East Asia (US$ 140.9 billion) and Africa (US$ 133.7 billion) constituting more than 60 per cent of the total regional trade potential. Overall, no country is found to emerge as the single dominant trade partner for any particular IOR-ARC country. However, there are select markets that cover the largest portion of the bilateral export potential existing within the region. Some of those are: Singapore for India and Iran; Australia, India and Singapore for Malaysia; and Singapore for South Africa. As noticed above, Singapore serves as a major trade destination for most economies in

the region. In terms of market access, Australia (US$ 67.4 billion) is identified as the largest market for bilateral exports of the IOR-ARC countries followed by India (US$ 60.4 billion), UAE (US$ 58.2 billion), Thailand (US$ 57.4 billion), Malaysia (US$ 40.8 billion), and Indonesia (US$ 31.1 billion). It is clearly evident that the South-East Asia sub-region with US$ 285.7 billion market provides the largest export opportunities to the member countries. Although most regional economies are projected to gain a fair share in the regional export market (barring a few) the market access opportunities may differ among them while considering the sectoral export potential (Table 4.7).

In terms of individual country markets, Malaysia provides the highest export potential (US$ 48.8 billion) and Mozambique is the lowest (US$ 3.2 billion) in the region. The other countries that have relatively large trade potential include India, South Africa, Iran, Kenya and the UAE with shares of 7.9 per cent, 7.6 per cent, 7.4 per cent, 6.1 per cent and 5.9 per cent, respectively (Figure 4.2).

A look at the distribution of sectoral export potential within the four sub-regions of the region shows a clear dominance of South-East Asia and South Asia in sectors such as arms and ammunition (HS Section 19) and works of art collectors' pieces (HS Section 21), respectively. Barring these two sectors, the export potential in all other sectors is mostly evenly distributed among the different sub-regions. As observed, South-East Asia and Africa individually hold, on an average, around

Table 4.7: Overall Bilateral Flow of Export Potential

(US$ Billion)

Country	ARE	AUS	BGD	IDN	IND	IRN	KEN	LKA	MDG	MOZ	MUS	MYS	OMN	SGP	THA	TZA	YEM	ZAF
Australia	4.0	0.0	3.7	3.4	5.6	4.3	4.8	3.3	2.9	2.6	3.1	7.0	2.0	5.0	4.1	3.0	3.5	5.1
Bangladesh	0.2	0.2	0.0	0.2	0.3	0.3	0.2	0.1	0.1	0.1	0.1	0.5	0.1	0.1	0.2	0.1	0.1	0.3
India	4.7	3.9	2.1	4.2	0.0	3.7	4.5	2.3	2.3	2.2	2.3	9.3	2.3	3.6	3.4	3.8	1.8	4.0
Indonesia	2.5	1.5	1.4	0.0	2.8	2.8	1.8	1.4	1.4	1.1	1.2	3.4	0.9	1.5	2.0	1.6	1.2	2.6
Iran	0.1	0.1	0.2	0.1	0.2	0.0	0.1	0.1	0.1	0.0	0.1	0.3	0.1	0.1	0.1	0.1	0.1	0.2
Kenya	0.1	0.1	0.1	0.1	0.1	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Madagascar	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Malaysia	3.2	2.0	2.6	3.0	4.4	3.5	2.3	2.4	1.8	0.8	1.0	0.0	1.9	1.9	3.0	1.7	1.9	3.4
Mauritius	0.1	0.1	0.1	0.1	0.2	0.1	0.1	0.1	0.0	0.1	0.0	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Mozambique	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.1	0.0	0.1	0.1	0.0	0.1	0.1
Oman	0.3	0.2	0.2	0.3	0.3	0.4	0.3	0.3	0.1	0.2	0.2	0.4	0.0	0.2	0.3	0.2	0.3	0.3
Singapore	5.3	5.0	6.0	4.3	9.1	7.4	4.1	4.7	2.3	2.1	2.8	11.7	2.6	0.0	4.5	2.9	5.3	8.9
South Africa	1.5	1.4	1.3	1.2	1.9	1.7	1.6	1.5	1.2	0.6	0.8	2.9	0.7	1.4	1.3	1.1	1.3	0.0
Sri Lanka	0.3	0.2	0.2	0.2	0.3	0.3	0.2	0.0	0.1	0.1	0.1	0.4	0.1	0.2	0.2	0.1	0.2	0.3
Tanzania	0.1	0.1	0.2	0.1	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.3	0.1	0.1	0.1	0.0	0.2	0.2
Thailand	4.2	2.9	2.4	3.8	5.0	4.4	3.3	2.7	3.2	2.0	2.3	6.6	2.2	3.3	0.0	2.8	1.9	4.4
UAE	0.0	3.5	2.4	3.8	4.8	3.8	3.7	2.8	2.0	2.3	3.2	5.1	2.4	3.8	3.8	4.0	2.6	4.2
Yemen	0.1	0.1	0.3	0.1	0.2	0.3	0.1	0.1	0.1	0.1	0.1	0.3	0.1	0.1	0.1	0.1	0.0	0.2
IOR	26.9	21.4	23.5	25.2	35.6	33.7	27.5	22.0	17.9	14.5	17.6	48.8	15.8	21.8	23.7	21.7	21.0	34.5

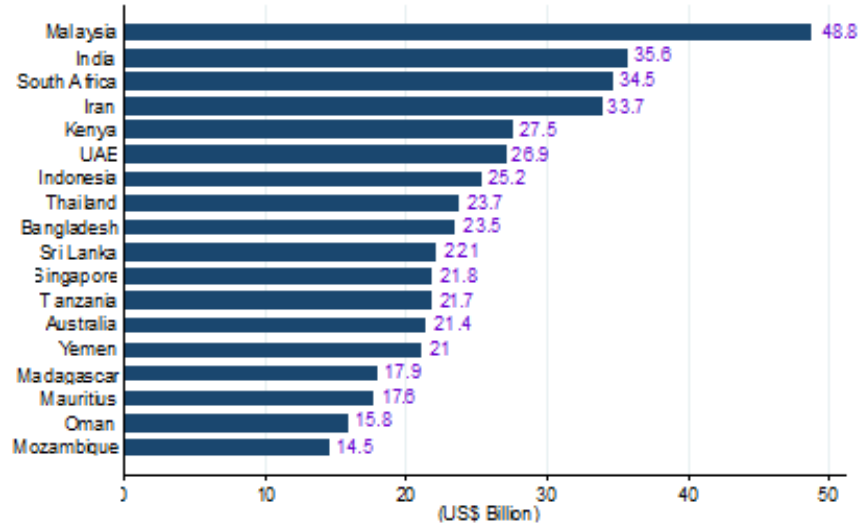
Source: RIS based on data from Comtrade online, extracted in October 2011, World Bank.

Notes: Export potential is estimated using Viner's trade creation approach.
The table is read as BGD's export potential in Australia to the extent of $3.7 billion in a year.

30 per cent each of the region's total export potential in large number of sectors. Compared to this trend, the average sectoral shares of the Middle East and South Asia in regional trade potential are lower. While two sectors, e.g. animal or vegetable fats & oils (HS Section 3) and live animals and animal products (HS Section 1) constitute 30 per cent each in regional total in the Middle East, no particular sector in South Asia except works of art collectors'pieces (HS Section 21) possesses significant export potential relative to other sectors (Table 4.8).

It is interesting to note that most regional economies are likely to gain equally by trading within the region. Although the aggregate export potential seems large for South-East Asia, the difference in country sectoral export shares in the regional total is not significant and asymmetric. The select trade sectors for which the country export shares are relatively higher include mineral products (Malaysia, 24.2 per cent), arms and ammunition (Malaysia, 23.1 per cent), animal or vegetable fats & oils (Malaysia, 22 per cent), and works of art collectors' pieces (16.7 per cent for Bangladesh, India, Kenya, Malaysia, South Africa and Sri Lanka) (Table 4.9). Besides Malaysia, which has the highest trade potential in many key product categories, Iran and Kenya retain large export shares in a number of sectors that IOR-ARC mostly trade. Iran's export potential is found high in animal or vegetable fats & oils, mineral products, base metals and articles of base metal, and plastics & articles thereof. Likewise, Kenya dominates regional exports in sectors such as footwear, headgear and umbrella, optical, photograph & cinematography, and wood & articles of wood. As the distribution of exports across sectors looks balanced, the fear of trade distortion due to large economy dominance in the region may be unwarranted.

Figure 4.2: Trade Potential of Member Economies within the Region



Source: RIS based on Comtrade, Online

Table 4.8: Sub-Regional Export Potential

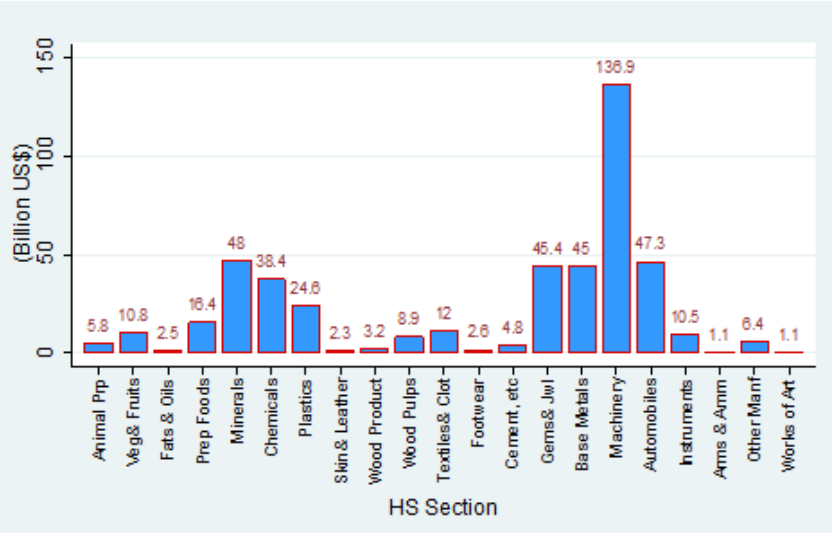
(US$ Billion)

Section	Description	South-East Asia	Middle East	South Asia	Africa
(1)	(2)	(3)	(4)	(5)	(6)
1	Live animals and animal products	1.44	1.4	0.64	1.32
2	Vegetable products	2.59	2.18	1.49	3.55
3	Animal or vegetable fats & oils	0.59	0.46	0.16	0.29
4	Prepared foodstuff, beverages, etc.	4.2	3.73	2.63	4.88
5	Mineral products	17.59	11.18	7.2	11.06
6	Products of chemicals	12.82	8.87	6	9.67
7	Plastics & articles thereof	6.7	6.03	4.18	6.7
8	Raw hides & skins, leather, etc.	0.33	0.35	0.26	0.37
9	Wood & articles of wood	0.71	0.33	0.32	0.83
10	Pulp of wood or of other fibres	2.27	1.79	1.55	2.32
11	Textiles & textile articles	3.49	2.06	2.35	3.1
12	Footwear, headgear and umbrella	0.47	0.3	0.39	0.43
13	Articles of stone, plaster, cement	1.06	0.87	0.75	1.11
14	Natural or cultured pearls, jewellery	17.53	5.81	2.95	18.08
15	Base metals & articles of base metal	13.52	10.95	6.85	12.64
16	Machinery and mechanical appliances	37.33	29.72	31.33	37.52
17	Vehicles, aircraft and vessels	13.75	8.47	8.79	15.3
18	Optical, photograph & cinematography	3	1.57	2.13	2.82
19	Arms and ammunition	0.08	0.02	0.01	0.02
20	Miscellaneous manufactured articles	1.34	1.27	1.1	1.64
21	Works of art collectors' pieces	0.01	0	0.03	0.02
	Total	**140.82**	**97.36**	**81.11**	**133.67**

Source: RIS based on data from Comtrade online, extracted in October 2011, World Bank.

Note: Sections are based on the HS system.

Figure 4.3: Estimates of Regional Trade Potential (Year 2009)



Source: Comtrade, World Bank, Washington D.C.

Trade within the region is concentrated in few sectors such as machinery and mechanical appliances, mineral products, vehicles, aircraft and vessels, natural or cultured pearls, jewellery, base metals & articles of base metal, and products of chemicals that cover 78 per cent of the total estimated regional export potential (Figure 4.3). Huge export potential also exists in sectors like prepared foodstuff, beverages, etc., plastics & articles thereof, vegetable products, textiles & textile articles, and optical, photograph & cinematography. Each country specialises in certain sectors and those sectors largely account for substantial chunk of exports in the region. Machinery and mechanical appliances (HS Section 16) is identified as the dominant sector in 16 out of 18 member countries in the IOR-ARC region. Other prominent sectors that exhibit massive export potential

Table 4.9: Sectoral Distribution of Trade Potential

(US$ Billion)

Section	AUS	BGD	IND	IDN	IRN	KEN	MDG	MYS	MUS	MOZ	OMN	SGP	ZAF	LKA	TZA	THA	ARE	YEM
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)	(19)
1	0.25	0.08	0.40	0.29	0.42	0.23	0.18	0.31	0.16	0.19	0.28	0.30	0.36	0.16	0.20	0.29	0.32	0.38
2	0.36	0.38	0.88	0.62	0.84	0.51	0.49	0.82	0.50	0.77	0.38	0.32	0.52	0.23	0.76	0.47	0.46	0.50
3	0.07	0.06	0.06	0.11	0.19	0.06	0.00	0.33	0.10	0.04	0.08	0.03	0.04	0.04	0.05	0.05	0.06	0.13
4	0.55	0.70	1.25	0.91	1.13	1.02	0.35	0.88	0.94	0.67	0.58	0.77	1.13	0.68	0.77	1.09	1.26	0.76
5	1.74	4.43	1.54	1.21	5.11	1.00	3.37	11.38	1.62	2.24	0.42	0.97	2.54	1.23	0.29	2.29	1.40	4.25
6	1.99	1.36	2.85	3.03	3.10	2.40	0.72	3.90	1.51	0.51	1.63	1.33	2.90	1.79	1.63	2.57	2.86	1.28
7	1.07	1.30	1.69	1.59	2.41	1.28	0.72	1.70	1.01	0.72	1.03	0.97	1.66	1.19	1.31	1.37	1.55	1.04
8	0.06	0.08	0.07	0.05	0.10	0.10	0.06	0.13	0.02	0.02	0.02	0.05	0.11	0.11	0.06	0.04	0.10	0.13
9	0.14	0.11	0.12	0.11	0.11	0.23	0.10	0.18	0.07	0.10	0.05	0.10	0.22	0.09	0.11	0.18	0.11	0.06
10	0.42	0.38	0.60	0.41	0.53	0.39	0.27	0.55	0.41	0.25	0.28	0.34	0.64	0.57	0.36	0.55	0.60	0.38
11	0.40	0.93	0.85	0.65	0.79	0.70	0.43	1.10	0.41	0.21	0.15	0.60	0.95	0.57	0.40	0.74	0.82	0.30
12	0.04	0.12	0.14	0.03	0.11	0.18	0.02	0.14	0.03	0.02	0.03	0.13	0.13	0.13	0.05	0.13	0.05	0.11
13	0.12	0.17	0.33	0.27	0.32	0.31	0.14	0.28	0.13	0.06	0.14	0.16	0.28	0.25	0.19	0.23	0.24	0.17
14	3.46	0.03	2.21	3.75	0.54	3.88	2.26	3.57	3.38	2.72	2.34	3.50	1.14	0.71	4.70	3.25	2.90	0.03
15	1.95	1.68	3.00	3.07	4.88	2.20	0.99	3.80	1.70	1.70	1.71	2.28	3.41	2.17	2.64	2.42	2.94	1.42
16	5.60	8.27	14.26	6.14	9.84	8.39	5.01	13.78	3.15	2.24	5.84	6.27	13.35	8.80	5.38	5.54	8.13	5.91
17	2.45	2.48	3.98	2.25	2.54	3.12	2.21	4.29	2.06	1.83	0.28	2.94	3.78	2.33	2.30	1.82	2.16	3.49
18	0.60	0.54	0.92	0.39	0.31	1.03	0.23	1.08	0.20	0.11	0.26	0.56	0.99	0.67	0.26	0.37	0.58	0.42
19	0.01	0.00	0.01	0.02	0.00	0.01	0.00	0.03	0.00	0.00	0.00	0.01	0.00	0.00	0.01	0.01	0.01	0.01
20	0.13	0.38	0.39	0.26	0.41	0.42	0.30	0.50	0.15	0.12	0.27	0.16	0.35	0.33	0.30	0.29	0.39	0.20
21	0.00	0.01	0.01	0.00	0.00	0.01	0.00	0.01	0.00	0.00	0.00	0.00	0.01	0.01	0.00	0.00	0.00	0.00
Total	**21.41**	**23.52**	**35.57**	**25.17**	**33.69**	**27.47**	**17.85**	**48.78**	**17.56**	**14.49**	**15.76**	**21.79**	**34.51**	**22.05**	**21.74**	**23.70**	**26.94**	**20.96**

Source: RIS based on data from Comtrade online, extracted in October 2011, World Bank.

Notes: 1 = live animals and animal products; 2 = vegetable products, 3 = animal or vegetable fats & oils, 4 = prepared foodstuff, beverages, etc., 5 = mineral products, 6 = products of chemicals, 7 = plastics & articles thereof, 8 = raw hides & skins, leather, etc., 9 = wood & articles of wood, 10 = pulp of wood or of other fibres, 11 = textiles & textile articles, 12 = footwear, headgear and umbrella, 13 = articles of stone, plaster, cement, 14 = natural or cultured pearls, jewellery, 15 = base metals & articles of base metal, 16 = machinery & mechanical appliances, 17 = vehicles, aircraft and vessels, 18 = optical, photograph & cinematography, 19 = arms and ammunition, 20 = miscellaneous manufactured articles, 21 = works of art collectors' pieces.

AUS =Australia, BGD = Bangladesh, IND = India, IDN = Indonesia, IRN = Iran, KEN = Kenya, MDG = Madagascar, MYS = Malaysia, MUS = Mauritius, MOZ = Mozambique, OMN = Oman, SGP = Singapore, ZAF = South Africa, LKA = Sri Lanka, TZA = Tanzania, THA = Thailand, ARE = UAE, YEM = Yemen.

Table 4.10: Dominant Sectors in IOR-ARC Countries in Trade Potential

Sl. No.	Country	Trade Sectors	Trade Potential (per cent)
(1)	(2)	(3)	(4)
1.	Australia	Machinery & mechanical appliances (16), Natural or cultured pearls, jewellery (14), Vehicles, aircraft & vessels (17)	53.8
2.	Bangladesh	Machinery & mechanical appliances (16), Mineral products (5), Vehicles, aircraft & vessels (17)	64.6
3.	India	Machinery & mechanical appliances (16), Vehicles, aircraft & vessels (17)	51.3
4.	Indonesia	Machinery & mechanical appliances (16), Natural or cultured pearls, jewellery (14), Base metals & articles of base metal (15), Products of chemicals (6)	63.5
5.	Iran	Machinery & mechanical appliances (16), Mineral products (5), Base metals & articles of base metal (15)	58.9
6.	Kenya	Machinery & mechanical appliances (16), Natural or cultured pearls, jewellery (14), Vehicles, aircraft & vessels (17)	56.0
7.	Madagascar	Machinery & mechanical appliances (16), Mineral products (5), Natural or cultured pearls, jewellery (14), Vehicles, aircraft & vessels (17)	72.0
8.	Malaysia	Machinery & mechanical appliances (16), Mineral products (5)	51.6
9.	Mauritius	Natural or cultured pearls, jewellery (14), Machinery & mechanical appliances (16), Vehicles, aircraft & vessels (17)	49.0
10.	Mozambique	Natural or cultured pearls, jewellery (14), Mineral products (5), Machinery & mechanical appliances (16), Vehicles, aircraft & vessels (17), Base metals & articles of base metal (15)	74.0
11.	Oman	Machinery & mechanical appliances (16), Natural or cultured pearls, jewellery (14), Base metals & articles of base metal (15), Products of chemicals (6)	73.1
12.	Singapore	Machinery & mechanical appliances (16), Natural or cultured pearls, jewellery (14), Vehicles, aircraft & vessels (17), Base metals & articles of base metal (15)	68.8
13.	South Africa	Machinery & mechanical appliances (16), Vehicles, aircraft & vessels (17)	49.7
14.	Sri Lanka	Machinery & mechanical appliances (16), Vehicles, aircraft & vessels (17)	50.5
15.	Tanzania	Machinery & mechanical appliances (16), Natural or cultured pearls, jewellery (14), Base metals & articles of base metal (15), Vehicles, aircraft & vessels (17)	69.1
16.	Thailand	Machinery & mechanical appliances (16), Natural or cultured pearls, jewellery (14), Products of chemicals (6), Base metals & articles of base metal (15)	58.1
17.	UAE	Machinery & mechanical appliances (16), Base metals & articles of base metal (15), Natural or cultured pearls, jewellery (14), Products of chemicals (6)	62.5
18.	Yemen	Machinery & mechanical appliances (16), Mineral products (5), Vehicles, aircraft & vessels (17)	65.1

Source: RIS based on data from Comtrade online, extracted in October 2011, World Bank.

Notes: Sections are arranged in declining order of their trade potential.
Section numbers as per HS system are given in parentheses.

are natural or cultured pearls, jewellery, base metals & articles of base metal, vehicles, aircraft and vessels (Table 4.10). For sectoral cooperation, specific sectors need to be identified in the realm of open regionalism. Identification of products in sectors like regional value chain (RVC), processed food, and environmentally sensitive goods (ESGs) is important for harnessing the trade potential exist in the region (appropriate methodologies for identifying the product in these sectors are provided in Annexure 2-4).

To sum up, there exists huge potential for intra-regional trade in the IOR-ARC region. The estimated export potential for most production sectors are high with all member countries having relatively fare shares. Although the aggregate export potential seems high for the South-East Asia region, the difference in country sectoral export shares in the region is not significant and asymmetric. No IOR-ARC country is found to emerge as the single dominant trade partner for any of the regional economies. But, Singapore, Australia and India are considered as the leading trade destinations for trade within the region. Each member country has at least some presence in each sectors of the region's trade. However, most of these countries compete among themselves for exports in few select sectors which could shift their trade strategy from product competitiveness to other policy measures, may be prices. Dominant trade sectors in the region are machinery and mechanical appliances, mineral products, vehicles, aircraft and vessels, natural or cultured pearls, jewellery, base metals & articles of base metal, and products of chemicals. As most trade potential is distributed evenly across sectors and between countries, the fear of trade distortion due to large economies in the region remains weak.

5

Business Environment and Sectoral Cooperation

Since its formation, IOR-ARC has cherished a number of economic and non-economic goals encompassing trade, investment, tourism, sharing of development experiences and so on. While the progress on trade and investment objectives has been manifested in the recent past, there are a number of sectors and frontiers which have remained unexplored or not given due emphasis over the years. It is believed that the synergistic cooperation in these areas could complement the ongoing process of regional integration in trade and investment and create conducive environment for furthering the larger objectives of the IOR-ARC as mentioned in the Charter. For deepening the process of integration within the region, efforts should be made not only to identify new areas of sectoral cooperation but also to improve trade-enabling environment to synthesize synergies within the region. In that light, this chapter attempts to identify some of those sectors and highlights the mechanisms to promote cooperation in those identified sectors.

Many sectors present opportunities for fruitful regional cooperation in the IOR-ARC, besides those identified in the previous section. In this section, we identify a few more sectors that present immense opportunities for expanding cooperation in the region.

5.1 Sectors

5.1.1 Regional Value Chain

The experiences of the East and South-East Asian countries indicate that the expected gains from the regional value chain (RVC) are many times higher than the expected gains from the RTAs. Regional integration in the RVC framework could be an effective way to

integrate industrial sectors in the region. The experiences of the Asian model may be relevant for the IOR-ARC member countries. A division of labour or some sort of specialisation between the regional countries would be fruitful in retaining their respective comparative advantages in the long-run.[31] Based on the industrial production efficiency and supply capabilities for exports, RVC could be an effective vehicle to promote IRT along with getting opportunities to create home-grown local multi national companies in the member countries. This sector may be encouraged to form industry associations for exploiting synergies in the regional production. Moreover, regional cooperation based on the RVC model seems to be consistent with the framework of 'open regionalism' that the IOR-ARC has emphasised since its inception.

5.1.2 Food Processing

Many countries in the region have emerged as the major exporters of processed foods[32] in the world. The technology and expertise developed by some of the South-Asian countries in processing, packaging, marketing and exporting food products and complying with the stringent food safety regulations applicable in the developed countries could be of great value for other sub-regions. Industry bodies of the region have already established liasioning in this regard. This needs to be strengthened for internal diffusion of the region's capabilities for expansion of trade, both within the region and with rest of the world.

5.1.3 Fisheries

Fisheries are a major source of food security and export earnings for the IOR-ARC countries. The regional economies possess considerable expertise in deep sea fishing and handling the stringent SPS regulations applicable in developed countries which could be shared for mutual advantage. Given its importance as a source of livelihood and nutrition for millions in the region, the Fisheries Support Unit (FSU) needs to identify the areas of mutual cooperation with respect to the rules and regulations for sustainable catching, standards and technical barriers, technology for processing and other relevant fields.

5.1.4 Environmentally Sensitive Goods Sector

The region is a large producer and consumer of Environmentally Sensitive Goods (ESGs) in the world.[33] These ESGs are both agricultural and manufactured products (Mohanty and Manoharan, 2007). Exports of these products face multiple environmentally-related barriers in developed countries' markets. Standards for these products are often higher than CODEX standards in many industrialised country markets (Mohanty, 2006). With rapid growth in many countries in the IOR-ARC region, the demand for such products has grown in these

economies. The IOR-ARC countries can cooperate in the production and trade of ESG products for improving IRT.

5.1.5 Tourism

Tourism offers rich potential for economic cooperation in the IOR-ARC region, both in intra-regional tourism and third country tourism. For many countries in the region, tourism plays an important role in the national economic activity. And, its importance is rising in other countries as well. Better connectivity through land routes and easing of visa procedures will go a long way in promoting intra-regional tourism. The region presents a major avenue for joint promotion of a tourist circuit. Most of the countries have cultural links and share Buddhist monuments. Joint packages combining all the important Buddhist sites could be highly attractive. These packages could combine air links, cruise liners and overland connections offering tourists a much greater variety than any single country presents. Likewise, other packages could be devised connecting ecotourism spots across the member countries. In this regard, the tour operators and travel agents of the region could form an association, or consortia in order to develop and market such joint packages.

5.1.6 SMEs

Considering small sizes of the domestic market in a number of member countries, there lies sufficient scope for promotion of the small and medium enterprises. Some of these countries may draw upon the experiences of others in the region for promotion of the SMEs. To facilitate this, a working group of national industry promotion bodies may be desirable.

5.1.7 Cooperation in Information Technology: Dealing with the Digital Divide

There exists immense scope for regional cooperation in information technology as many of its members have gained tremendous comparative advantage in complementary directions. India, being one of the key founders of the IOR-ARC, is acclaimed for its competence in the field of software development. Keeping in mind the wider use and application of IT, there is a need for launching a programme in the region on ICT cooperation that may include focus on IT training and software development, IT-enabled services, transfer of hardware technologies, joint ventures for computer manufacturing, adaptation of communications technologies for local use, etc. India and other member countries could utilise their expertise in this endeavour by facilitating exchange of technical and human resources in the region. This may also include collective efforts for promoting *e*-governance, promoting *e*-commerce and establishing a knowledge society.

5.1.8 Exchange of Development Experiences and Network of Think-Tanks

The IOR-ARC countries not only possess complementary strengths, but provide a great scope for learning from each other, particularly development experiences. For instance, Bangladesh's experiments in micro-credit and population management, Thailand's experiences in managing globalisation and universal coverage health insurance, Sri Lanka's experiences in human development, India's experiences in prudent management of banking and capital markets and rural telecommunication, Mauritius's experiences in tourism, South Africa's experiences in coal technology and so on could be effectively shared among the member countries for mutual advantage and deepening economic cooperation.

To facilitate the exchange of development experiences, an IOR-ARC Network of Policy Think-Tanks could be created. This Network should meet regularly like the meetings of the economic and business forums to discuss and draw policy lessons from the development experiences of different member countries and potential for economic cooperation and present its report to the Ministerial Meetings for follow-up.

5.2 Cooperation for Developing Business Enabling Environment

Trade and investment cooperation form the core of any regional economic integration arrangements. IOR-ARC as a grouping of geographically contiguous countries has rich potential to provide a new engine for growth to the member countries by exploiting the synergies for mutual benefit resulting from the efficiency-seeking restructuring of industry in the region. For this restructuring to take place certain necessary institutional and policy conditions need to be present. Regional cooperation in trade and investment areas can also strengthen export competitiveness of the countries in the region.

5.2.1 Sub-Regional Trade Agreement and Beyond

As discussed earlier, the IOR-ARC region comprises of four sub-regions, and a number of initiatives are already underway towards trade liberalisation in individual member countries under bilateral and sub-regional cooperation framework. An overarching trade agreement may not be possible at a distant future as regional countries are currently having highly differentiated trade policy regimes. As IOR-ARC failed to take off during the past decade, new regional initiatives within the region need to be undertaken. Interestingly, some progress has been made in this direction in the recent years. One possibility is the closer bilateral cooperation which could help the member countries

to strengthen and harmonise ongoing attempts for greater regional cooperation.

Some studies have examined the potential of a comprehensive economic cooperation for the IOR-ARC region. The results indicate that the region has strong economic potential for regional cooperation, and all the member states would gain equally from the regional trading arrangements. To begin with, the regional forum should aim at promoting trade along with fast track trade liberalisation in order to bring harmony in their trade policy regimes. This may be implemented within a specific time frame. However, detailed modalities for tariff reduction or elimination, rules of origin, NTBs and safeguard issues are subject to further consultation among the member countries. The negotiations on rules of origin, phasing out of NTBs and other provisions should be undertaken in a mutually agreed time frame. Formation of a PTA, which is under active consideration by a select set of countries, may facilitate industrial restructuring within the sub-region, provided strong liberalisation measures are in place. The proposed PTA could be based on horizontal specialisation. In this regard, the requisite steps need to be undertaken in the areas of trade and investment facilitation, development of transport linkages and other logistics.

5.2.2 Investment Facilitation and Double Taxation Avoidance

Liberalisation of investment regimes and other facilitating measures can help in the exploitation of the efficiency-seeking restructuring of industries in the region. This includes rationalisation of industries on the basis of overall efficiency taking into account the special advantages of different locations in terms of availability and relative cost of labour and skills, natural resources and other factors. The conclusion of Indo-Sri Lanka FTA has unleashed the potential of such efficiency-seeking restructuring where Indian companies are making export-oriented investments in rubber and plantation-based industries in Sri Lanka. According to the recent reports, Indian investments in Sri Lanka following the implementation of FTA have gone up significantly.

As per the draft Framework Agreement, the liberalisation of investment regime has been given due emphasis in the policy agenda. In the current scenario of increasingly liberal investment regimes across the world, FDI is expected to flow from rest of the world to the IOR-ARC countries with liberal investment regimes. In that perspective, countries should actively engage in Bilateral Investment Promotion Agreements (BIPAs) for harmonising the rules and regulations pertaining to FDI in the region. The Framework Agreement provides for the protection and promotion of investments and facilitation of

investments including transparency of rules and regulations. The existing double taxation avoidance treaties between the member states would be useful in promoting investment in the region. In this light, the IOR-ARC may consider incorporating the provision of avoidance of double taxation in the draft Framework Agreement.

5.2.3 Institutional Framework for Monetary Cooperation

In most successful trading arrangement, IRT grows faster than the region's world trade. The proportion of IRT is expected to rise following the implementation of RTA and other trade facilitation measures contemplated within the scope of the Framework Agreement. Monetary cooperation between the member countries has the potential to further promote IRT by reducing transaction costs and exchange rate uncertainty. Studies conducted at the RIS, New Delhi find that the IRT in the IOR-ARC region is characterised by a high degree of compensability.[34] The analysis finds that the compensable trade ratio (CTR) for the grouping as a whole is significant suggesting that nearly half of total IRT can be conducted and settled in local currencies if a clearance mechanism is available.[35]

The pattern of compensability of trade in the IOR-ARC is estimated for a few member countries.[36] Among them the index was reasonably large for some countries. One of the reasons for the higher value of the ratio for these large trading partners is due to the large proportion of IRT among themselves. The CTR is relatively small for many other countries.

Asian Clearing Union (ACU) has played an important role in monetary cooperation in Asia. Similar institutional arrangement may be considered for the IOR-ARC member countries as well.

5.2.4 Commercial Banking Links and Capital Market Integration

Firms in the member countries often fail to operate effectively within the region on account of financial constraints. It may be either due to the lack of support from the financial institutions or inability of firms to raise resources from the public for undertaking various productive economic activities. In this regard, commercial banking and capital market integration could be fruitful mechanisms for cooperation. Commercial banks in the region should be encouraged to establish reciprocal links in the member countries.

In addition, the stock exchanges in the region should develop mutual linkages and allow cross-listing of securities within the region. This would facilitate smooth flow of capital across the member states

and facilitate industrialisation of countries where capital markets are in infancy and cannot provide adequate intermediation for the new enterprises. The cooperation of stock exchanges in turn may contribute to the development of a regional bond market enabling effective financing of infrastructure development.

5.2.5 Fund for Regional Projects

The lack of adequate infrastructure affects economic activities in the region. Therefore, large investment is required for developing regional infrastructure in order to facilitate intra-regional flow of trade. Funds for the commercially viable infrastructure projects are usually available from the local and international capital markets and/or from multilateral or regional development banks. However, the funding for development of viable projects, i.e. funding for the preparation of project reports and for preparation of feasibility studies, is scarce especially when projects are of regional character. In order to facilitate investments in infrastructure and industrial development, the IOR-ARC should consider setting up a Regional Fund for regional projects. The Fund should have two windows. One window should provide seed capital for preparation of project reports and feasibility reports. And, the other window could take part in lending for the viable projects along with other lenders. The lending arm should also be able to support the investment activities of joint ventures in industry and manufacturing by providing term loans or venture capital to projects set up exclusively by the enterprises from one member country in another. The IOR-ARC think-tanks may be engaged for the preparation of a more detailed concept paper for the Regional Fund which can be placed before the Ministers for consideration.

5.2.6 Business Information and Networking

The potential of IRT and cooperation among business enterprises will remain unfulfilled until there is an institutional mechanism for interaction among the business persons on a regular basis. At present, the IOR-ARC has a business forum, IORBF, that meets regularly before the Senior Officials Meetings. There is a need for more such sectoral associations/ federations of business enterprises in order to facilitate the formation of consortia/ strategic alliances. Such institutional links need to be strengthened. In addition, IOR-ARC Trade Fairs should take place from time to time in different member countries, and such initiatives should be instituted and held on a regular basis. Business delegations should meet their counterparts in the member countries to explore business opportunities in the region. Moreover, the business travel needs to be made easier and simpler by evolving a business visa to accredited business persons of the member countries.

The regional economic-cooperation also has a major role to play in strengthening the competitiveness of IOR-ARC exports in third country trade besides promoting IRT.

5.2.7 Joint Marketing and Coordination in Third Country Trading

At present, the IOR-ARC countries compete with each other in their extra-regional exports in a number of commodities. A greater coordination and cooperation among them could help in improving the terms of trade for mutual advantage. In this regard, marketing joint ventures could be formed to extract greater value addition for the exporters. Joint research and development on common problems could help in saving valuable resources in the region. Commodities in which such coordination could be fruitful include:

- Rice: India, Thailand
- Jute: India, Bangladesh
- Tea: India, Sri Lanka, Bangladesh, Kenya
- Spices: India, Sri Lanka, Thailand
- Leather goods: India, Bangladesh, Thailand
- Marine Products: India, Sri Lanka, Bangladesh, Thailand, Yemen
- Textiles and garments: most of the IOR-ARC countries
- Gems and Jewellery: India, Thailand, Sri Lanka, South Africa
- Film: India

Several such products may be identified where effective collaboration may be made to evolve joint marketing strategy in the third country markets.

5.2.8 Regional Cooperation for Dealing with Non-Tariff Barriers in Developed Countries

Regional cooperation could also be valuable in responding to externally imposed standards and requirements such as environment, health safety, and labelling requirements imposed by the developed countries on developing countries' exports of marine, agro products, textiles and garments, and leather products. In this regard, the scheme for regional cooperation could involve the following:

- Sharing certain costs of compliance such as translations of standards in local languages
- Setting up of internationally accredited laboratories for common use

- Launching regional eco-labels
- Cooperation for evolving international standards through coordination of position in CODEX Meetings and other forums.

5.2.9 Coordination for WTO Negotiations

By coordinating their position on WTO negotiations on issues of common interest, the IOR-ARC countries can get a much better deal than dealing with those unilaterally. Although there may not be a common view on all issues raised before the WTO, there could be a common position on several issues which could be taken up jointly for negotiations. Therefore, the IOR-ARC countries should evolve mechanisms for expediting such processes of coordination. The Permanent Missions of the IOR-ARC countries at the WTO, for instance, could meet regularly and coordinate their positions and make joint submissions.

They can jointly take up a common cause with the WTO and its Dispute Settlement Bodies and other organisations for seeking redressal on antidumping and other unfair practices on the part of importers. As major exporters of textiles and garments they could form an alliance to fight the cases of anti-dumping and other protectionist measures initiated by the developed countries against their exports in the post-MFA phase. Such measures have become more common and are frequently used during the present episode of global recession.

5.2.10 Technical Assistance for Compliance with Commitments and Standards

The IOR-ARC countries will have to comply with a number of commitments arising from the WTO Agreements such as Product Patents by 2005 for developing countries and by 2015 for the least developed countries. Their exporters are also required to implement a number of technical standards and benchmarking standards to remain competitive in the market. The WTO Agreements usually have provisions for technical assistance. However, the experience shows that such assistance is either not adequate or not provided in a timely manner. Most of the times, the requisite expertise for dealing with such requirements in tropical climate is not available. Hence, cooperation among the IOR-ARC countries could extend to assisting each other in the following:

- Technical Assistance for compliance with emerging requirements and benchmarks that are becoming essential conditions for export success in the developed countries such as CODEX, HACCP, Good Manufacturing Practices (GMP),

Traceability, ISO 9000, ISO 14000, TS standards for the auto components, FDA approvals for pharmaceuticals, SEI-CMM for software industry, among others.

- Technical Assistance for compliance with other WTO commitments such as Product Patents under TRIPS Agreement.

With a view to deepen economic integration among the IOR-ARC countries, some proposals are discussed in the foregoing section. These proposals are designed to exploit the potential of the region in efficiency-seeking restructuring of industry and become an engine of growth. We have also discussed some proposals that may strengthen the external competitiveness of region's exports in third country markets.

6

Conclusion and Policy Imperatives

The study observes that the IOR-ARC can be a mutually beneficial regional economic grouping by expanding economic linkages in the region. By examining various economic dimensions of the region, it is concluded that the region has potential economic complementarities. The recent performances of the regional economies indicate that they have been dynamic and resilient to insulate themselves from the intermittent recurrence of global exogenous shocks. They have successfully come out of the recent episode of global financial crisis. The economies in the region have both traditional and modern knowledge-based sectors. Many of the regional economies have adjusted to the regime of regionalism. During the last decade, these economies have adhered to a wide range of economic reforms to improve domestic business environment and encourage corporate sectors to become globally competitive. With the infusion of outward-oriented trade strategy in their overall economic policies, conducive conditions are created in these countries to enter into different trading arrangements at the multilateral, regional and bilateral levels.

Despite perceptible changes in their trade policy regimes, the level of IRT in certain sub-regions of the IOR-ARC is yet to reach a significant threshold compared to the global trade profiles of its member countries. Several reasons have been cited for the sluggish performance of the region in promoting IRT. Empirical analysis is indicative of the fact that the region has ample opportunities which can spur trade across the region if tapped appropriately. However, realisation of these regional potentials cannot be automatic, and therefore requires a big push to move the region forward from the present state of inertia. Recovery of the region from the recent global recession can consolidate the process of regional cooperation to boost trade and production integration in the region. Based on the findings of the study, the following recommendations are suggested for improving performances of the regional caucus in fulfilling its mandates.

6.1 Trade

- The IOR-ARC is not a non-starter because of the fact that IRT is rising faster than total trade of the region with the rest of the world during the last decade. This shows the strength of the region and it requires a radical trade strategy to deepen IRT further.
- Tradable sectors in the region include the traditional as well as the knowledge-economy sectors. Considering the complementary endowments of the region in the post-recovery phase, there exists enough potential for regional cooperation in trade, investment and other areas of importance to the region.

6.2 Tariff

- Average tariff rates of the member countries have been highly dispersed. These trade policies act as stumbling blocks in the free flow of goods and services in the region. It is suggested that tariff reduction and possible elimination, which is consistent with the WTO provisions, will increase market access opportunities for the regional countries. While tariff harmonisation is necessary for creating trade enabling environment, radical tariff reduction approach for the highly protected economies could be painful. Therefore, a practical and flexible approach may be adopted to respect the sensitivities of these economies and creating conducive environment for promoting trade in the region.
- FTA is not a feasible proposition for the IOR-ARC now because of the existence of three different Custom Unions in the region in which most of the IOR-ARC countries are members. Tariff harmonisation is not possible between the Custom Unions unless other non-IOR-ARC members of these Custom Unions agree to the proposal. Considering the remote possibility of tariff harmonisation between the Custom Unions, the IOR-ARC should adopt the framework of 'open regionalism' with sectoral liberalisation as its key policy for regional cooperation.
- In the absence of an FTA/PTA, unilateral liberalisation may be suggested based on sectoral cooperation at the regional level where each member country has the option of choosing appropriate sectors based on its resource endowments.

6.3 Processed Food

- The IOR-ARC countries have strong interest in the expansion of market access for processed food products in which many counties in the region have competitive edge. With the rise of middle income group in the region, demand for 'ready to eat' food has gone up significantly in the recent years. Empirical

evidence indicates that there is an opportunity for trade in agricultural exports among the member countries. The IOR-ARC may recommend certain new initiatives to promote trade in the processed food sector.

- The study has identified the extent of competitiveness of each of the member countries in specific processed food sectors and also their demand patterns. The member countries have options to cooperate with other competitive members in promoting specific process food sectors in their economies.
- Regional countries should strengthen, exchange and cooperate in the field of SPS on animals, plants and other products. The IOR-ARC may set up a 'Joint Task Force' to identify and address various NTBs affecting regional trade. The Task Force may be mandated to suggest measures to eliminate trade barriers among the member countries, consider adoption of a Pre-Shipment Inspection Agreement to facilitate movement of goods within the region, and to undertake necessary measures for promotion of trade in the processed food sector.

6.4 Standards

- Regional trade is often affected by complexities in product standards. Moving towards harmonisation of standards and conformity procedures through cooperation could improve regional trade. Therefore, there should be a mechanism to strengthen cooperation and consultation among the member countries to resolve standard-related impediments. Institutional mechanisms need to be evolved to improve standardisation and certification regulations and to promote coordination between the government departments, implementing institutions and supervision authorities of each country.
- Institutional mechanisms are to be set up to make available relevant information and documents on the laws, rules and regulations affecting trade among the member countries on a regular basis. As a part of the SPS-related commitment, member countries follow transparency, and base standards according to the international standards and guidelines. Further, cooperation in this area would improve compatibility of technical regulations and trade between the member countries.

6.5 Regional Value Chain

- Empirical analysis suggests that the region has large potential in RVC in parts and component sector. The current economic literature presents similar evidence for other sectors in various sub-regions of the IOR-ARC. While some member countries are specialised in product outsourcing, others have

great potential in undertaking projects internationally. In this regard, firms in the region can cooperate in contracting outsourcing businesses in several sectors including agriculture, manufacturing and services for mutual benefit.

6.6 Mining

- Mining sector has emerged as an important sector for trade in the region. Most of the counties are simultaneously exporting as well as importing minerals for meeting their domestic demand. Some mechanism including setting up of a task force may be evolved to coordinate relevant governmental departments for conducting research, formulating policies and taking measures to encourage regional enterprises for strengthening investment and cooperation in mining.

6.7 Pharmaceutical Sector

- Pharmaceutical sector has emerged as an important sector in the region for cooperation. Many member countries are highly competitive in diversified affordable generic drugs which most of the IOR-ARC members import from outside the region. There could be new initiatives to identify the possibility of production and trade to facilitate proper and adequate supply of such drugs within the region.
- Cooperation may be extended to other systems of drug formulations such as *Ayurveda*, *Unani*, etc., in which rich traditional knowledge exists in the region.

6.8 Coordination among EXIM Banks

- Trade financing is a major issue for the IOR-ARC member countries. The success of sectoral cooperation is closely linked with the level of trade financing among the member countries through their EXIM banks. Therefore, close coordination between the EXIM banks of the region is required for undertaking direct banking links and bilateral confirmation of Lines of Credit (L/Cs) by the regional financial entities to strengthen regional trade activities.

6.9 Investment

- There are vast investment opportunities in the region in almost all areas of economic activities, including infrastructure, manufacturing and services. Investment is critical for improving productivity and enhancing growth and employment. FDI assists in bridging the gap between domestic savings and capital formation besides encouraging technology upgradation and inducting international best practices. With

appropriate investment enabling environment, intra- and extra-regional investment flow is likely to grow.

- Many regional countries have Bilateral Investment Promotion and Protection Agreements (BIPPA) and many of them need to be revisited and updated in the broader regional context. Such Agreements may be adopted on the basis of the principle of most favoured nation (MFN) and national treatment (NT) without prejudice to the laws and regulations of each country.
- New initiatives are required to augment regional inflows of FDI by improving investment environment in the IOR-ARC countries, by removing investment barriers, relaxing regulations and addressing the general concerns of investors, with a focus placed on improved investment access to each other's markets and the promotion and protection of investments in these countries.
- For encouraging regional flow of investment, some measures such as regular interaction among the governments, business and industry associations on regular basis; exchange of information on foreign investment laws and regulations; sector-specific cooperation measures for investment and technical collaboration in infrastructure sector and establishment of a Joint Investment Promotion mechanism may be undertaken. It is suggested that investment agreement needs to address a wide variety of issues including national treatment, transparency, facilitation, investment promotion, protection and dispute settlement.

6.10 Trade Facilitation

- Adoption of various trade facilitation measures could improve trade linkages among the member countries and implications of such measures could go beyond tariff liberalisation. Some of these measures include developing stronger links between the regulators and, in due course, entering into mutual recognition agreements (MRAs) to deal with the issues of technical barriers to trade (TBT); sanitary and phyto-sanitary measures (SPS); customs cooperation and the harmonisation of standards and conformity assessment.
- Inclusion of various WTO-consistent trade remedy provisions may not undermine the benefits of trade liberalisation.
- Procedures for handling goods at ports and customs clearance may be simplified and made more efficient.
- Increased frequency of direct shipping routes, reduced costs of transportation and expansion of air cargo facilities between the member countries need consideration.

Endnotes

1 See the IOR-ARC Charter at http://www.iornet.com/iorarc/charter.htm.

2 For details on the potential and prospects of IOR-ARC, see Singh (2011) address at Indian Council of World Affairs, May 5-6.

3 See Dabee and Reddy (2000).

4 Kelegama (2011) (*mimeo*). See Mohanty (2010). The then Prime Minister of India, Mr. P.V. Narasimha Rao, observed that the disparities in the level of development, cultural and social differences, widespread poverty, financial shortages and technological inadequacies, relatively low level of intra-trade and investment, high level of dependence on extra-regional sources and industrialised countries are the obvious impediments in meeting the goals of the IOR-ARC (see the Conference volume titled "The Making of an Indian Ocean Community" by the Indira Gandhi Memorial Trust, 1996).

5 See Mohanty (2011) and Kelegama (2002, 2011).

6 Several studies in Asia, Africa and Latin America show that small countries stand to gain more than large countries from regional trading arrangements (see for details Kawai and Wignaraja, 2006; Mohanty and Pohit, 2007 and Mohanty and De, 2008)

7 Mohanty (2011).

8 Meetings of the Council of Ministers (COM), Teheran, March 2007; Vines and Oruitemeka (2008).

9 When proposal for formation of IOR-ARC was mooted in the mid-1990s, the issue of membership was raised in various forums. It was strongly felt that widening of the size of the grouping may affect its capability to deliver desired results (for detail discussion see Mehta and Mohanty, 1997 and Mohanty, 1995).

10 On prospects of regional integration in COMESA and SADC, Khandelwal (2004) identifies the costs involved with overlapping membership in RTAs arising from complex rules of origin, expensive membership fees, slow progress in implementation due to multiple commitments, etc.

11 Kelegama (2011) mentions a few examples: junior delegations of Australia and Singapore focus on Organization of African Unity (OAU) by South Africa, opting out of Seychelles, etc.

12 Repeated appearance of global slowdown since inception days of IOR-ARC has squeezed its space for further progress in the economic front (see e.g. Mohanty, 2011; Kelegama, 2011).

13 Assuming that savings rate between 25 and 30 per cent as threshold for an average growing developing country.

14 Low savings rate in Kenya, one of the most developed financial system in Sub-Saharan Africa, remains unexplained (see Odhiambo 2008).

15 See Odhiambo (2009).

16 See Seth (2011) and Mohan (2008).

17 Trade Policy Reviews (*Various Countries*).

18 For details, see Wang and Swain (1995), Billington (1999) and Choi (2003).

19 Similar findings are shared by Dunning (1980), Kravis and Lipsey (1982), Samsuddin (1994), Billington (1999) and Goh and Wong (2011).

20 For details see Bernard and Wagner (2001), Kim (1997) and Kogut (1983).

21 For this study, FDI breakdown in manufacturing at sub-sector level is available for Indonesia, Sri Lanka and Thailand. Likewise, sector/sub-sector-level investment data in services are available for Australia, Indonesia, India, Singapore and Thailand. Any view on sectoral distribution of FDI flows in the IOR-ARC region is merely an approximation based on data on the abovementioned countries.

22 In 1997, six countries were members of the regional forum. This analysis has covered all the 20 countries while estimating IRT of the region as if they were there in 1997. The purpose of this analysis is to show how Intra-regional trade has progressed over the years with joining of more countries in the regional caucus. This analysis covers two new Members of the caucus namely Seychelles and Comoros.

23 IRT ratio refers to total IRT trade as a ratio of total trade of the region.

24 See Mohanty (2010).

25 In 2009, Productivity Commission recommended retaining the anti-dumping and countervailing system on the grounds of trade reforms.

26 WTO Trade Policy Review, 2011.

27 Oman has adopted the provisions on contingency trade remedies contained in the GCC Treaty through Sultani Decree No. 39/2006. UAE is also a party to GCC Treaty.

28 Average tariff rate of a country up to 5 per cent is denoted as liberal tariff regime, average tariffs ranging between 5 and 12 per cent as moderate tariff regime and average tariffs above 12 per cent as restrictive trade regime.

29 Detailed discussion on the estimate of trade potential is presented in Annexure 1.

30 For details see Annexure 1

[31] Composition of products (at 6-digit level) in GVC is presented in Annexure 2.

[32] Though the current literature provides wide spectrum of discussion on production and trade in processed food in the world economy and various regional arrangements, there is no complete unanimity on the comprehensive definition of processed food. A taxonomy of processed food accounting is presented in Annexure 3.

[33] Perception differs between developed and developing countries in regard to composition of ESGs. The list of products identified by APEC, OECD and RIS is presented in Annexure 4.

[34] Kumar and Mohanty (2004).

[35] CTR of a member country measures the extent of compensability between its imports and exports with the region in relation to country's total trade with the region. For the estimation of compensable trade of *i*th country, we first estimate compensable trade of *i*th country with regional partners separately which are added to arrive at the CT_I for *i*th country. This procedure takes note of bilateral trade imbalances between different pairs of countries in the RTA.

[36] Kumar and Mohanty (2000).

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Annexure 1

Estimation of Export Potential

In the present study, for the estimation of price competitiveness, we consider each product separately at a disaggregate level (i.e. at the 6-digit HS level). In this measure, we compare the export price of India in each product group (at the 6-digit level) with the corresponding prices offered by its competitors in the market of Brazil/South Africa.

Suppose India is exporting *i*th product to Brazil/South Africa at a given price (PX_{Nij}) and another competing supplier is also exporting the same product to Brazil/South Africa at a different price (PX_{kij}) where

PX_{Nij} = Export price of India, for the *i*th product, in *j*th market (Brazil/South Africa).

PX_{kij} = Export price *k*th competitor, for the *i*th product, in the *j*th market.

N = India

i = 1, 2, ……., *P* (Products)

k = 1, 2, ……l…., *K* (India's *K* competitors in the *i*th product segment).

For a given product '*i*', if India has price competitiveness over other competitors in the *j*th market then the export price of India should be lower than those of other competitors. In such case, the condition may be

$PX_{Nij} < PX_{kij}$ ……..….. (1)

If India has price competitiveness in one product, it does not mean that all the competitors in that product category necessarily have higher prices than that of India. In the given product, some of them may also be having lower prices than India. In that case, India should look at the market share of those competitors, whose export prices are higher than that of India. The export market shares of India's inefficient competitors may be considered as India's export potentials.

Suppose in Brazil/South Africa's market, India is exporting *i*th product and another K-1 number of suppliers are present in the same product segment. So each competitor holds some portion of market share (Sh_{ikj}) in the import of the *i*th product by Brazil/South Africa. Therefore, the total market of the *i*th product is shared by all the *K* suppliers in Brazil/South Africa. It means,

$$\sum_{k=1}^{K} Sh_{ikj} = 100 \quad \text{.....(2)}$$

where Sh_{ikj} stands for market share of the *k*th exporter of the *i*th product to Brazil/South Africa.

Suppose India has price competitiveness over a few competitors (but not all of them) in the export of *i*th product, and in case India effectively enters the Brazil/South African market as a supplier the combined market share of incompetitive competitors (let us assume the ratio as μ) may be treated as India's potential export share, where

$0 > \mu > 1$ …….(3)

and μ denotes proportion of the *i*th product market, which is covered by the exports of less competitive competitors of India in the markets of Brazil/South Africa.

The export potential of India (POT_{Nij}) in the exports of *i*th product in Brazil/South Africa may be estimated as:

$$POT_{Nij} = \mu IM_{ij} \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (4)$$

where IM_{ij} stands for total imports of the *i*th product by Brazil/South Africa from all sources.

If μ is less than 1, it means that India has a price edge over a few competitors and a part of the *i*th import market of Brazil/South Africa would form India's potential export. If μ is equal to 1, it means that the entire import of the *i*th product by Brazil/South Africa would be India's potential export. Jacob Viner denotes such trade potential as the trade creation effect of a regional trading arrangement.

In this measure, we assume that with changes in the policy environment, India may be able to improve its market share by taking over market segments from less efficient competitors in Brazil/South Africa on the basis of her absolute cost comparative advantage. One of the limitations of this measure is that we cannot identify the products where India has global competitiveness but is yet to tap the export potentials in Brazil/South Africa. This issue is empirically examined in a recent study (for details see Mehta and Mohanty, 2001).

What are the prospects for India, should it go for a bilateral FTA with Brazil/South Africa? To analyse this it is necessary first to estimate the size of the export potential for those commodities where Brazil/South Africa continues to have a high tariff. These tariff peaks include both *ad valorem* and specific tariffs (taking *ad valorem* tariff equivalence). The negotiation would be on the basis of total trade opportunities created by the trade creation and trade diversion effects based on the existing tariff structure. The preferential bilateral tariff reduction would determine the level of trade diversion in both the countries. The sharing of potential benefit from the FTA between the countries would be at the core of bilateral negotiations.

For the negotiations, we have to identify commodities, which are exported or likely to be exported by Brazil/South Africa, and are also facing different levels of tariff (both *ad valorem* and tariff equivalence of specific tariffs) in India. A similar exercise may be repeated for India too. Based on the coverage of identified commodities and their potential exports, recommendations are to be made about the future course of negotiations. In this study, we have extended our analysis to cover commodities of both the agricultural and industrial sectors.

Since India and Brazil/South Africa have decided to consider the possibilities of close economic cooperation, there is a need to examine the potentials of trade in both the countries. In case the potential exists to augment trade between both the countries, there is a need to examine the extent to which the FTA agreement can help both the countries in providing tariff and other support on a reciprocal basis. The reduction of tariffs under the purview of FTA agreement would provide immense advantage to the exporting partner over other exporting competitors in the market of the importing partner country. This would, in fact, support some of the marginally cost disadvantage products of the exporting partner, which we describe as the 'trade diversion effect' in the framework of Jacob Viner's 'customs union' model. In this context, we would like to examine the competitiveness of Brazil/South Africa's exports in the Indian market and vice versa.

Annexure 2

List of products under Parts and Components (P&C) under RVC Analysis

HS Section	Descriptions	Product lines
7	Plastics & leather articles thereof	33
8	Raw Hides & Skins, Leather, etc.	1
11	Textile & Textile Articles	8
15	Base Metals & Articles of Base Metal	26
16	Machinery & Mechanical Appliances	246
17	Vehicles, Aircraft and Vessels	43
18	Optical, Photograph & Cinematography	30
20	Miscellaneous Manufactured Articles	2

***Source*:** Mohanty (2011) based on BEC Classification, UN Statistical Division, Geneva.
Note: Products are identified at 6-digit HS.

Annexure 3

Classification of Food & Processed Food Products

Product	SITC	Product Description
1. Manufacturing (SITC 5 + 6 + 7 + 8 + 68)	5 6 7 8 68	Chemical and related products, nes Manufactured goods classified chiefly by materials Machinery and transport equipment Miscellaneous manufactured articles Non-ferrous metals
2. Agriculture Products (SITC 0 + 1 + 2 + 4 + 27+ 28)	0 1 2 4 27 28	Food and live animals chiefly for food Beverages and tobacco Crude materials, inedible, except fuels Animal and vegetable oils, fats and waxes Crude fertilizers and crude minerals Metalliferous ores and metal scrap
3. Agriculture raw materials (SITC 21+23+24+25+26+29+121)	21 23 24 25 26 29 121	Hides, skins and fur skins, raw Crude rubber (including synthetic and reclaimed) Cork and wood Pulp and waste paper Textile fibres (not wool tops) and then wastes (not in yarn) Crude animal and vegetable materials, nes Tobacco unmanufactured; tobacco refuse
4. Food (SITC 0+1+4+22+121)	0 1 4 22 121	Food and live animals chiefly for food Beverages and tobacco Animal and vegetable oils, fats and waxes Oil seeds and oleaginous fruit Tobacco unmanufactured; tobacco refuse
5. Processed food	121	Tobacco unmanufactured; tobacco refuse
5.1 Meat Products (SITC 01)	01	Meat and preparations
5.2 Diary products (SITC 02-025)	02 025	Dairy products and birds' eggs Eggs, birds' and egg yolks, fresh, dried or preserved
5.3 Fish products (SITC 03)	03	Fish, crustacean and molluses, and preparations thereof
5.4 Flour and cereals (SITC 046+047+048+0483+0488)	046 047 048 0483 0488	Meal and flour of wheat and flour of meslin Other cereal meals and flour Cereal, flour or starch preparations of fruits or vegetables Macaroni, spaghetti and similar products Malt extract; cereals preparations with less 50 per cent of cocoa
5.5 Vegetables (SITC 054+056+05645)	054 056 05645	Vegetables, fresh or simply preserved; roots and tubers, nes Vegetables, roots and tubers, prepared or preserved, nes Tapioca, sago and substitutes obtained from starches
5.6 Fruit, fresh or dried (SITC 057+058+05645)	057 058 0583	Fruits, nuts excluding oil nuts Fruit, preserved and fruits preparations Jams, jellies, marmalades, etc. as cooked preparations
5.7 Eggs and egg products (SITC 025)	025	Eggs, birds' and egg yolks, fresh, dried or preserved

Annexure 3: continued...

Annexure 3: continued...

5.8 Sugar preparations and honey (SITC 025+0611+0615)	025 06 0611 0615 0712	Eggs, birds' and egg yolks, fresh, dried or preserved Sugar, sugar preparations and honey Sugars, beet and cane, raw, solid Molasses Coffee extracts, essences or concentrates
5.9 Coffee extracts, instant tea, cocoa-based products (SITC 0712+0722+0723+074)	0712 0722 0723 074	Coffee extracts, essences or concentrates Cocoa powder, unsweetened Cocoa butter and paste Tea and mate
5.10 Edible products and preparations (SITC 0149+0583+0483+0488+098)	0149 0583 0483 0488 098	Other prepared or preserved meat or meat offal Jams, jellies, marmalades, etc. as cooked preparations Macaroni, spaghetti and similar products Malt extract; cereals preparations with less 50 per cent of cocoa Edible products and preparations, nes
5.11 Processed vegetable oils (SITC4+4113+4232+4233+4234+4239+4241+ 4242+4243+4244+ 4314)	4 4113 4232 4233 4234 4239 4241 4242 4243 4244 4314	Animal and vegetable oils, fats and waxes Animals oils, fats and greases, nes. Soya bean oil (crude refined or purified) Cotton seed oil (crude refined or purified) Groundnut (peanut) oil (crude refined or purified) Other fixed vegetable oils, soft (crude refined or purified) Linseed oil (crude refined or purified) Palm oil (crude refined or purified) Coconut (copra) oil (crude refined or purified) Palm kernel oil (crude refined or purified) Waxes of animal or vegetable origin (crude refined or purified)

***Source*:** Athukorala and Jayasuriya (2005).

Annexure 4

What are Environmentally Sensitive Products (ESGs): A comparison between Three Lists

Sec		APEC	OECD	RIS
1	Animal Products			141
2	Fruits & vegetable			231
3	Fats & Oils			36
4	Prepared Food	1	2	40
5	Minerals & metals		4	2
6	Chemicals		27	95
7	Plastics	2	4	1
8	Skin & Leather			48
9	Wood Products	1		45
11	T&C	2	1	81
12	Footwear			16
13	Cement, etc	10	3	5
14	Gems & Jewel			1
15	Base Metals		2	8
16	Machinery	48	83	64
17	Vehicles, etc	2	1	27
18	Photography	42	26	15
19	Arms & Ammunitions			1
20	Other Manufactures			16
21	Works of Art			1
	Total products	108	153	874

***Source*:** Mohanty (2010a).

RIS A Think-Tank of Developing Countries

Research and Information System for Developing Countries (RIS), a New Delhi based autonomous think-tank under the Ministry of External Affairs, Government of India, is an organisation that specialises in policy research on international economic issues and development cooperation. RIS is envisioned as a forum for fostering effective policy dialogue and capacity-building among developing countries on international economic issues.

The focus of the work programme of RIS is to promote South-South Cooperation and assist developing countries in multilateral negotiations in various forums. RIS is engaged in the Track II process of several regional initiatives. RIS is providing analytical support to the Government of India in the negotiations for concluding comprehensive economic cooperation agreements with partner countries. Through its intensive network of policy think-tanks, RIS seeks to strengthen policy coherence on international economic issues.

For more information about RIS and its work programme, please visit its website: www.ris.org.in

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