

BOX 2.5.1 Regional integration and spillovers: South Asia

South Asia's integration with the global economy is low and integration within the region is even more limited. The ability to do business across borders is constrained by poor business environments and policies that have weighed on competitiveness, contributed to large-scale emigration and limited the ability to do business across borders. While this has reduced exposure to global shocks in the short-term, these very factors limit the potential of South Asian firms to fully benefit from the strengthening demand in the United States and Europe over the medium term. Over the long term, enhancing regional and global integration will be critical in raising productivity and growth, providing jobs and reducing poverty.

Introduction

South Asia is one of the least globally integrated regions (Figure 2.5.1.1), both in trade and finance. However, the degree of integration at the regional level, measured by flow in goods, capital and ideas, is even lower. This is despite shared cultural ties, extensive common borders, and high population densities with large populations living close to border areas (Ahmad and Ghani 2007; Kemal 2005; Palit and Spittel 2013).

This box takes a closer look at South Asia's openness to the rest of the world, and to countries within the region itself. It discusses the following questions:

- How open is South Asia to global and regional trade and financial flows?
- How large are the potential intra-regional spillovers from the region's largest economy, India?

The box documents that spillovers from global output shocks are generally small, but large for financial shocks (for India). Regional spillovers are also small. This implies that positive spillovers to the region from the strengthening economic cycle in the US and India to other large South Asian economies will likely be modest.

How open is South Asia to global and regional trade and financial flows?

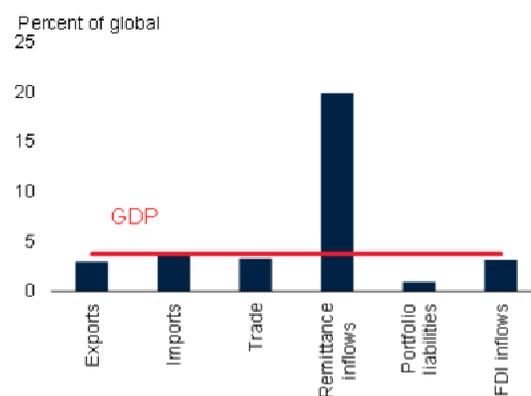
Although economic linkages between South Asia and the rest of the world have deepened in recent decades, progress has been slow and uneven (Ahmad and Ghani 2007). High-income countries and China account for the bulk of exports earnings, portfolio investments, FDI and aid (Figure 2.5.1.2). Regional integration, meanwhile, has lagged considerably (Ahmad and Ghani 2008 and Ahmad et. al. 2010). A number of factors are at work: poor transport connectivity within South Asia and to global markets; poor trade facilitation policies and trade barriers

Note: This box was prepared by Tehmina Khan, Jesper Hanson and Raju Huidrom.

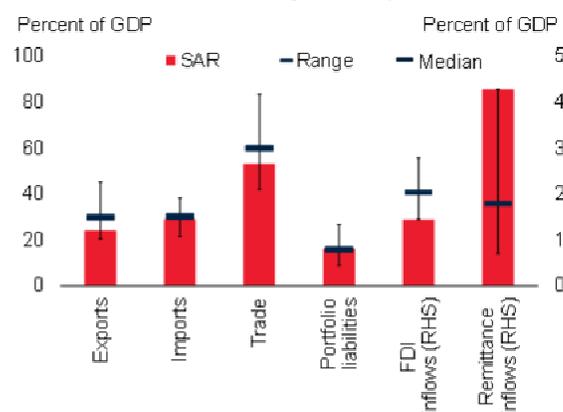
FIGURE 2.5.1.1 Cross-region comparison

South Asia is one of the least globally integrated regions, in terms of trade and finance. However, it absorbs a large share of global remittances.

A. SAR: Share of global activity, trade and finance, 2014



B. SAR: Trade and finance in regional comparison, 2014



Sources: IMF October 2015 World Economic Outlook, IMF International Financial Statistics, IMF Direction of Trade Statistics, UNCTAD FDI/TNC database, World Bank Remittance and Migration Database, World Bank World Development Indicators.

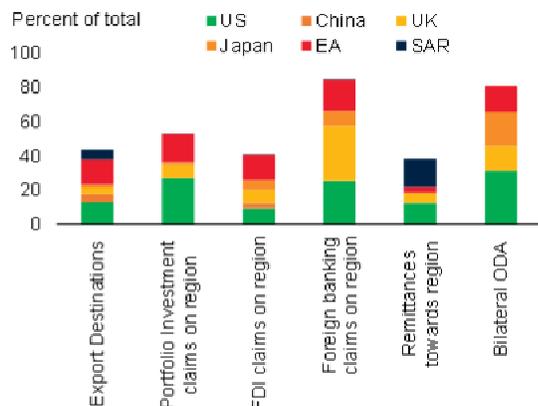
B. The red bar denotes exports, imports, trade, remittance inflows, portfolio liabilities and FDI inflows in percent of GDP on average across SAR countries. The vertical line denotes the range of averages for all six developing country regions.

BOX 2.5.1 Regional integration and spillovers: South Asia (continued)

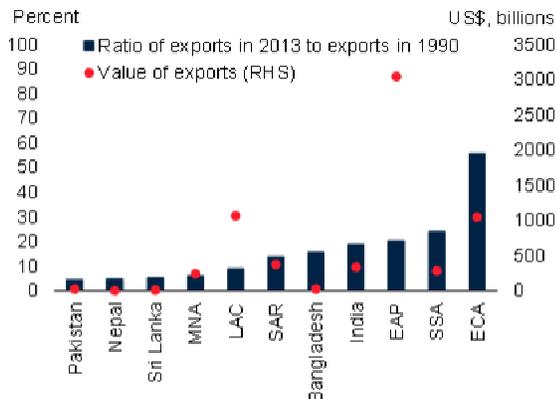
FIGURE 2.5.1.2 Regional and global integration in South Asian countries

Flows of goods and capital across borders are low compared to other regions. Exports have increased by much less over the past two decades than in other regions, and remain concentrated by destination.

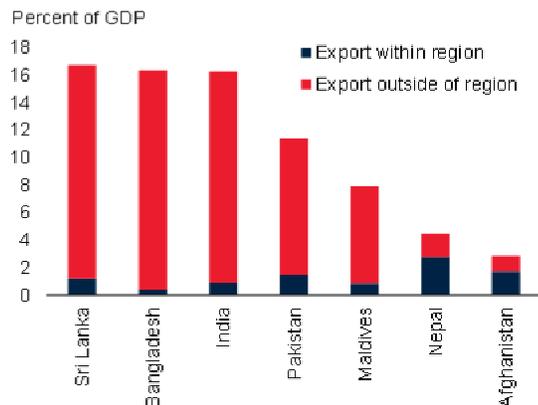
A. Regional and global integration, 2014



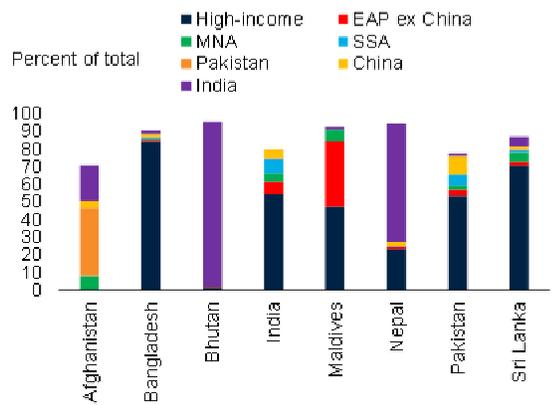
B. Increase in exports since 1990



C. Trade openness, 2014



D. Exports by major trading partners, 2014



Source: World Bank, BIS, IMF, OECD.

Notes: Weighted averages.

B. EAP stands for East Asia and Pacific. ECA stands for Europe and Central Asia. LAC stands for Latin America and the Caribbean. MNA stands for Middle East and North Africa. SAR stands for South Asia Region. SSA stands for Sub-Saharan Africa.

that have resulted in high costs of trading; and restrictions on doing business with countries within the region (De et al. 2013; Palit and Spittel 2013; Romero-Torres 2014; World Bank 2013b). The exception are within-region remittances: the Bangladesh-India migrant corridor, for instance, is the third largest in the world.

Trade: Unilateral trade liberalization measures introduced in the late 1980s and 1990s have led to rising trade flows between South Asia and the rest of the world (Ahmad and Ghani 2007). Still, the degree of integration remains much lower in South Asia than in other major developing regions, with exports amounting to a fifth, or

less, of GDP in most countries. Moreover, export flows tend to be highly concentrated, with the European Union and United States as major trading partners notwithstanding a recent shift of India and Pakistan toward East Asia and Sub-Saharan Africa.

As a share of GDP, intra-regional exports are smaller than anywhere else in the world (Palit and Spittel 2013). On average, India, Pakistan, Sri Lanka and Bangladesh’s exports to each other amount to less than 2 percent of total exports. Average trade costs between country pairs in South Asia are 85 percent higher than between country pairs in East Asia (Kathuria et al. 2015) reflecting border

BOX 2.5.1 Regional integration and spillovers: South Asia (continued)

barriers, poor infrastructure and transport connectivity, and generally poor business environments. However, unofficial trade (in narcotics, but also illegal food trade in the Punjab) is reported to be significant (Fagan 2011). Estimates of the size of unofficial trade vary between countries (Taneja 2004), with recent studies placing the value of Indian exports to Pakistan at about \$1.8 bn (or nearly 1 percent of GDP, Ahmed et. al. 2014). While the larger countries in the region predominantly trade outside the region, India is the dominant trading partner for the smallest countries in the region: Bhutan (mainly hydro-electricity), Nepal (textiles, agriculture, tourism) and Afghanistan (for which, Pakistan too is a major trading partner).¹

Capital flows: Relative to GDP, capital flows to South Asia are lower than those to East Asia and the Pacific and Europe and Central Asia regions (Figure 2.5.1.3), reflecting underdeveloped capital markets as well as inflow restrictions in some countries (Romero-Torres et. al. 2013). They are dominated by banking sector flows, mainly from the United Kingdom. Financial integration is limited by restrictive domestic policies. For instance, in India, notwithstanding some gradual liberalization over the years, and in Sri Lanka non-resident holdings of government debt remain capped.

India receives over 90 percent of the region's FDI and portfolio inflows, a substantial share of which originates from Mauritius and Singapore (low-tax countries with which India has double taxation treaties).² In recent years FDI has tended to head into services rather than mining or industry (World Bank 2013a). China has made substantial investments into the region in recent years, in extractives in Afghanistan, renewable energy in Nepal, port construction in Sri Lanka, and manufacturing and infrastructure in Pakistan.

Within-region FDI accounts for only a small share of all FDI inflows. Bhutan, Nepal, Maldives and Sri Lanka do, however, receive non-negligible amounts of FDI from India. Cross-border investments from India have flowed into energy and public sector-linked investment in Nepal;

¹Several countries run sizable merchandise trade deficits with India, including Nepal, Bhutan, Bangladesh and Sri Lanka. Large imports from India mainly reflect capital goods (in Bhutan, related to hydropower investments), other production-side inputs and food in the smaller landlocked countries. In Bangladesh, for instance, these comprise mainly cotton for the garment sector, food and other consumer goods.

²FDI inflows from Mauritius and Singapore may also, indirectly, originate in India.

chemicals, food processing, banking and garments production in Bangladesh, and a similarly diverse range of sectors in Sri Lanka over the past decade (World Bank 2013a).

Remittances: South Asia's diaspora stock is the largest among developing regions, and remittances exceed 6 percent of GDP in Pakistan, Sri Lanka, Nepal and Bangladesh. India is the largest recipient country in the world in terms of value of remittances (about \$US 70 billion). By source, Gulf Cooperation Council (GCC) countries account for just over half of total remittances to the region, with the United States and United Kingdom also major source countries. Within-region migration flows are also substantial: the Bangladesh-India migrant corridor is the third largest in the world (after the Mexico-U.S. and Ukraine-Russia corridors), with more than 40 percent of Bangladeshi emigrants located in India. India also hosts large numbers of migrants from Bhutan, Nepal and Sri Lanka, and Pakistan from Afghanistan (World Bank 2015l).

Official development assistance: Although the bulk of aid flows to South Asia originate from OECD countries, among non-OECD countries both India and China are increasingly important sources of development finance (mixing grants, loans and project finance). The recently signed US\$46 billion China Pakistan Economic Corridor (CPEC) agreement should see rising investment in energy, port and transport infrastructure in Pakistan over the next few years. India, meanwhile, allocates nearly two thirds of its foreign aid budget to Bhutan, and significant amounts to Nepal, Afghanistan, Sri Lanka and Bangladesh (Piccio 2015).

How large are the potential intra-regional spillovers from the region's largest economy, India?

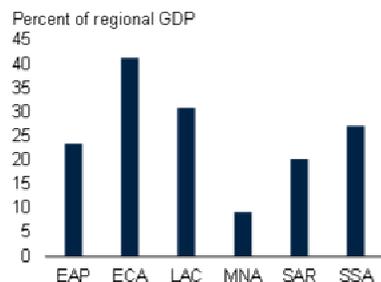
India's sizeable remittances and FDI flows to neighboring countries may give rise to spillovers. To analyze spillovers within the region, a Bayesian structural vector autoregression model is estimated using quarterly data to 2015Q2 from 1998Q1 (Bangladesh) 2002Q2 (Sri Lanka) or 2001Q3 (Pakistan), the only countries in the region with sufficient data. The model focuses on the short- and medium term effects of negative growth shocks in India on other countries in the region. The estimation includes G7 country growth, JP Morgan's Emerging Market Bond Index, India's growth, a trade-weighted commodity price index, and SAR country growth and real effective exchange rate. Data is available for Bangladesh, Pakistan, and Sri

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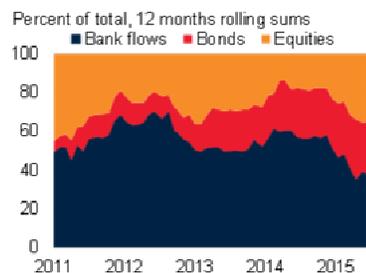
FIGURE 2.5.1.3 Financial flows to SAR

Relative to GDP, capital flows to South Asia are smaller than to other major developing regions, excluding MNA. They are dominated by banking sector flows, mainly from the United Kingdom. India receives over 90 percent of FDI inflows. South Asia's diaspora is the largest among developing regions, with a substantial number located in GCC countries.

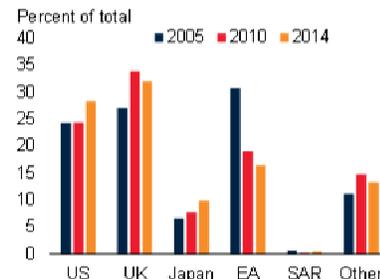
A. Capital flows to developing regions, 2014



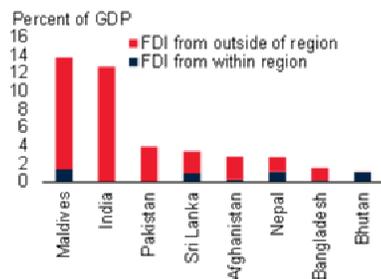
B. Composition of capital flows to South Asia



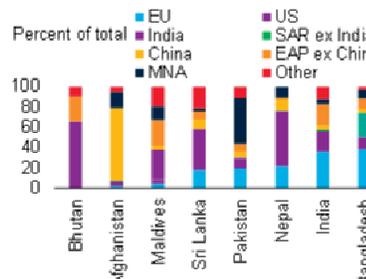
C. BIS foreign claims on SAR by source



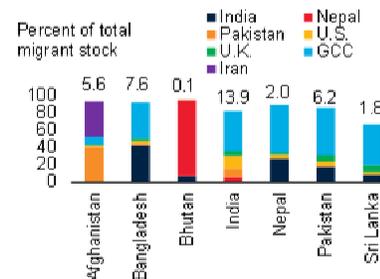
D. FDI flows by country, 2014



E. FDI inflows, 2003-11



F. South Asian migrants by destination, 2013



Source: IMF, World Bank, BIS, UNCTAD.
Note: Weighted averages.

A.C.E. EA stands for Euro Area. EU stands for European Union. EAP stands for East Asia and Pacific. ECA stands for Europe and Central Asia. LAC stands for Latin America and the Caribbean. MNA stands for Middle East and North Africa. SAR stands for South Asia Region. SSA stands for Sub-Saharan Africa.

F. Number above columns indicate total number of migrants in millions of people. GCC stands for Gulf Cooperation Council.

Lanka. For Bangladesh and Pakistan, industrial production growth is used to proxy real GDP growth.

The estimates suggest that spillovers from a 1 percent negative growth shock in India result in a 0.6 percentage points decline in Bangladesh, and a 0.2 percentage points fall in Sri Lanka. There are no statistically significant spillovers for Pakistan (Figure 2.5.1.4). Other studies find positive, but modest, spillovers from India to Pakistan, Sri Lanka and Bangladesh (World Bank 2013b; IMF 2014e). Using a panel regression framework covering 1961-2009, Ding and Masha (2012) find that growth in India is useful in explaining overall growth in South Asia, but only after 1995, and that a 1 percentage point increase in India's growth is associated with a 0.37 percentage point increase for South Asian countries.

Estimated within-region growth spillovers are smaller than those from the rest of the world to the region. A 1 percentage point decline in GDP growth in G-7 countries causes growth in India to fall by 1.7 percentage points. This is broadly in line with earlier findings that external spillovers to India are smaller than those in other more open economies in East Asia (Chapter 3, Box 3.5). They are, however, larger than other results in the literature that find that a 1 percentage point decline in U.S. GDP is associated with a 0.12 percent fall below baseline in India's GDP (IMF 2014e). In Bangladesh and Sri Lanka, growth falls by 1.2 and 0.5 percentage points respectively in response to a 1 percent decline in global growth, and by 2 percentage points in Pakistan (although, as before, the last result is not statistically significant). This is consistent with World Bank (2013b) that finds that a positive impulse

BOX 2.5.1 Regional integration and spillovers: South Asia (continued)

from the US or other advanced economies tends to be associated with a one- to two- quarter initial increase in cyclical real GDP in India and the rest of South Asia. Financial shocks and rising global financial volatility reduce output and depreciate the exchange rate in India (IMF 2014e, 2015j).³

Conclusion

Limited global and regional economic integration in South Asia partly reflects business environments that have constrained the ability to do business across borders and policies that have weighed on competitiveness, growth and job creation (Palit and Spittel 2013, De et al. 2012). For instance, an improvement in South Asia's infrastructure to around 50 percent of East Asia's could improve intra-regional trade by about 60 percent (Wilson and Ostuki 2005). Although India is major source of spillovers for some economies, poor trade and transport connectivity in South Asia also implies fewer benefits to smaller economies in the region (relative to potential) from stronger growth in India.

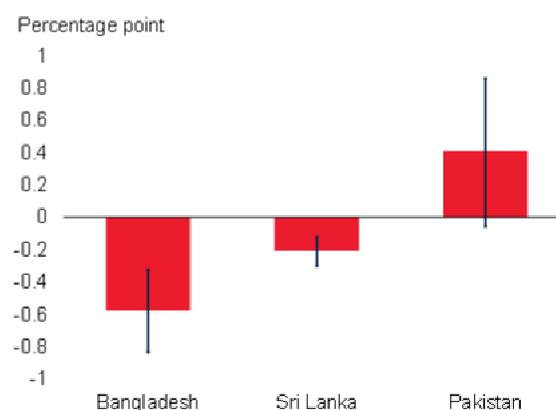
While the closed nature of the region (compared with other emerging market regions) has reduced exposure to large global shocks, it also limits the potential of South Asian firms to benefit from the strengthening of demand in the United States and Europe over the medium term. At the same time, the scope for negative spillovers from global financial market volatility may be rising as India increasingly integrates into global capital markets. This was evident during the "taper tantrum" of 2013, although vulnerabilities have since receded.

³Although India's capital account remains relatively closed, an active offshore derivatives market in the Indian Rupee may be a conduit for volatility in global markets to currency markets.

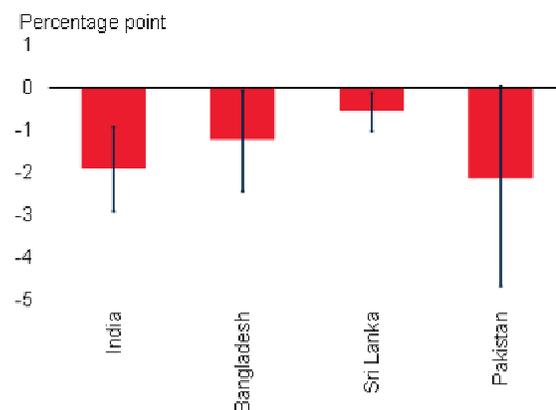
FIGURE 2.5.1.4 Global and regional growth spillovers

Spillovers from a growth shock in India are sizeable for Bangladesh, modest for Sri Lanka and statistically uninformative for Pakistan. Spillovers from large advanced countries are larger, reflecting greater integration with trading partners outside the region.

A. Impact of a 1 percentage point decline in India's growth



B. Impact of a 1 percentage point decline in G7 growth on growth



Source: World Bank.

Notes: Based on country-specific structural vector autoregressions (VARs) using the earliest possible data from 1998:1 to 2015:2 for India, Pakistan, Bangladesh and Sri Lanka; time series coverage for some countries is shorter. The country-specific VARs include G7 growth, the EMBI, a trade-weighted commodity price index, India's growth and country-specific growth of spillover source and recipients. For instance, when Pakistan is the spillover destination country, the variables include, in this Cholesky ordering: G-7 growth, EMBI, India's growth, Pakistan's trade-weighted commodity prices, Pakistan's growth, and Pakistan's real effective exchange rates. The model includes a dummy that captures the global financial crisis of 2008-09. Further details of the model, including the construction of the trade weighted commodity prices, are provided in Annex 3.2. Solid bars indicate medians and error bars indicate the 33-66 percent confidence bands.