Institute of South Asian Studies

National University of Singapore

ISAS Working Paper 2011

ISAS Working Paper

No. 119 – 6 January 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Women Empowerment in Bangladesh: The Rise of the Other Half

M. Shahidul Islam and Suvi Dogra[1]

Executive Summary

Increasing freedom around the world, especially women's freedom, is one of the hallmarks of the current wave of globalisation. Some analysts project that this could further intensify and favourably transform societies across the world. The economic and socio-political conditions of women in South Asia are not unique. Within the regions, Sri Lanka emerged as a pioneer of sorts in terms of the process of women empowerment. However, Bangladesh too has made significant strides in recent years. It has outshone some of its South Asian neighbours, including India, as far as women empowerment is concerned. The country's achievements in this regard are unparalleled in the Muslim world, bar Indonesia.

Using statistical data, this paper compares Bangladesh *vis-à-vis* South Asia, China and Vietnam to see where it stands in the regional context as far as gender balance, more precisely women empowerment, is concerned. It then identifies the factors that contributed to women empowerment—the primary thrust of this study—in Bangladesh. It also explores how the country's steady progress in gender-related development indicators could be a critical factor in guiding Bangladesh towards a higher growth trajectory.

---

[1] The authors are research associates at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. M. Shahidul Islam can be reached at isasmsi@nus.edu.sg and Suvi Dogra at isassuvi@nus.edu.sg. The views reflected in the paper are those of the authors and not of the institute. The authors are grateful to Dr Iftekhar Ahmed Chowdhury, Senior Research Fellow, ISAS, for his valuable comments.

While the highly skewed preference for boys over girls continues to amplify the number of 'missing women' [the term owes its origin to the economist, A.K. Sen], in Asia, notably in India and China, this preference has sharply declined in Bangladesh in the past three decades, thereby improving the sex ratio in favour of girls.

Based on the available economic literature and anecdotal evidence, we show that women's access to education played a key role in Bangladesh's successful population transition. A tripartite effort by the government, Non-Government Organisations (NGOs) and donor agencies has been the key catalyst in educating the female population of Bangladesh. These efforts have also been extended to making healthcare more accessible for the women in the country.

When it comes to access to employment and earnings, women find better opportunities in Bangladesh than many of their South Asian peers. This is largely due to, among other factors, the meteoric rise of microfinance industry in the country that generally offers easy access to credit for the poorest of the poor. Moreover, the labour-intensive apparel industry absorbs a large number of young women. As a result, the labour force participation rate of women in Bangladesh is very high compared to most South Asian economies.

Apart from economic factors, Bangladesh's social and political institutions (such as courts, law and order, civil society, etc.) play a supportive role in protecting women's rights.

While Bangladesh's stride towards a gender-balanced society has paid some tangible benefits to the nation, the country has only been able to utilise a part of its female human capital. Moreover, Bangladesh's success in women's empowerment is happening at a time when the nation's demographic window is about to open, with a growing share of females in the working age population.

There exists a nexus between gender equality and economic growth. What is interesting to note, is that the actual growth rates of South Asia and other lagging regions were at least one percentage point lower than their potential growth owing to the gender imbalance. Studies also suggest that the growth impact of education for girls may be greater than the impact for boys. A pioneering study on Bangladesh supports this view. Consequently, Bangladesh's stride towards a gender-balanced society could be one of the benefactors in the country's pursuit of higher economic growth.

Bangladesh's success in balancing its gender gap offers some policy lessons for other South Asian, as well as a number of African, countries. The nexus between female education and successful population transition might have particular importance for Pakistan and Afghanistan.

Bangladesh’s successful revolution in the area of microfinance, which provides alternative employment and income opportunities to the female population, is another area that has increasing global appeal.

Nevertheless, the benefits of women’s empowerment cannot be measured by merely economic numbers. Greater involvement of NGOs and women’s wider role in society are believed to be marginalised by the extremists’ thoughts in Bangladesh; this is an issue that needs to be studied further for the wider benefit of South Asia and beyond the region.

I. Introduction

In his latest book titled *Sonic Boom: Globalization at Mach Speed*[2], Gregg Easterbrook identified a few mega trends that could expedite the globalisation process in years to come. One of them is increasing freedom around the world, especially women's freedom. Advances in literacy rates and the greater assimilation of women throughout the world into the workforce could double the world's supply of ideas, the author observed.

Most developed nations, with the exception of Japan, have narrowed their gender gap[3]. The scenario is also changing rapidly in a number of developing countries, India being the biggest outlier[4]. In South Asia, Sri Lanka has achieved the most progress[5] thanks to, among other factors, its relatively early entry in the 'catch-up' game. In recent years Bangladesh has made significant strides after Sri Lanka[6] as far as women empowerment[7] is concerned. This is not because the country has been alternately ruled by the two *Begums* since 1990 except for brief periods when interim governments facilitated power transitions. In the current parliament, the Prime Minster, the opposition leader, the foreign minister, the home minister and the agriculture minister are all women. Nevertheless, the changes concerning women empowerment in Bangladesh are much more fundamental than a number of powerful women leaders holding key ministerial portfolios. From enrolment in schools to participation in the workforce to decision making in family matters, the gender gap in Bangladesh is fast closing. It is also one of the few Muslim nations that recognises women's wider role in the economy and in society.

The important contribution made by its female population both in cities and the countryside has made Bangladesh's economic growth more balanced, which is reflected in income distribution and gender-related development indices. We discuss this issue with some statistics in the subsequent sections. As the country is showing some vital signs to grow faster than its current pace, greater female participation in the workforce and other societal externalities arising from women's empowerment are expected to be huge contributing factors in this context.

2 Gregg Easterbrook, *Sonic Boom: Globalization at Mach Speed* (New York: Random House, 2010).
3 Indeed, most East Asian economies do not fare well in the global gender gap ranking. For details, see the Global Gender Gap Index (2009), World Economic Forum. Also see Gender Related Development Index, Human Development Report (2009), United Nations: New York.
4 *Ibid*.
5 *Ibid*.
6 Nepal has also made significant progress despite its low per capita income.
7 While the definition of 'gender balance' could be different from 'women empowerment', in this paper, the two terms are used interchangeably to indicate the state of the economic, social and political development of the female population *vis-à-vis* their male counterparts.

That said, the purpose of this paper is twofold. First, it identifies the critical factors behind women empowerment in Bangladesh. Second, it examines how the country's success in balancing its gender gap could play a significant role in helping the economy move towards a higher growth trajectory. The rest of the paper is organised as follows. In Section II the paper presents some data concerning the gender gap and women empowerment in Bangladesh. In particular, a comparative picture with its South Asian neighbours and other developing countries could help us understand where Bangladesh stands from a regional perspective. Factors that have contributed to women empowerment in the country, the major thrust of this paper, are discussed in Section III. In Section IV, following a review of the existing economic literature, we discuss how the country's stride towards a gender-balanced society could boost its economic growth in the coming years. The final section concludes the paper.

II. The State of Women Empowerment: Bangladesh in a Regional Perspective

The global gender gap index, devised by the World Economic Forum, gives a snapshot of the state of women's empowerment across the world. Most developed countries, notably the Scandinavian nations, rule the ranking. As reflected in Table 1, the gender gap in Asia remains wide with the exception of the Philippines and Sri Lanka. While China and Vietnam are catching up fast, Bangladesh has made significant strides if one compares the nation with its South Asian neighbours. It also outshone all Muslim countries, bar Indonesia.

<u>Table 1</u>: Gender Gap Rankings, 2009

Country	**Overall Rank**	**Overall Score***
Iceland	1	0.8276
Philippines	9	0.7579
Sri Lanka	16	0.7402
China	60	0.6907
Vietnam	71	0.6802
Singapore	84	0.6664
Indonesia	92	0.6580
Bangladesh	**93**	**0.6526**
Maldives	99	0.6482
Malaysia	100	0.6467
Japan	101	0.6445
Nepal	110	0.6213
Jordan	113	0.6182
India	114	0.6151
Korea, Republic	115	0.6146
Egypt	126	0.5862
Iran	128	0.5839
Turkey	129	0.5828
Saudi Arabia	130	0.5651
Pakistan	132	0.5458

<u>Source</u>: 'The Global Gender Gap Index 2009', The Global Gender Gap Report 2009, World Economic Forum, Geneva, Switzerland.

<u>Note</u>: *scale of 0 to 1, 0=inequality, 1=equality. This ranking is based on five criteria: economic participation, economic opportunity, political empowerment, educational attainment and health and well-being.

It is important to note that the per capita income in Bangladesh remains very low. With approximately US$750 per capita income[8], as of Fiscal Year 2009-10 (US$1,500 in Purchasing Power Parity terms, 2009), Bangladesh is still a least developed country. If one looks at income-related indices it ranks very low. Despite the low per capita income, the nation's human development record is highly impressive. This is more so when one looks at its gender-related development indicators. Column 2 and Column 3, of Table 2, show that Bangladesh ranks 8th among the sample countries (out of nine) on GDP (Gross Domestic Product) per capita. But the last column shows that it ranks first if one compares the country's income level with its human development records *vis-à-vis* other countries. Its income distribution is the most egalitarian among all South Asian countries as well as China and Vietnam, which is reflected in the Gini coefficient value reported in Column 5 of the table.

[8] Bangladesh Bureau of Statistics (BBS), quoted in the *Daily Star* (28 May 2010) and The World Fact Book, Central Intelligence Agency, available at https://www.cia.gov. Accessed on 27 September 2010.

<u>Table 2</u>: Bangladesh's GDP and HDI Records *vis-à-vis* Selected Developing Countries

	GDP per capita (PPP US$), 2007	**GDP Index, 2007**	**HDI Index, 2007**	**Gini Index, 2000-2007**	**GDP per capita (PPP US$) rank minus HDI rank*, 2007**
China	5383	0.665 (1)	0.772 (1)	41.5 (7)	10 (5)
Bhutan	4837	0.647 (2)	0.619 (5)	46.8 (8)	-24
Sri Lanka	4,243	0.626 (3)	0.759 (2)	41.1 (6)	14 (2)
Indonesia	3712	0.603 (4)	0.734 (3)	39.4 (5)	10 (4)
India	2753	0.553 (5)	0.612 (6)	36.8 (3)	-9 (6)
Vietnam	2600	0.544 (6)	0.725 (4)	37.8 (4)	13 (3)
Pakistan	2496	0.537 (7)	0.572 (7)	31.2 (2)	-9 (6)
Bangladesh	**1241**	**0.420 (8)**	**0.543 (9)**	**31 (1)**	**21 (1)**
Nepal	1049	0.392 (9)	0.553 (8)	47.3 (9)	21 (1)

<u>Source</u>: Human Development Report 2009, United Nations: New York.

<u>Note</u>: Figures in parentheses show ranking. The ranking is based on the countries listed in the table.
*A positive figure indicates that the HDI rank is higher than the GDP per capita (PPP US$) rank.

Table 3 shows the gender disparity in selected South Asian countries and China. Among the sample countries, Bangladesh placed third after China and Sri Lanka if one looks at the gender-related development index (GDI) that captures inequalities in achievement between women and men. As reflected in Table 3, Bangladesh has done particularly well in educating its female population.

<u>Table 3</u>: GDI Compared to HDI: Bangladesh *vis-à-vis* Selected Countries

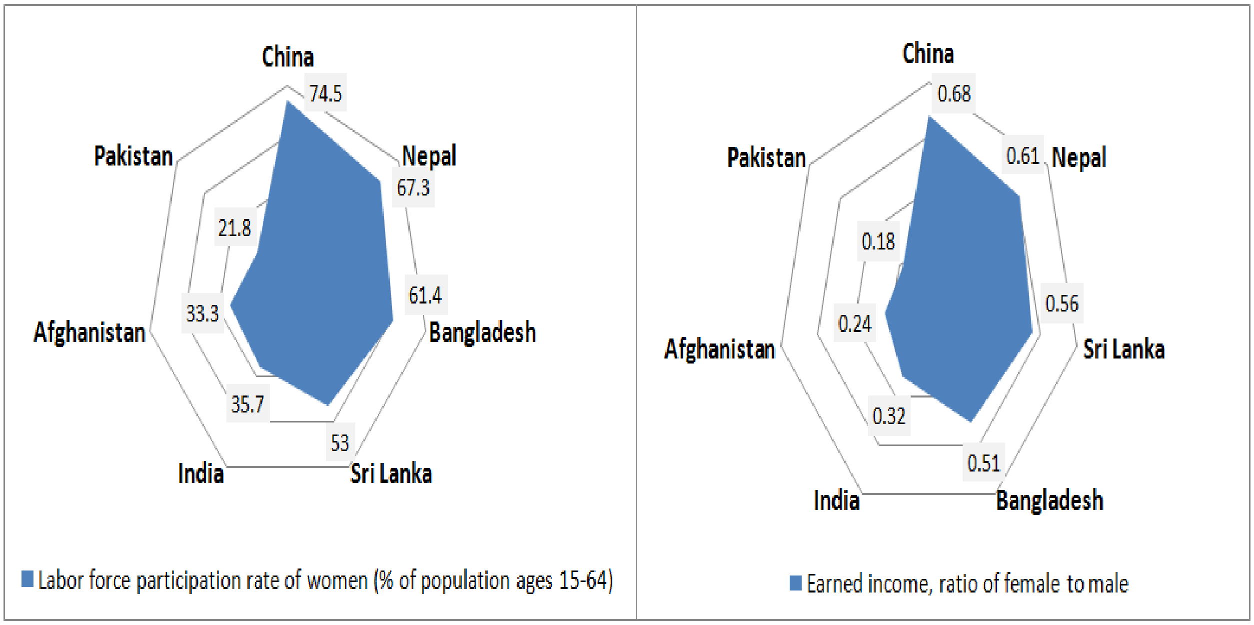
	GDI as % of HDI	**Life expectancy at birth (years), Female as % male**	**Adult literacy rate (% ages 15 and older), Female as % male**	**Combined primary, secondary and tertiary gross enrolment ratio, Female as % male**
China	99.8	104.8	93.3	99.4
Sri Lanka	99.6	110.9	96.1	103.6
Bangladesh	**98.7**	**103.1**	**81.9**	**101.4**
Nepal	98.4	101.9	62	91.6
India	97.1	104.7	70.9	89.3
Pakistan	93	101	58.6	78.3
Afghanistan	88	99.8	29.2	55.6

<u>Source</u>: Human Development Report 2009, United Nations: New York.

Figure 1 reflects two important measures of women's empowerment in terms of income and employment. The left panel shows that the labour force participation rate of women in Bangladesh is lower than in China and Nepal but higher than the rest of South Asia. The right panel shows that an average Bangladeshi woman earns half of what a man makes in the country, which is higher than in India, Pakistan and Afghanistan but lower than in China, Sri Lanka and Nepal.

To sum up, Bangladesh has outshone some of its key neighbours, including India and Pakistan, in closing the gender gap and it has also been bridging the gap with China, Vietnam and Sri Lanka. In the next section, we identify and discuss the factors behind the steady empowerment of women in Bangladesh.

Figure 1: Labour force Participation Rate of Women and Income Ratios (Female to Male) in Bangladesh, China and Select South Asian Economies



Source: Based on Human Development Report 2009, United Nations: New York and World Development Indicators online, World Bank: Washington.

III. Factors behind Women's Empowerment in Bangladesh

Before we identify the critical factors that are prompting women empowerment in Bangladesh, it is imperative to define women empowerment. The United Nations views women empowerment as having 'five components: women's sense of self-worth; their right to have and to determine choices; their right to have access to opportunities and resources; their right to have the power to control their own lives, both within and outside the home; and their ability to influence the direction of social change to create a more just social and economic order, nationally and internationally'.[9] One notices an increasing recognition of the centrality of women empowerment in the overall development process since the 1990s.[10] In this paper, we look at the economic and social empowerment of women in Bangladesh.

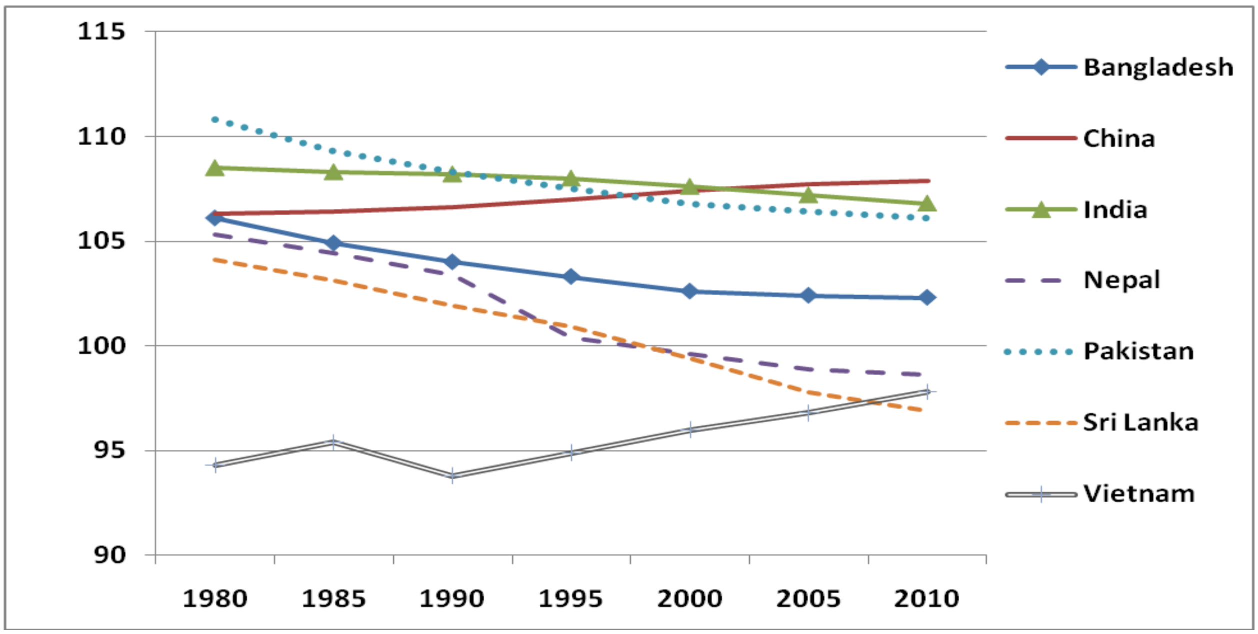
---

9 See 'Guidelines on Women Empowerment', Department of Economic and Social Affairs, UN Population Division. Available at www.un.org/popin/unfpa/taskforce/guide/iatfwemp.gdl.html. Accessed on 28 August 2010.

10 The empowerment of women was essential to the declarations and platforms for action of the 1990 World Conference on Education for All, the 1992 United Nations Conference on Environment and Development, the 1993 Human Rights Conference, the 1994 International Conference on Population and Development, the 1995 World Summit for Social Development, and the Regional Preparatory Conferences for the 1995 Fourth World Conference on Women. For details, see Guidelines on Women Empowerment', Department of Economic and Social Affairs, UN Population Division. Available at www.un.org/popin/unfpa/taskforce/guide/iatfwemp.gdl.html. Accessed on 28 August 2010.

Why has Bangladesh done relatively better than many South Asian countries when it comes to women empowerment, although it has experienced a relatively lower to moderate level of economic growth than its peers? Before we conduct a micro-level enquiry on this, it is worth looking at the sex ratios in Bangladesh, China, Vietnam and key South Asian countries. As can be seen in Figure 2, there has been a strong preference for male over female babies in India, Pakistan and Bangladesh. While Bangladesh has been closing the gap rapidly, India and Pakistan's success in this regard has been less than satisfactory. China's progress is even worse than India's; there is a strong cultural preference among Indian and Chinese parents, for sons over daughters. China's one-child policy is believed to have contributed to the skewed preference for boys.

<u>Figure 2</u>: Trends in Male to Female Sex Ratios in Key South Asian Countries, China and Vietnam: 1980-2010.



<u>Source</u>: Based on Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: The 2008 Revision. http://esa.un.org/unpp.

The global average sex ratio is 101.7 (males per 100 females). This means that there are 101.7 boys for 100 girls.[11] However, the ratio can vary widely. For instance, in Europe and North America there are 105 women for 100 men. In India, the regional variation in gender ratio is extremely skewed – in Punjab there are 80 girls for every 100 boys, whereas in Sikkim the ratio

[11] Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, 'World Population Prospects: The 2008 Revision', http://esa.un.org/unpp.

is fairly balanced.[12] In Bangladesh, for every 100 females there are 102.3 males. For India, Pakistan and China the corresponding figures are 106.8, 106.1 and 107.9, respectively.[13]

It is hardly surprising that the number of 'missing girls' – a term coined by the economist A. K. Sen – is staggering both in India and China. Sen first estimated the number of 'missing women' by calculating the number of extra women who would have existed in a particular country if they had received similar care as men. According to Sen, in countries where men and women receive similar care, the female to male ratio is about 1.05.[14]

A back-of-the-envelope calculation (see Table 4) shows that there are at least 39 million fewer women in India's total population, owing to the lower preference for female than male children (0.94). The figure for China is even worse, with at least 40 million fewer females added to the population due to parents' skewed gender bias for boys. If one uses the Sen Criteria, the corresponding numbers can be as high as 67 million for India and 80 million for China. While Bangladesh has made the most progress in the sample by improving its sex ratio in favour of girls, at least 0.8 million females did not survive due to parents' slightly skewed gender bias. In the case of Pakistan the most optimistic number is 4.1 million. The number of missing women in Pakistan and Bangladesh can be as high as 9.7 and 6 million, respectively.

Table 4: Missing Women in Selected South Asian Countries and China

	Based on world's average sex ratio 101.7 (males per 100 females) or 99 (females per 100 males)		Based on A K Sen Criteria, sex ratio 95 (males per 100 females) or 105 (females per 100 males)		Actual sex ratios, (females per 100 males)	
	1980, in millions	2010, in millions	1980, in millions	2010, in millions	1980	2010
Bangladesh	1.8	0.8	4.7	6	94.2	97.8
India	20	39	38	67	92.5	93.6
Pakistan	3.1	4.1	5.7	9.7	90.3	94.3
China	20	40	51	80	94.1	92.7

Source: Author's calculations based on World Population Prospects: The 2008 Revision, The United Nations: New York and Sen, A. K. (1990).

12 'Indicus Analytics: The missing daughters', *Business Standard* (2 December 2010), http://business-standard.com/india/news/indicus-analyticsmissing-daughters/416777/. Accessed on 3 December 2010.

13 Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, 'World Population Prospects: The 2008 Revision', http://esa.un.org/unpp. Accessed on 6 January 2011.

14 Sen Amartya, 'More Than 100 Million Women Are Missing', Feature, *The New York Review of Books,* Vol.37, no.20 (20 December 1990).

Nicholas D. Kristof and Sheryl WuDunn in their Pulitzer Prize winning book titled *Half the Sky: Turning Oppression into Opportunity for Women Worldwide* called this gender bias in sex selection as gendercide. According to the authors, the daily slaughter of girls in the developing world, steals more lives in any given decade ‘than all the genocides of the 20th century.’ Detailing the extensive account of gendercide in the developing countries, they claim that more girls have been killed in the last fifty years than men were killed in all the wars of the twentieth century.[15]

Apart from a less skewed gender bias, other notable factor that helped Bangladesh balance the sex ratio is the nation’s success in reducing the female infant mortality rate for which the country received a United Nations award in 2010.[16] It also showed similar success in minimising under-5 child mortality rates. Table 5 shows infant mortality rates by sex in selected South Asian countries and China. Sri Lanka, Bangladesh and Nepal outperformed the two largest and fastest growing Asian economies, *viz.,* China and India, by reducing the female infant mortality rate. The scenario in Pakistan is the worst among the selected countries. Going forward, the United Nation’s projection for 2010-2015 (medium variant) shows that Bangladesh will continue to see a faster decline in the female infant mortality rate (35 female deaths per 1,000 live births against 39.4 male deaths per 1,000 live births). The corresponding figures for India would be 50.2 (48.9). The projection is almost identical when one looks at the under-5 mortality rates by sex.[17]

[15] Nicholas D. Kristof and Sheryl WuDunn, *Half the Sky: Turning Oppression into Opportunity for Women Worldwide* (New York: Vintage Books, Random House, 1990).

[16] Bangladesh received a United Nations award for its remarkable achievements in attaining the Millennium Development Goals (MDGs) particularly in reducing child mortality. Source: ‘Child Deaths Halved: UN Award for Bangladesh’, *The Daily Star*, Dhaka (21 September 2010).

[17] Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, ‘World Population Prospects: The 2008 Revision’, http://esa.un.org/unpp.

<u>Table 5</u>: Infant Mortality Rates and Under-5 mortality (by sex) in Selected South Asian Economies and China, 2005-2010

	Infant Mortality Rate by Sex			**Under-five Mortality by Sex**		
	Both sexes combined (infant deaths per 1,000 live births)	Male (infant deaths per 1,000 live male births)	Female (infant deaths per 1,000 live female births)	Both sexes combined (deaths under age 5 per 1,000 live births)	Male (deaths under age 5 per 1,000 live male births)	Female (deaths under age 5 per 1,000 live female births)
Sri Lanka	15.9	17.1	14.6	20	21	18
Bangladesh	44.7	46.4	42.8	57	58	56
Nepal	42.2	42.2	42.1	54	52	55
India	54.6	54	55.2	81	77	86
Pakistan	63.9	61.3	66.6	89	85	94
China	22.9	18.4	28.2	29	25	35
World	47.3	48.4	46.1	71	71	71

<u>Source</u>: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, 'World Population Prospects: The 2008 Revision'

While the strong preference for female over male children (or gender neutrality) and lower female infant mortality rates (or indifferent preference) might explain the improving conditions of the female population, they are not the panacea. These should be seen, at best, as some necessary conditions and a big step forward towards a gender-balanced society. China is a good example in this regard, if one isolates its 'one-child policy effect' on its gender preferences. Despite the highly skewed gender bias, the combined education enrolment in China (female over male) reached 99.4 per cent (Table 3). Nevertheless, in the case of Bangladesh the significant improvement in the sex ratio – female over male – shows families' strong commitment to a gender-balanced society.

Another demographic factor that played a critical role in minimising the gender gap in Bangladesh is the country's successful population transition owing to a steady decline in both birth rates and death rates. Total fertility rates (TFR) in Bangladesh have declined from 6.85 children per woman in 1970-75 to 2.36 in 2005-2010. The TFR is projected to approach a replacement level (2.1) in the period of 2015-2020.[18] A successful population transition means a rise in the working age population and a steady decline in dependency ratios that leave more surplus income to support health and education expenses. A back-of-the envelope calculation shows that Pakistan would have had at least 40 million fewer people than Bangladesh had it followed the latter's population growth trends (more precisely, the population policy).

Bangladesh's favourable demographic transition, the rapid decline in mortality rates, notably the female mortality rate, improvements in the health and nutrition of the female population and their associated benefits are in line with what many researchers have demonstrated. Hill and King (1993) and Schultz (1997) found that increasing women's literacy level mainly results in high individual private market returns, reduced child mortality and fertility, better health and education of children, and increases in the income potential of poorer individuals. Bangladesh's success in educating its female population perhaps supports these findings. This issue is discussed in some detail in the later part of the paper and in the subsequent section.

A tripartite effort helped Bangladesh make one of the most successful population transitions in developing countries as well as in the Muslim world. Initially, the donor agencies financed and the government implemented a highly successful family planning programme, which is perhaps one of the most successful among Muslim nations. Owing to the conflict between religion and contraceptive use, birth control programmes still face tremendous opposition, particularly from *Mullahs* (or other religious leaders and priests), around the world. This has led many Muslim countries into 'demographic traps' – a situation where the population grows rapidly due to a high birth rate and a low death rate. A high child dependency ratio leaves very little surplus income to be spent on health and education. It is hardly surprising that most of the 20 countries that lead the list of 'failing states'– predominantly Muslim countries – are caught in a 'demographic trap'.[19]

Non-government organisations (NGOs) also played a large part in creating social awareness that eventually helped control Bangladesh's chronic population problem. There has also been a lasting intervention by NGOs in the country's health sector. BRAC, which is one of the largest NGOs in the world, has an essential healthcare programme that operates in the country's 64 districts with 80,000 volunteers.[20] It also provides healthcare programmes in malaria, mental health, HIV/AIDS and tuberculosis. The contribution made by the International Centre for Diarrhoeal Disease Research, Bangladesh (ICDDR,B), a health research institution dedicated to

---

[18] *Ibid.*

[19] For details, see The 2010 Failed State Index, *Foreign Policy*, Available at www.foreignpolicy.com/articles/2010/06/21/2010_failed_states_index_interactive_map_and_rankings. Accessed on 25 August 2010.

[20] BRAC, www.brac.net. Accessed on 11 August 2010.

saving lives through research and treatment, and its Matlab Hospitals in this regard has been phenomenal.[21]

In the education sector, with the help of donor assistance, the government played an important role by offering free primary education to both boys and girls. Subsequently, secondary and higher secondary education were made free for female students. The government also initiated several financial incentive schemes for female students that dramatically increased enrolment.

NGOs have also been playing a supporting role in Bangladesh's non-formal education sector by providing basic schooling to a target group (age between 8 and 45) who cannot be at formal schools due to high opportunity costs, among other reasons. The non-formal education projects are generally undertaken by the government and implemented by the NGOs who target out-of-school children, school drop outs, adolescents and young adults as well as urban slum dwelling working children and adolescents engaged in hazardous professions.[22] BRAC, for instance, offers various pre- through post-primary schools with modern curricula.[23] BRAC alone runs 38,250 non-formal primary and pre-primary schools in all 64 districts of Bangladesh. Over 4 million students graduated from BRAC schools and generally 70 percent of its students are girls.[24] BRAC is now going global, with a growing presence in Afghanistan and Pakistan. There are numerous NGOs, such as Proshika, Gono Shahajjo Shangstha (GSS) and Dhaka Ahsania Mission (DAM) that offer similar programmes. Moreover, a large number of primary schools in the country are run by communities.

The rise of NGOs, steady urbanisation and the presence of a vibrant civil society have minimised the influence of *madrashas* that generally offer religion-based education. The ideological battle between NGOs and other progressive segments of society *vis-à-vis Mullahs* is still ongoing, with the former gradually marginalising extremist thinking in the country. Tensions between secular and religious-based education have partly eased following the effects of modernisation, which include the enrolment of female students, the appointment of female teachers and higher demand for graduates from non-religious-based educational institutions.

The rising urban population in recent years has also increased the influence of modern education over religion-based institutions. With steady economic growth, the country, particularly in the

21 For details of the activities of ICDDR,B, see its website (www.icddrb.org/). Accessed on 11 August 2010.

22 For details see Non-Formal Education Policy Bangladesh, 2007, United Nations Economic and Social Council. Available at http://webapps01.un.org/nvp/frontend!policy.action?id=190&tab=analysis, Accessed on 28 November 2010.

23 BRAC runs two types of non-formal schools: the BRAC Primary School (BPS) and the BRAC Adolescent Primary School (BAPS).

24 BRAC, www.brac.net. Accessed on 11 August 2010.

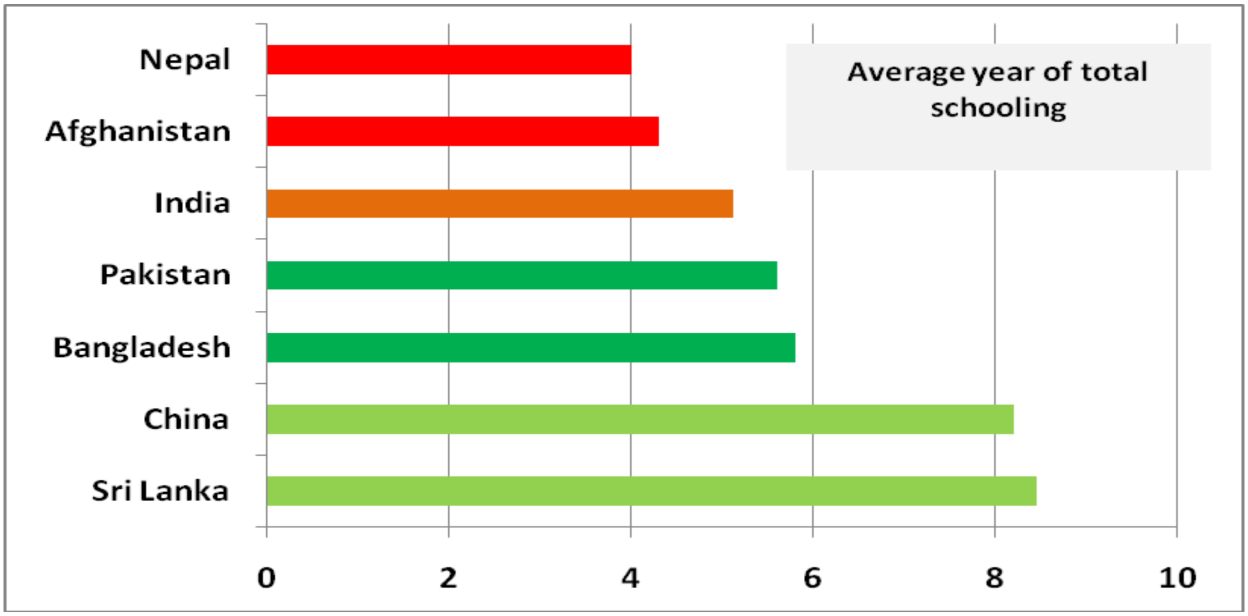
cities, is witnessing a rapid rise in the number of private schools that offer secular and modern education. For instance, nearly 87 per cent of the female students enrol in non-religious primary schools.[25] Except for *madrasha*s, in recent years there has been a marked improvement in the gender balance in primary schools, with females constituting 36 per cent of the teaching staff.

Nevertheless, the role of *madrasha*s concerning the expansion of female education is important for several reasons. First, these religious schools are generally operated in rural and isolated areas that, in most cases, have neither formal nor informal education facilities. So, *madrasha*s are critical in reaching out to the extremely poor female population that otherwise may not get any kind of education. Today, females constitute nearly half of the total student population in these religious schools.

All these factors have helped Bangladesh achieve marked success in its education sector. As reflected in Figure 3, Bangladesh has progressed more than most of its South Asian neighbours, bar Sri Lanka, in terms of average years of total schooling. When it comes to education attainment of females to males, the country outshone all of its South Asian neighbours and China, particularly in primary and secondary enrolments. However, it is way behind in tertiary enrolment (Figure 4).

[25] The World Bank, 'Education for All in Bangladesh: Where Does Bangladesh Stand in Achieving the EFA Goals by 2015?', *Human Development Unit, South Asia Region*, http://siteresources.worldbank.org/INTBANGLADESH/Resources/education24.pdf. Accessed on 22 August 2010.

<u>Figure 3</u>: Average Years of Total Schooling in Bangladesh and Selected Countries



<u>Source</u>: Robert J. Barro and Jong-Wha Lee (2010), 'International Data on Educational Attainment: Updates and Implications', *CID Working Paper No. 42*, Centre for International Development, Harvard University: Massachusetts.

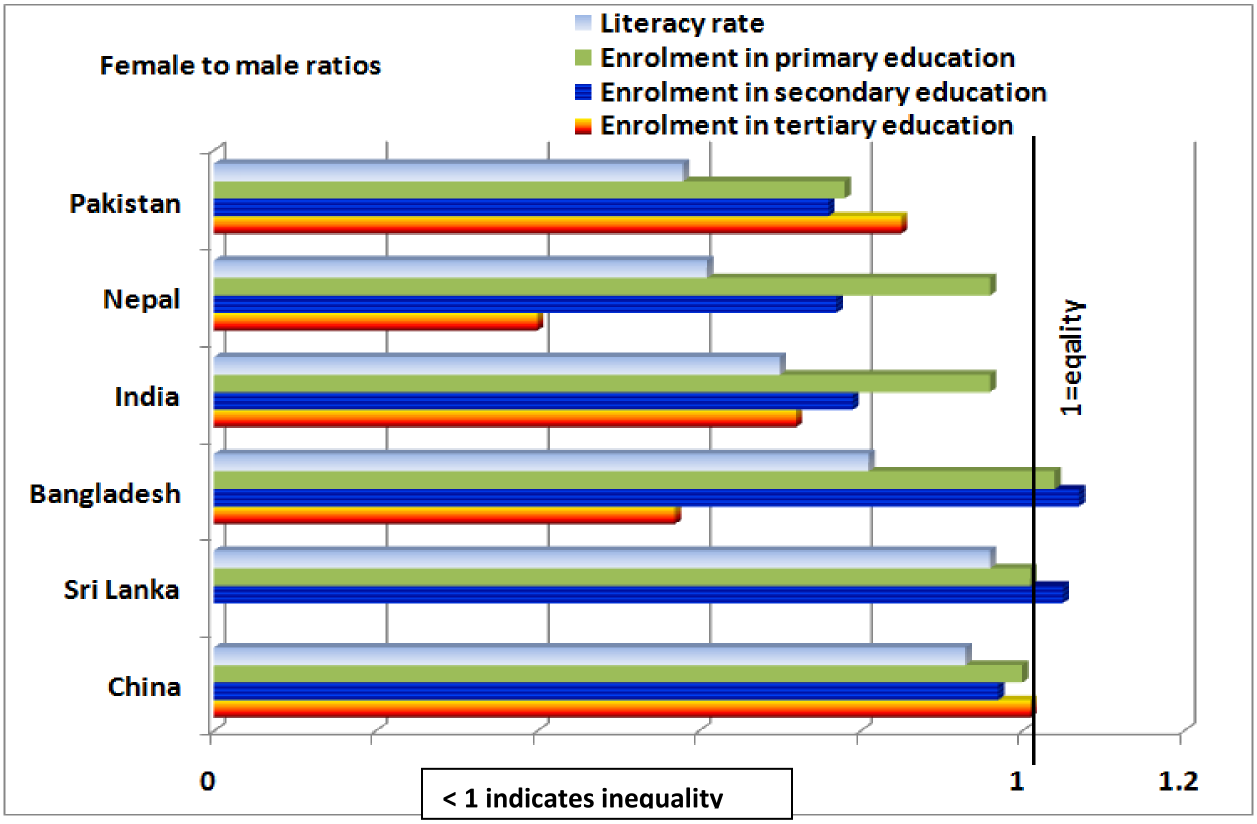
Bangladesh's success in primary enrolment and its impact on demographic transition – notably, the decline in TFR – are in line with cross-country findings. In a seminal paper, Barro (2001) observed '[that] education of women at the primary level stimulates economic growth indirectly by inducing a lower fertility rate.' However, he also found that 'growth is insignificantly related to years of school attainment of females at the secondary and higher levels. This result suggests that highly educated women are not well utilised in the labour markets of many countries.'[26]

Empirical evidence also highlights that an increase in female education can improve human development outcomes such as child survival, health and schooling; the impacts on these outcomes are larger for a given increase in women's education than for an equal increase in men's education.[27]

[26] Barro, Robert J., 'Education and Economic Growth', in J.F. Helliwell (ed.), *The Contribution of Human and Social Capital to Sustained Economic Growth and Well-Being*, Organisation for Economic Cooperation and Development (2001), www.oecd.org/dataoecd/5/49/1825455.pdf . Accessed on 12 August 2010.

[27] Sinha, Nistha, Raju, Dhushyanth, and Morrison, Andrew Robert. 'Gender Equality, Poverty and Economic Growth', *World Bank Policy Research Working Paper No. 4349* (2007), http://ssrn.com/abstract=1014233. Accessed on 10 August 2010.

<u>Figure 4</u>: Education Attainment of Females to Males in Selected South Asian Countries and China, 2008.



<u>Source</u>: Based on Global Gender Gap Report 2009, The World Economic Forum: Geneva.

Female enrolment in Bangladesh has been phenomenal, particularly following the introduction of a cash transfer scheme, namely, the female secondary stipend programme (FSS), in 1994. However, greater emphasis on female enrolment has also resulted in an unintended outcome – what some analysts have termed the 'reverse gender gap'. Some analysts have captured the development with statistical evidence. Asadullah and Chaudhury (2009), for instance, found '[that] more than closing gender gap, the stipend scheme may have led to a reversal of the gap and this gap is pronounced among poor households where the FSS programme has had the most impact.'[28]

That said, while Bangladesh has made marked strides in female enrolment in primary and secondary education, it needs to put enormous effort into improving its female enrolment in tertiary education. The total literacy rate for females is still lower than for their male counterparts, due to the former's low enrolment in tertiary education.

[28] Mohammad Niaz Asadullah and Nazmul Chaudhury, 'Reverse Gender Gap in Schooling in Bangladesh: Insights from Urban and Rural Households', *The Journal of Development Studies*, Vol.45, no.8 (2009), pp.1360-80.

While the battle was half-won with the high enrolment of female students and a gradual marginalisation of extremist thinking[29], following a successful population transition, the creation of economic opportunities was the next challenge for Bangladesh. Although a large part of the Bangladesh economy is informal, it is difficult to present a comparative analysis *vis-à-vis* other countries regarding women's real contribution in the economy. A similar problem prevails in many parts of South Asia. However, highlighting two sectors – microfinance and the apparel industry – we discuss the role of women in Bangladesh's formal economy.

The meteoric rise of microfinance and the rapid expansion of the apparel industry helped Bangladesh's female population enormously in terms of their employment and other economic opportunities. While the apparel industry offers direct employment in cities 3 to 3.5 million people[30], mainly women, microfinance helps create self-employment for millions of women, particularly in the countryside. As can be seen in Table 6, the penetration of microfinance is very high in Bangladesh. The figures in the table do not provide a complete picture but they give some indications about the state of microfinance penetration in South Asia. Table A.1 in the appendix shows the strong presence of Bangladeshi microfinance firms in the Top-10 Microfinance Information Index Global Composite Ranking.

Microfinance institutes generally offer small loans (US$ 50-200) to the economically active poor population – often without collateral – to undertake or strengthen income-generating activities. However, the size of the loan to the enterprises could be as high as a few thousand dollars. The disbursement of loans is only one aspect of microfinance. Microfinance and microcredit institutes are an important part of enterprise development programmes[31], where the loan is generally invested and employment is generated.

The role of microfinance in the process of women empowerment is well documented. Numerous studies have found a direct association between the two variables. Focusing on the impact of participation in microfinance by gender on labour supply, schooling, household expenditure and assets in Bangladeshi villages, Pit and Shahidur (1998)[32] found that women microcredit recipients (as opposed to men) are more successful in increasing women's non-land assets and children's education. Aghion and Morduch (2005) conclude that the role of group lending and peer borrowers deters domestic violence and provides a way for women to save by keeping

[29] Nevertheless, the marginalisation of extremist thinking does not indicate that there is a decline in the number of religious schools or rate of enrolment. It rather means that there has been a declining role of religious thought in Bangladeshi politics and society.

[30] 'Bangladesh, With Low Pay, Moves In on China', *New York Times* (16 July 2010).

[31] They include, among others, poultry and livestock, dairy, fisheries, agriculture and handicrafts.

[32] Mark Pitt and Shahidur R. Khandker, 'The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of Participants Matter?' *Journal of Political Economy*, Vol.106, no.5 (1998).

money away from their husbands. Moreover, one of the key reasons behind the success of microcredit in Bangladesh is that women are found to be better than men in repaying loans. See the fact sheet of Grameen Bank in the appendix (Table A.2) that clearly shows that women borrowers outnumbered (as well as marginalised) male borrowers over the years.

Table 6: Microfinance Penetration in South Asia

	Number of active borrowers, 2008, in million	% of women borrower	% of working age population under microfinance coverage	Gross loan portfolio US$, 2008
Afghanistan (14)	0.3	69	2.1	113.2 million
Bangladesh (22)	**21.6**	**92**	**22.0**	**2.1 billion**
India (75)	16.2	95	1.1	2.1 billion
Pakistan (20)	1.1	71	1.1	162.9 million
Sri Lanka (12)	1	59	4.0	288.8 million
Nepal (27)	0.6	98	3.4	101.8 million

Note: This table is based on the number of microfinance institutions (MF) reporting to the Microfinance Information Exchange. Figures in parentheses show the number of reporting MFI in the respective countries. For time-series data, see www.mixmarket.org/. Accessed on 29 August 2010.

The apparel industry is another sector where a large number of women work. The industry employs over three million people and women constitute the largest part of the workforce.[33] The industry, which is highly labour-intensive, does not demand a highly educated labour force. This development, perhaps, separates Bangladesh from most South Asian economies that have been less successful in penetrating low-end manufacturing that could employ a large number of women with a primary or secondary school education but with minimal technical skills. Bangladesh offers one of the lowest manufacturing wages, particularly in the textile sector, in the world.[34] Apart from labour-intensive manufacturing, women are becoming increasingly competitive in the modern service sector. The rapid expansion of Bangladesh's apparel industry and the high penetration of microfinance are two key reasons behind the higher participation rate of the female workforce in the country.

---

33 'Bangladesh, With Low Pay, Moves In on China', *New York Times* (16 July 2010).

34 M. Shahidul Islam, 'Window of Opportunity for South Asia', *Roubini Global Economics*, www.roubini.com/emergingmarkets-monitor/259222/window_of_opportunity_for_south_asia. Accessed on 12 August 2010.

Women's participation in the workplace is expected to rise further with the rising share of the working age female population in the Bangladeshi workforce. This issue is discussed in the next section.

In summary, parents' less skewed preference for boys over girls, a successful population transition, the state's strong hand in health and education, NGO's role in informal education, health and microfinance adding upon the rise of the apparel industry, steady urbanisation, and a gradual marginalisation of extremist thinking, have all helped Bangladesh to close its gender gap and empowered its female population. This could benefit the nation economically in an even greater way, which is the issue we take on in the next section.

IV. Women Empowerment and Economic Development: Cross-country Experience and Prospects for Bangladesh

In this section, we explore how gender could be a positive factor for Bangladesh's medium- to long-term growth. It is hard to conduct a quantitative exercise owing to the complex linkages between gender and growth. However, we attempt to offer a scenario for Bangladesh based on the available literature as well as the country's current socio-economic conditions. The existing literature, especially at the macro level, indicates that there exists a nexus between gender equality (or lack thereof) and economic growth. This has been studied by economists and gender experts alike. A range of theories point towards a long-term correlation between GDP level and gender equality (Forsythe et al., 2000; Stotsky, 2006)[35], especially in regards to more equal human capital investments. A counter-argument also exists wherein it is proposed that there is not an unequivocal positive correlation but that it varies with the level of development in the concerned country.[36]

Figure 5, taken from the World Development Report 2001[37], shows the growth effect of closing the gender gap in schooling in three lagging regions including South Asia. The actual growth

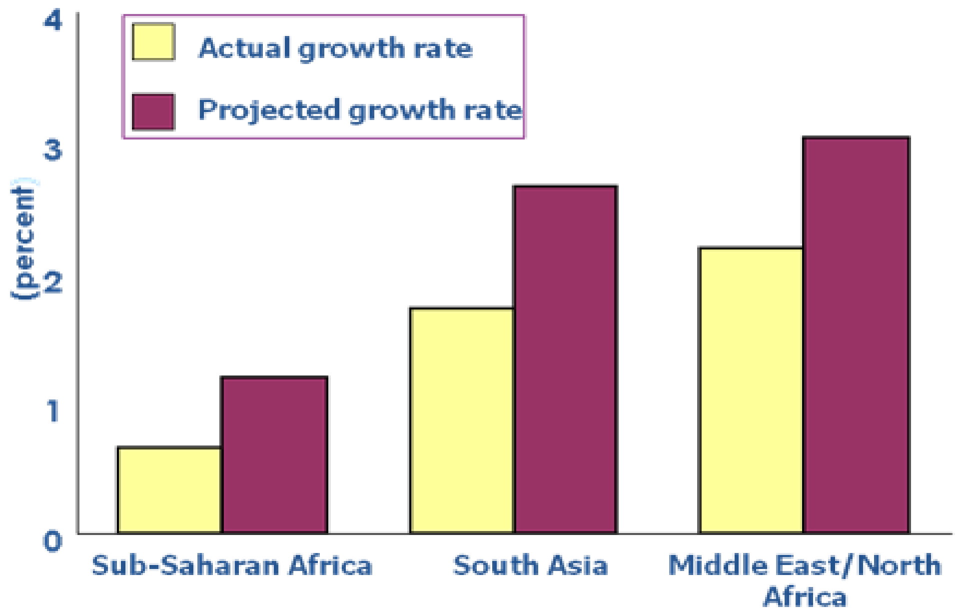
[35] N. R. Korzeniewicz Forsythe and V. Durrant, 'Gender Inequality and Economic Growth. A Longitudinal Evaluation', *Economic Development and Cultural Change*, Vol. 48 (April 2000), pp. 573– 617. Also see: J.G. Stotsky, 'Gender and its Relevance to Macroeconomic Policy: A survey', *IMF Working Paper P/06/233*, (Washington: International Monetary Fund, 2006).

[36] Ester Boserup is the foremost proponent of this hypothesis and her book in 1970, 'Women's Role in Economic Development', is among the most cited literature in this connection. Boserup has strongly influenced perceptions of women's status in the Third World.

[37] World Development Report 2001, The World Bank: Washington.

rates of all these regions were at least one percentage point lower than their potential growth due to this critical factor. This underlies the important role of gender balance in economic growth.[38]

Figure 5: Trends in Actual and Projected GDP Growth Rates in South Asia and Other Regions



Source: World Development Report 2001, The World Bank: Washington.

In a model of long-run growth that incorporates time-averaged stocks of female and male education for about 70 countries, Knowles, Lorgelly and Owen (2002) found GDP per worker elasticity with respect to the stock of female education to be between 0.2 and 0.45, while male education productivity elasticities are either not statistically significant or slightly negative. Gender gaps in education also tend to have negative effects on growth in their study. Asadullah (2009) estimated gender-specific returns to primary, secondary and higher education in Bangladesh and found that the females' returns to primary and secondary education are much higher than their male counterparts. His estimation shows that respective returns for males are 3.4 per cent, 3.2 per cent and 12.7 per cent, while the respective figures for females are 8.9 per cent, 9.6 per cent and 12.4 per cent.[39] Based on this, one can argue that a higher share of the working age population, particularly the rising share of the female age group (as Figure 6

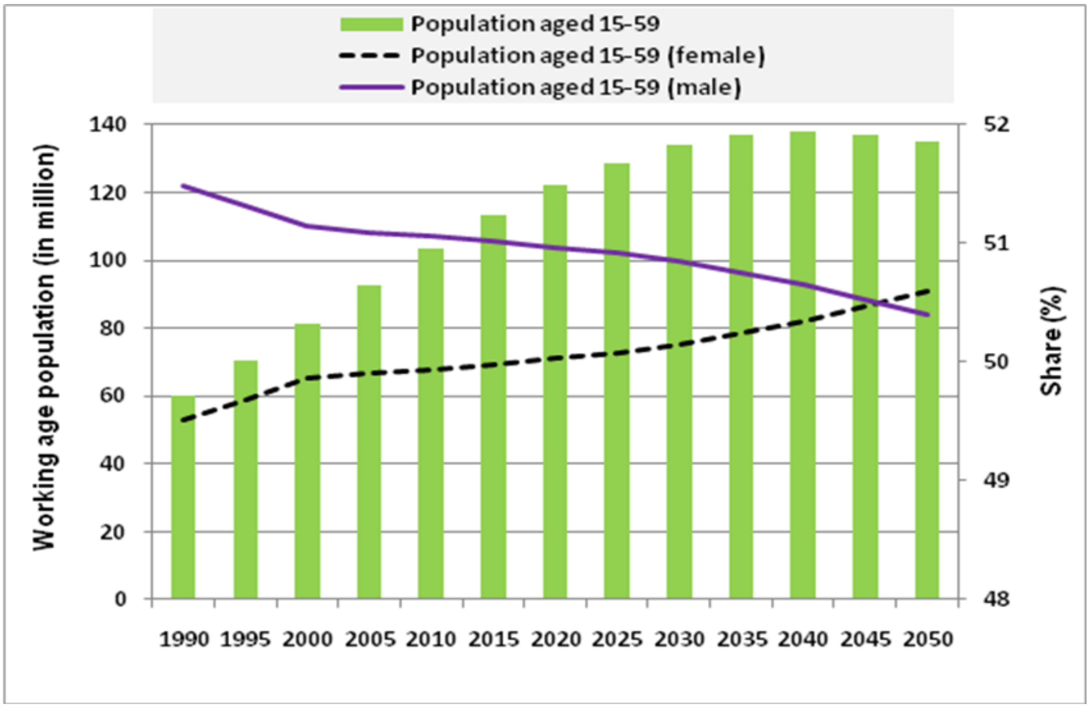
---

38 For a comprehensive analysis, see S. Klasen, 'Does Gender Inequality Reduce Growth and Development? Evidence from Cross-Country Regressions', *Policy Research Report On Gender And Development Working Paper Series, No. 7* (Washington: The World Bank, 1999).

39 M. N. Asadullah, 'Returns to Private and Public Education in Bangladesh and Pakistan: A Comparative Analysis', *Journal of Asian Economics*, Vol.20, no.1 (January 2009), pp. 77-86.

exhibits) could help Bangladesh's economic growth in the coming years. Consequently, Bangladesh is likely to close the gap between its potential and actual GDP growth.

Figure 6: Total Size and Share of Working Age Population (Male and Female) in Bangladesh: 1990-2050



Source: Based on World Population Prospects: The 2008 Revision

That said, we look at Bangladesh's past growth records and future prospects. In particular we explore how gender balance can fuel its growth rate. Its GDP growth averaged 5.3 per cent annually since the fall of the military regime in 1990, which is just less than one percentage point of India's growth. In the past five years the economy grew over 6 per cent per annum. Looking forward, with its sound macroeconomic management, growing exports earnings and remittance flows and high savings rates, it is very likely to grow faster than its current pace.

However, it is hard to calculate how much of this growth is due to Bangladesh's improving gender balance. As we discussed in the preceding sections (based on statistics and research studies) the country fares well *vis-à-vis* some of its South Asian neighbours. In the global picture it is still far behind, though its progress on gender balance has been steady. So, one can say that while Bangladesh has benefited from its stride in gender balance, it stands to benefit (at an increasing rate) in line with its steady progress in closing its gender gap.

Moreover, these strides come at a time when the nation's demographic window is about to open.[40] As seen in Figure 6, as Bangladesh's demographic window opens, the country is experiencing a rising share of the working age population (aged 15-59). For instance, in 2010, nearly two-thirds (63 per cent) of its total population fell into the working age group that expected to peak at 66 per cent in 2025, with the female share approaching half of the total working age population. As discussed, with Bangladesh's success in primary and secondary enrolment and increasing opportunities for the female workforce, women's share in income and employment are expected to be higher than the existing level.

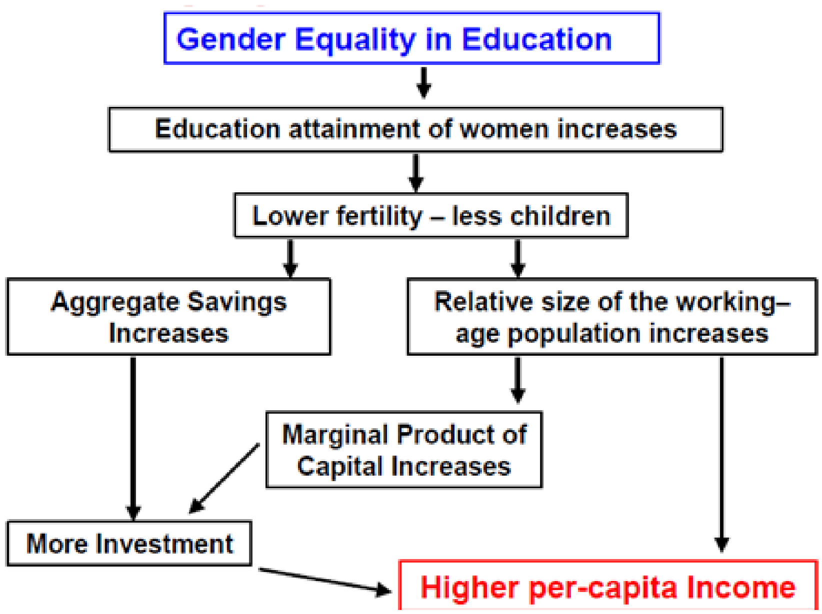
This could help the country immensely in bridging the gap between its potential and actual GDP growth. As discussed in Section II, Bangladesh's success in high female enrolment in primary and secondary education has been a contributing factor in the country's successful demographic transition. Bloom and Williamson (1997), for instance, found that lower fertility rates expedite the demographic transition that works as a benefactor for economic growth through a sequence of events.[41] Lower fertility rates reduce the youth dependency ratio and increase the size of the working age population. A low overall dependency ratio means higher savings and surplus investables, leading to higher economic growth. The process is captured in Figure 7.

---

40 'Demographic Window' is defined as the period of time in a nation's demographic evolution when the proportion of the working age group population is particularly prominent. Typically, the demographic window of opportunity lasts for 30-40 years depending on the country. According to *World Population Prospects: The 2008 Revision, the United Nations*, Bangladesh's demographic window is projected to open in the period of 2010-15 and is expected to continue till 2050.

41 David E. Bloom, and Jeffrey G. Williamson, 'Demographic Transitions and Economic Miracles in Emerging Asia.' *NBER Working Paper No. 6268* (Cambridge, Massachusetts: National Bureau of Economic Research, 1997)

Figure 7: Demographic Transition Effect



Source: Chen, Derek H. C. (2004), 'Gender Equality and Economic Development: the Role for Information and Communication Technologies', *The Knowledge for Development Program*, The World Bank: Washington.

Seguino & Floro (2003)[42] and Stotsky (2006)[43] have argued that improved gender equality can lead to economic growth, resulting from difference in savings and consumption patterns of women and men. Women are likely to save more than men. Women's consumption revolves primarily around the children and household necessities (basic consumer goods). Women with incomes of their own may, therefore, contribute to a more stable and sustainable economic growth in the long run.[44]

To sum up, the existing literature supports the fact that there is a direct nexus between gender balance and economic growth. This works through several mechanisms. The impact of gender balance through education has a notable impact on demography that eventually gives more space to households to allocate larger budgets on health and education, making the overall population

---

[42] S. Seguino and M. Floro, 'Does Gender Have Any Effect on Aggregate Saving: An Empirical Analysis', *International Review of Applied Economics*, Vol.17, no.2 (2003), pp.147–66.

[43] J. G. Stotsky, 'Gender and Its Relevance to Macroeconomic Policy: A survey', *IMF Working Paper WP/06/233* (Washington: International Monetary Fund, 2006).

[44] Organisation for Economic Cooperation and Development (2008), 'Consumption in OECD-countries is distinctly gender-related', p.65. www.oecd.org/dataoecd/58/1/40881538.pdf. Accessed on 9 October 2010.

economically productive. This could bring other societal benefits that may not be captured in economic numbers.

With this, one can expect that Bangladesh's progress in gender development and its success in empowering its female population could be a contributing factor, as the nation is expected to grow faster than its current pace. One can argue that similar experiences have been noticed elsewhere, including in the case of Bangladesh's South Asian neighbour, Sri Lanka. However, many of them could not translate better gender indicators into economic growth. Bangladesh's context, however, should be seen in a different light. Women in Bangladesh are now finding a number of favourable conditions that many countries might not have found in their economic and social transitions. This is not merely limited to economic factors such as demographic window, better access to education and health, or better work opportunities. Bangladeshi institutions (such as courts, civil society, etc.) are very supportive of women's greater role in the economy and society and many scholars have documented this development. As a noted political scientist observed, 'development and progress is always a combination of political, economic, social and cultural changes that complement one another. The combined impact of a number of initiatives has been that Bangladesh is currently the calmest country in the region'.[45] After some struggle after independence in 1971, perhaps the country has been evolving with its own character which is politically secular, religiously Muslim and culturally Bengali.[46]

Another important point that deserves mention is the nexus between growth and distribution, which, more precisely, is the question of equity. There is no straight relationship between these two phenomena except cross-country experience, including China and India, indicates that inequality widens with a rising economic tide. It is too early to comment on Bangladesh as far as growth and inequality are concerned. However, anecdotal evidence and a low Gini coefficient (Table 2) indicate that Bangladesh's growth has been so far more equitable. It is difficult to estimate the factors that made Bangladesh's growth more egalitarian but gender, among others, could be an important contributing factor.

---

[45] Ishtiaq Ahmed, 'The Political Economy of Bangladesh,' *The Daily Times*, Pakistan (17 Aug 2010).

[46] For a comprehensive analysis, see I. Ahmed Chowdhury, 'The Roots of Bangladeshi National Identity: Their Impact on State Behaviour', *ISAS Working Paper No. 63* (Singapore: Institute of South Asian Studies). Also see I. Ahmed Chowdhury, 'Bangladeshi Courts: Reaffirmation of Democratic and Secular Norms, *ISAS Insights No. 113* (Singapore: Institute of South Asian Studies), and 'Bangladesh: Basket Case No More', *The Wall Street Journal* (29 September 2010).

V. Conclusion and Policy Notes

This paper uses the relevant statistics to demonstrate that in South Asia, after Sri Lanka, Bangladesh has made the most significant strides in closing its gender gap. The improved conditions of its female population are reflected in their better access to education and healthcare. Women also find better employment and income opportunities in the country. Another striking feature is that Bangladesh has improved its gender-related development indicators with a relatively low per capita income *vis-à-vis* the sample countries that we discussed in this paper. Bangladesh's success in this regard also needs to be seen from another perspective; it is perhaps one of the few Muslim countries that recognises women's wider role in society, polity and economy.

As discussed, a number of factors have helped the Bangladeshi female population to improve its economic and social standing. The factors discussed in Section III have some complementary functions regarding women empowerment in Bangladesh. However, the role played by education in this regard has been phenomenal. Bangladesh's success in primary and secondary enrolment have had a profound impact on the country's successful demographic transition, this could have some lasting impact as the nation is showing signs of growing faster than its current rate. NGOs played a critical role in netting the underprivileged in primary education who, otherwise, could not be at schools, owing to the high opportunity costs. This silent revolution, some analysts believe, has marginalised extremist thinking in the country by limiting the role of religious schools in Bangladeshi society and politics.

The economic benefits of female education can be captured by sophisticated economic models. As we have shown by citing some academic work, including on Bangladesh, economic returns have proved to be higher for girls than boys. This brings us to the next critical issue, namely, Bangladesh's tremendous success in improving the sex ratio in favour of females, in this area it outshone two Asian giants, India and China, not to mention Pakistan. While child mortality rates in the country have declined sharply, the rate of decline for female infants has been faster than for male ones. This explains why there are millions of 'missing women' in many parts of Asia. This is due to parents' highly skewed preference for sons over daughters. The country also provided better healthcare to its female population, both in the health and education sectors where the government failed, NGOs helped the underprivileged, mostly female population, to gain access to these two basic necessities. Market and government failures in the social sector in many developing and underdeveloped countries are rampant. Perhaps, Bangladesh offers a successful case study in this regard.

Bangladeshi women's increased access to health and education has better prepared them for the job market. Many underdeveloped and developing countries face tremendous constraints in creating employment opportunities, particularly for women. In Bangladesh the rise of the labour-intensive apparel industry and the high penetration of microfinance has made it the second most successful country in South Asia in terms of women's labour force participation rate.

However, the study acknowledges that Bangladesh is still far behind the developed world and many developing countries as far as women empowerment is concerned. While Bangladesh's strides in women empowerment have paid some tangible benefits to the nation, the country has only exploited part of its female human capital. Bangladesh's economic potential as far as the gender factor is concerned, is being exploited only partially and the nation stands to benefit in a profound way with its continued improved gender balances along with its steady economic growth. How this could happen is a matter for further research; however, with the help of the existing economic literature and cross-country experience, we briefly focused the issue in Section IV. As discussed, Bangladesh's moderate but steady strides as far as economic growth is concerned and its steady progress in women empowerment in the past two decades, give us a strong signal that the country is well-poised to move towards a higher growth trajectory.

Bangladesh's success in women empowerment offers some policy lessons for many South Asian and Muslim countries. We highlight three points here.

1. Women's education, population transition and women empowerment: Due to the conflict between religion and contraceptive use, family planning programmes still face tremendous opposition, particularly from *Mullahs* (or other religious leaders and priests), around the world. This has led many countries, notably Muslim countries, to fall into demographic traps. Bangladesh's success in this regard can be a useful reference for Muslim countries, particularly Pakistan and Afghanistan in South Asia. Moreover, Bangladesh's experience in this regard can be advanced to other countries, especially in Africa that face social, political and economic problems with higher population growth- owing to high birth rates and low death rates.

2. Microfinance and women empowerment: Job creation is a key challenge for most developing countries and unemployment rates are particularly high among the female population. Microfinance provides self-employment to millions of female entrepreneurs in Bangladesh is another idea generated from the country, an idea that is becoming increasingly global. Though there is growing consensus on the role of microfinance in women empowerment, the low penetration of microfinance in most countries of South Asia indicates that it has not gained institutional roots in many parts of the region. India's microfinance industry can take

a closer look at Bangladesh's extraordinary achievements in this context, especially the success of women borrowers and the associated economic and social well-being, to see if latter's success can offer any light in mitigating the former's ongoing crisis concerning microfinance lending.

3. The role of NGOs in women empowerment: NGOs play a substitute as well as a complementary role to government (and perhaps markets, too) in empowering the female population in Bangladesh. Whether the NGOs are a credible third force to address both market and government failures needs further research; in Bangladesh their role clearly makes a strong point for those who are in favour of this argument. A relevant point here is that some analysts argue that the rise of NGOs and their role in empowering the female population in Bangladesh has marginalised extremist thinking in the country. This might be of huge interest to a number of South Asian countries and other countries around the world that face the rise of religious extremism.

There could be some wider applications of Bangladesh's success in women empowerment. There is some interest among policy makers to gauge if the Bangladesh model of women empowerment can be useful in conflict prevention and resolution, particularly in Africa. All these issues need to be studied further for the wider benefit of South Asia as well other parts of the world.

.....

APPENDIX

<u>Table A.1</u>: Top-10 MIX (Microfinance Information Index) Global Composite Ranking

Rank	Microfinance Institutions	Country
1	MBK Ventura	Indonesia
2	SDBL	Sri Lanka
3	Shakti	Bangladesh
4	GFSPL	India
5	CARD Bank	Philippines
6	BURO Bangladesh	Bangladesh
7	SKS	India
8	Spandana	India
9	Grameen Bank	Bangladesh
10	Lead Foundation	Egypt

<u>Source</u>: *Microfinance Information Index*,
http://www.themix.org/sites/default/files/2009%20MIX%20Global%20100%20Composite.pdf.
Accessed on 12 August 2010.

Table A.2: Micro Credit Fact Sheet of Grameen Bank

Grameen Bank's Historical Data Series, 1976-2009 (amount in million US$)					
Performance Indicator	***1976***	***1980***	***1990***	***2000***	***2009***
Cumulative Disbursement (all loans)	0.001	1.31	248.08	3060.44	8741.86
Disbursement during the Year (all loans)	0.001	1.1	68.73	268.44	1150.54
Year-end Outstanding Amount	0.0003	0.83	38.6	193.26	791.82
Total Deposits (Balance)	NA	0.1	25.86	126.78	1200.49
Deposits of GB Members (Balance)	NA	0.1	16.51	100.54	648.68
Number of Groups	NA	2935	173907	503001	1253160
Number of Members	10	14830	869538	2378356	7970616
Percentage of Female Members	20	31	91	95	97
Number of Villages covered	1	363	19536	40225	83458
Number of Branches	1	24	781	1160	2562

Source: *Grameen Bank*, www.grameen-info.org/index.php?option=com_content&task=view&id=177&Itemid=144, Accessed on 17 August 2010.

ISAS Working Paper

No. 120 – 20 January 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

China's Play in South Asia

Shahid Javed Burki[1]

Abstract

This paper examines the changing nature of China's involvement in the South Asian mainland in light of the back-to-back visits by Chinese Premier Wen Jiabao to India and Pakistan. The Chinese leader was in New Delhi on 15-17 December and in Islamabad on 17-19 December 2010. These visits were the subject of two past ISAS briefs in 2010.[2]

This paper takes a longer-term view of Chinese interest in South Asia in the context of the way the country perceives its role in the global economy and the international political system. The global system is in a state of considerable flux; while the economic dominance of the United States (US) in the global system is declining, that of China and India is increasing. The way these three countries play out their roles on the international stage will have enormous impact on the world economy and the structure of international politics. Pakistan, a substantially smaller economy, which at this time is faced with serious economic strife and security issues, will also have its part on the global stage. In fact, because of its geographical location and also having become the epicentre of Islamic extremism, Pakistan finds itself in the middle of this large-power triangle. The direction it takes could be influenced by China, India and the US.

---

1 Mr Shahid Javed Burki is Visiting Senior Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. He can be reached at sjburki@yahoo.com. The views reflected in the paper are those of the author and not of the institute.

2 Amitendu Palit, 'Wen Jiabao in India: Mission Business', *ISAS Brief* No.180 (20 December 2010) www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_Brief_180_-_Email_-Wen_Jiabao_in_India_-_Mission_Business_21122010100044.pdf. Accessed on 7 January 2011; and Rajshree Jetly, 'Chinese Premier's Visits to India and Pakistan: Strategic Implications', *ISAS Brief* No.181 (22 December 2010), www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_Brief_181-Email-Chinese_Premier's_Visits_to_India&Pakistan_22122010114236.pdf. Accessed on 7 January 2011.

China's Rise: Is it a Threat for the Established World Order?

China's extraordinary economic rise began in 1978 with the reforms instituted by Deng Xiaoping. This development has been extensively written about, examined and analysed in a number of studies, including the work done by this author for the Institute of South Asian Studies[3]. This rise should be viewed in terms of how the world perceives it, as well as how Beijing sees its own progression. More than a quarter century ago, the Chinese economy started moving on the trajectory of growth which made it the second largest in the world by 2010, when it surpassed Japan. Its global influence really increased after the Great Recession of 2008-09. Like the US, Beijing adopted a large stimulus package to stop its economy from a sharp decline. However, China adopted an approach different from Washington for reviving its economy. The US invested in what President Obama called 'shovel ready projects'. The American aim was to create as many employment opportunities as possible. China, on other hand, used the additional money to improve the quality of its physical infrastructure and to improve links with countries in its immediate region. Following the 'Great Recession', the Chinese economy has returned to a similar path of growth that it had enjoyed before, with only a few deviations spanning the past three decades. It has also positioned itself to influence all parts of the Asian continent.

What has now begun to interest academics and policy analysts, even more than China's remarkable economic rise, is the shift in global and economic power that is occurring as result of the growth of China's economy. This will require accommodation of China in the existing economic and political systems and that can only happen if the US is prepared to yield some space to the rising Asian power. As *The Economist* wrote in its special survey titled, *The Dangers of Rising China,* 'in the real world the dealings between rising and declining powers are not straightforward…International relations theorists have devoted much thought to the passing of empires. The insight of "power-transition theory" is that satisfied powers such as post-war Germany and Japan do not challenge the world order when they rise. But dissatisfied ones, such as pre-war Germany and Japan, conclude that the system shaped and maintained by the incumbent powers is rigged against them. In the anarchic arena of geopolitics they believe that they will be denied what is rightfully theirs unless they enforce their claim.'[4] The implication of this is obvious: for global peace and prosperity the large powers that are actively involved in this period of transition – the US, China, the European Union, India and Japan in particular – should be kept satisfied with their place in

[3] See, Shahid Javed Burki, 'Asia in "Catch-Up" Game: I', *ISAS Working Paper* No.106, (09 April 2010), www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_Working_Paper_106_-_Email_-_Asia_in_the_Catch-Up_Game_(2)_13042010114904.pdf . Accessed on 7 January 2011; and Shahid Javed Burki, 'Asia in the "Catch-Up" Game: II', *ISAS Working Paper* No.107 (10 May 2010), www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_Working_Paper_107_-_Email_-_Asia_in_the_Catch-Up_Game_(Part_2)_10052010171030.pdf. Accessed 7 January 2011.

[4] Edward Carr, 'The dangers of a rising China', *The Economist* (4 December 2010), p.4.

the evolving structures. Even if one of them is unhappy with its position with respect to the others, the result will undoubtedly be some turbulence in the evolving world order.

The way in which the adjustment in the global economic and political takes place as China continues to rise, will depend on how both Washington and Beijing act and behave over the next few years. Both Washington and Beijing are feeling their way in determining how they should interact with one another. Soon after taking office, President Barack Obama took the position that his country had to step back a bit in order to bring in China as a major player in the global economic and political systems. His speech in Tokyo in November 2009, as he began his first official visit to Asia, welcomed China's rise and indicated America's willingness to find a place for China at the very top of the 'new order' that was taking shape. He seemed to be suggesting a G2 arrangement, in which there will be a more intricate relationship between the two large economic powers, to guide the global economy with more detailed work that is done by the G20 that includes large emerging economies such as India, Indonesia, South Korea and Turkey.[5]

This American initiative resulted in the launch of the conversation termed the 'US-China Strategic and Economic Dialogue' between the two countries that covered a variety of issues in both economic and political fields. The first dialogue was held in Washington in July 2009 followed by one in Beijing on 24 May 2010. In a statement to the participants in the Beijing meeting, President Obama reminded his audience what he had said when we began this dialogue, 'that the relationship between the US and China will shape the 21st century, which makes it as important as any bilateral relationship in the world. Together, we set out to build a positive, constructive, and comprehensive relationship, and we pledged to cooperate to advance our shared interests. That is what we have done.'[6]

But for reasons that remain opaque, China did not initially greet the new American president enthusiastically. There was a lack of warmth expressed during Obama's visits to Beijing and Shanghai. His various public appearances were poorly covered by the Chinese official media and President Hu Jintao did not agree to hold a joint press conference after the two leaders had held their discussions. The Chinese went on to snub the US at the global climate talks in Copenhagen a month after the American leader had visited their country. Beijing also ignored the repeated pleas by Washington to revalue its currency by making it more expensive in terms of the US dollar. These unhelpful reactions to the initial American overtures persuaded the administration in Washington to harden its stance. A year later, when President Obama undertook his twice postponed second official visit to Asia, he decided to make India the first

[5] For a discussion of President Barack Obama's first visit to Asia see, Shahid Javed Burki, 'President Obama's first Asian visit', *ISAS Brief* No.138 (9 November 2009), www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_Brief_138_-_Email_-_President_Obama's_First_Asian_Visit_22022010155310.pdf. Accessed on 7 January 2011.

[6] 'Statement of President Barack Obama to the U.S.-China Strategic & Economic Dialogue', *The White House*, www.whitehouse.gov/the-press-official/stat. Accessed on 25 December 2010.

stop in his itinerary. His approach to India was more in line with the one George W. Bush, his predecessor, had adopted towards the other rising Asian powers. During the second visit Obama also made visits to three other countries – Indonesia, South Korea and Japan – in an effort that seemed directed at 'containing' China.

At the same time, the US decided to move aggressively against China at the World Trade Organization (WTO) by challenging some of the practices adopted by Beijing in a number of industries in which the US was a competitor. In late December 2010, Washington filed a complaint with WTO that Beijing was supporting the development of its wind-turbine industry by using subsidies not allowed under the rules of the Geneva-based organisation. The US' move was in response to a detailed brief prepared by the country's labour unions.[7] Washington was also upset that Beijing had not used its influence over North Korea to stop the latter's aggressive behaviour, in particular towards its sister state, South Korea.

These differences notwithstanding, some observers began to notice a thaw in the relationship between China and the US as 2010 drew to a close. According to John Pomfret of *The Washington Post*, 'after a tense year during which US officials, including President Obama, openly criticised China, and their Chinese counterparts returned the favour, there is a sudden switch in tone from the Commerce Department to the National Security Council. Instead of portraying China as a protectionist or an enabler of North Korea's provocations, administration officials are praising China, referring to it as a responsible partner.'[8] Beijing's softer approach was also visible at the resumed climate deliberations in Cancun, Mexico. While in Copenhagen, the Chinese had been totally unwilling to allow any international inspection of their carbon reduction programmes – an American demand – they agreed to periodically present their progress for foreign review. Some of the changes in the policy stance may be to prepare a better environment for President Hu Jintao's visit to Washington on 19 January 2011, the first since the assumption of office by Barack Obama.

While it makes sense to view Premier Wen's South Asia visit in the context of China's evolving relations with the US, there are reasons of its own that are compelling Beijing to reach out to its large neighbours, not just India and Pakistan but also Bangladesh, Myanmar, Thailand and Vietnam. The Chinese leadership recognises that it needs peace on its borders in order to cement its claim to world leadership. China now has closer and more amiable relationships with its 14 neighbours than it ever had previously. This was one reason why the theme of Wen's visit to India was friendship not rivalry.

---

7 'United Steelworkers' Section 301 Petition Demonstrates China's Green Technology Practices Violate WTO Rules', *United Steelworkers* (October 2010), http://assets.usw.org/releases/misc/section-301.pdf. Accessed on 19 January 2011.

8 John Pomfet, 'U.S. and China and improvement tone despite big gap in trust', *The Washington Post* (24 December 2010), p.A6.

China and India

Premier Wen Jiabao set the tone of his second visit to India in a speech to Indian Council of World Affairs (ICWA) by declaring, 'we will always be friends and will never be rivals. This should be the firm conviction of every Chinese and every Indian.'[9] However, many in the world looked at the rapid growth of the two Asian giants from the perspective of competition. 'China will rumble along at eight per cent rather than double digits; India will rack up successive years of nine to ten per cent', wrote *The Economist* in early October 2010 citing the work of Chetan Ahya and Tanvee Gupta of Morgan Stanley. 'For the next 20-25 years, India is expected to grow faster than any other large country.'[10] There are reasons why these analysts believe that the Indian growth rate would surpass that of China. What the demographers call the 'demographic dividend' being one of them. It had contributed to China's performance before the results of the 'one-child' policy began to kick in and increased the dependency ratio. In India, on the other hand, the demographic window had just opened up. According to the United Nations Population Division, the proportion of Indians aged under 15 and over 64 – the people who were dependent on those who were in the work force – declined from 69 per cent in 1995 to 56 per cent in 2010. India's working-age population will increase by 136 million by 2020; China's will grow by a mere 23 million.[11]

The other important difference is the role of the state in the two countries. In spite of the larger role assigned to the private sector from the time of Deng, when the Chinese economy began to open up, the state has remained in the driver's seat. In India, on the other hand, the state had pulled back from the time of the 'license raj'. According to Amit Mitra, the Secretary-General of the Federation of Indian Chambers of Commerce (FICCI), the recent remarkable performance of the Indian economy has been driven by 45 million small entrepreneurs many of whom were engaged in bringing to the market what some economists had begun to call 'frugal innovation.'[12] This offered affordable goods and services to the hundreds of millions of low-income Indian consumers thus keeping the growth of the country's economy anchored in domestic consumption. China, on the other hand, continued to rely on the export of increasingly sophisticated products not only to the West but to all parts of the world.

The Chinese Premier's visit to India emphasised developing closer business ties with his host country. His first visit to India was in 2005. According to Amitendu Palit, writing for ISAS, 'between the Premier's two visits, Sino-Indian merchandise trade has increased from

9 Quoted by Jim Yardley, 'Chinese leader hails India and vows to double trade', *The New York Times* (17 December 2010), p.A8.

10 'Business in India: A bumpier but a freer road', *The Economist* (2 October 2010), pp.75-77.

11 'Population Facts no. 2010/5', *United Nations Population Division* (August 2010), www.un.org/esa/population/publications/popfacts/popfacts_2010-5.pdf. Accessed on 7 January 2011.

12 'Business in India: A bumpier but a freer road', *The Economist* (2 October 2010), pp.75-77

US$12.7 billion (2004-05) to US$42.4 billion (2009-10).' Overall trade figures would be even larger if bilateral services trade was included 'on which, unfortunately, no official estimates are available.'[13] China had become India's largest trading partner over the last few years. The two countries agreed to work towards increasing their trade to US$100 billion by 2015 with China committing to take steps to narrow, if not altogether eliminate, the trade gap which was at this time in its favour. At this time, India is primarily an exporter of raw material for the Chinese industry providing some of the minerals for which China has to rely on imports. In return, India imports mostly manufactured products from China. This structure of trade has caused the owners of several Indian industries to complain that China is using practices that do not comply with the regulations of the WTO. There was some expectation that the investments China was planning to make in India would increase the proportion of manufactures in bilateral trade. China's new enterprises in India were expected to produce not only for the Indian markets but also for export to China.

While New Delhi was pleased with what the Chinese promised on the economic front – particularly in bringing about a change in the structure of trade between the two countries – there were a number of issues in which the Indians would have wanted to see more progress and greater movement on the part of Beijing. The first was the unsettled matter of the long border between the two countries, disputes that had led to an open conflict in 1962 between China and India. The two countries contested the territories in Aksai Chin that China controls, and Arunachal Pradesh, which is one of the Indian states. China eyed India's attitude towards its incorporation of Tibet with some suspicion. However, these were not the only Indian concerns. New Dehli was less than content when China's actions did not imply Kashmir as an integral part of India, but as disputed territory with Pakistan. India protested when Chinese officials began stapling a separate paper visa – rather than the usual stamp on the passport – for anyone from the state of Jammu and Kashmir wishing to travel to China. New Delhi viewed this move as a challenge to India's sovereignty and showed its unhappiness by allowing some Tibetans to protest in New Delhi while Wen Jiabao was in the Indian capital.

The Indians wanted the Chinese to be more proactive in terms of putting pressure on Pakistan to control the extremist Islamic groups that had launched operations against India from the Pakistani territory. India had two demands on which they would have appreciated China's support. The first was to bring a speedy conclusion to the trials of the people who were alleged to be involved in the November 2008 terrorist attack on Mumbai.[14] It had pleased the

[13] Amitendu Palit, 'Wen Jiabao in India: Mission Business', *ISAS Brief* No.180 (20 December 2010), www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_Brief_180_-_Email_-Wen_Jiabao_in_India_-_Mission_Business_21122010100044.pdf. Accessed on 7 January 2011.

[14] Mumbai was the site of a deadly three-day siege in November 2008, when gunmen attacked a five-star hotel, a train station, a café and a Jewish prayer centre killing more than 160 people. India is concerned about the activities of *Lashkar-e-Taiba* (LeT), the organisation that the Indians hold responsible for several attacks on India and which is reported to be active again. On 24 December 2010, a week after the departure of the

Indians that President Obama began his trip to their country in November 2010, a month before the Chinese Prime Minster arrived, by staying at the Taj Mahal Palace and Tower, the hotel the terrorists had attacked, and addressing the world on the evil such acts represented. The Chinese leader made no such gesture. India wished Pakistan to dismantle the recruitment and training facilities, which some of the groups determined to hurt India had used and were continuing to use. However, China was reluctant to apply pressure on Pakistan even though it was also concerned about terrorism in its western provinces in which Muslims have a large presence. In fact, as discussed below, Premier Wen applauded the efforts Pakistan was making to combat terrorism and extremism.

Water was the second contentious issue, '[given] reports that China is undertaking hydro projects in Tibet that would affect water flow on the Brahmaputra River in India. In his speech, Mr Wen offered assurances that China would be responsible in any hydro projects in the Himalayas to ensure that downstream nations would not be affected.'[15] This was a veiled hint at what India needed to do as an upper riparian to allay Pakistani fears that it would be hurt by the storage dams it was constructing on the upper reaches of some of the rivers that had been allotted to Pakistan as a part of the Indus Water Treaty of 1960.

Few issues, however, are more potentially long-lasting and divisive than access to energy for the two economic giants. India imports 75 per cent of its oil while China imports a little more than half of its requirements, according to a US Energy Department report. By 2025, China's oil demand will double to about 14.2 million barrels a day (mb/d). By contrast, India imports only about 1.4 mb/d, which is likely to increase to 5 mb/d in the next decade. Both countries are scurrying around looking for sources from which they can obtain assured supplies over the long term.[16] As Vikram Sood, former head of the Research Analysis Wing (RAW), India's external intelligence agency puts it: 'China has much deeper pockets when competing for the same resources. India tends to lose out. This will, long-term, be a real source of tension.'[17] If India was hoping for a concerted action in this difficult area, it was not promised by the visiting Chinese leader.

How successful was the Premier's visit when viewed from India's perspective? The answer came from India's Foreign Secretary Nirupama Rao in a press briefing after the Chinese leader had met his Indian counterpart, Dr Manmohan Singh. 'Asked if Mr Wen's visit had

---

Chinese Prime Minister, there were reports of another infiltration into Mumbai by terrorists was said to be associated with LeT. The city was put under heightened alert by the Indian authorities. See Rama Lakshmi, 'Mumbai police on manhunt in effort to head of terrorist attacks', *The Washington Post* (25 December 2010), p.A7.

[15] Jim Yardley, 'Chinese leader hails India and vows to double trade', *The New York Times* (17 December 2010), p.A8.

[16] U.S. Energy Information Administration, *Annual Energy Review* (19 August 2010) http://eia.doe.gov/emeu/aer/contents.html. Accessed on 7 January 2011.

[17] Quoted in Emily Wax, 'Chinese premier turns on the charm', *The Washington Post* (17 December 2010), p.A14.

essentially accomplished little except maintain the status quo, Ms Rao said the relationship was slowly moving forward. "I would say this is gradual process.'"[18]

China and Pakistan

As Rajshree Jetly wrote in the ISAS Brief cited below, 'in contrast to the India visit that was relatively low key in terms of expectations and deliverables, the Pakistan visit was marked by greater fanfare and resulted in more deliverables, signifying the close relations between the two countries. While there was an element of restraint in the Chinese dialogue with India, there was little ambiguity or coyness in China's affirmative statements during Premier Wen's visit to Pakistan.'[19]

Premier Wen was attempting to achieve a number of objectives during his visit to Islamabad. Four of these were implicit in the statements that he made while in Islamabad. First, Beijing wanted to cement its long-enduring ties with Pakistan by linking the Pakistani economy closer to that of the Chinese. Second, he wanted to further tie the militaries of the two countries. Third, he wished to draw a clear distinction between Chinese and American interests in Pakistan. Fourth, while Washington seemed to be recruiting India to its side in its continuing and growing conflicts with Beijing, the Chinese were attempting to do something similar with Pakistan.

The large Chinese programme of economic assistance to Pakistan announced during the Premier's stay in Islamabad came at an opportune moment for his hosts. While the Chinese Premier was in Pakistan, Islamabad was engaged in difficult negotiations with the International Monetary Fund (IMF) in an attempt to save its Stand-by Agreement with the institution. At stake was the release of US$3.9 billion from the Fund out of a total commitment of US$ 11.3 billion. In other words, half of Pakistan's reserves of about US$14 billion were made up of disbursements from the Fund. A hold-up in the release of the next *tranche* would bring Pakistan's external accounts under great pressure. The Fund's release was contingent upon Pakistan's ability to demonstrate that it had the political will to increase the low tax-to-GDP ratio which had declined to less than ten per cent leaving little space for development expenditure. The Fund's emphasis on better budgetary management by Pakistan had the result of sharply decreasing the size of the public sector development programme. China, by infusing a large dose of resources into development, may have saved the Pakistani economy from collapsing.

---

18 Jim Yardley, 'Chinese leader hails India and vows to double trade', *The New York Times* (17 December 2010), p.A8.

19 Rajshree Jetly, 'Chinese Premier's Visits to India and Pakistan: Strategic Implications', *ISAS Brief* No.181 (22 December 2010), www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_Brief_181-Email-Chinese_Premier's_Visits_to_India&Pakistan_22122010114236.pdf. Accessed on 7 January 2011.

Premier Wen Jiabao unveiled a programme of government-to-government assistance amounting to US$20 billion and another US$15 billion in private sector deals. In a joint communiqué issued after the talks between the leaders of the two countries, Beijing and Islamabad pledged to cooperate on security and military issues, energy, transportation, space technology, banking, infrastructure development, heavy machinery manufacturing, cultural exchange and finance.[20] According to James Lamont and Farhan Bokhari reporting for the *Financial Times* from the Pakistani capital, Wen was aiming to 'create a deep alliance between Islamabad and Beijing based on economic cooperation that would tie the South Asian nation to China's economic transformation.'[21]

The Chinese economic effort in Pakistan was not limited to financial assistance and foreign direct investment. There was also emphasis on trade. In his address to the Pakistan-China Business Summit in Islamabad, the Chinese leader noted that the value of trade between the two neighbours amounted to only US$1 billion in 2002. However, after the signing of the free-trade agreement in 2006, trade began to increase. It was estimated at US$6.8 billion in 2009. China wanted to see it increase to US$10 billion in a year or two and reach US$15 billion by 2015. If this were to happen it would be China rather than the US that would become Pakistan's largest trading partner in about five years. While the share of the US in Pakistan's total exports had declined by almost six percentage points since 2001-02, from 24.7 per cent to 18.9 per cent, America still remained the largest importer of Pakistani goods and commodities.[22]

Infrastructure development is another area of collaboration between China and Pakistan. This was already an area of Chinese interest in Pakistan. Some high profile projects were constructed with Chinese help. These included the Karakoram Highway (KKH) and the Port of Gwadar that linked China's western provinces with the Arabian Sea. In the new programme, China indicated that it will help to widen the KKH and make it an all-weather highway, lay a railway line alongside it and further develop the port at Gwadar. There was also indication that China will help to link the Port of Gwadar with Balochistan and Afghanistan by building highways that could carry heavy loads. Gwadar could thus be used to transport minerals that China was already exploiting in these two places.

There has always been a large military component in China's assistance to Pakistan. In fact, Pakistan is one of those rare countries that are receiving large amounts of assistance from China as well as the US aimed at modernising its military. According to Lamont and Bokhari

[20] Ministry of Foreign Affairs, Pakistan, *Joint Statement between the People's Republic of China and the Islamic Republic of Pakistan* (19 December 2010), www.mofa.gov.pk_Releases/2010/Dec/PR_310.htm. Accessed on 23 December 2010.

[21] James Lamont and Farhan Bokhari, 'Wen seals $35 billion pact in Pakistan friendship', *Financial Times* (20 December 2010), p.3.

[22] Government of Pakistan, *Pakistan Economic Survey, 2009-10* (Islamabad: Ministry of Finance), Table 7.5, p.95.

of the *Financial Times*, 'ahead of Mr Wen's visit, Pakistani officials let slip details of a new collaboration to support Islamabad's increasingly difficult hardware purchases. One project is the development of armed unmanned vehicles, commonly called drones.'[23] There was an intensive use of these aircrafts by the Americans in Afghanistan; according to one count, drone attacks on North Waziristan and other tribal agencies had increased significantly in late 2010, averaging at 12.5 per month during September-December compared to 7.5 in the previous eight months.[24] While it was well known that these attacks had the sanction of Islamabad – in fact Pakistani intelligence agencies helped to identify the targets – they caused considerable political risk for the administration headed by President Asif Ali Zardari. One of the many demands made by Pakistan, as a part of the help it needed from Washington to improve its capability for fighting terrorism, was to obtain American technology for manufacturing the drones. The Americans did not oblige and Islamabad turned to Beijing for assistance which it appears to have received.

This was not the only piece of equipment China obliged them with, China was prepared to provide Pakistan in terms of military hardware. 'The Pakistan navy has plans for the purchase of two missile boats from China, four frigates and helicopters. Submarines are on the cards too.'[25] The most visible area of collaboration in the military field between the two countries is in the development of a new fighter aircraft called the JF-17 'Thunder.' Jointly developed by the air forces of the two countries, Pakistan is likely to introduce 250 of these aircrafts in the next five years to its arsenal and also make them available for export to the Middle East and East Asia.

It was not only the size and content of the Chinese economic programme for Pakistan that struck a pleasant note in Islamabad, it was Mr Wen's position taken on terrorism. He praised Pakistan's sacrifices in combating terrorism and extremism, words that were in stark contrast to those used in the US' review of the situation in Afghanistan and Pakistan.[26] The American review was made public a couple of days before the Chinese Premier addressed the Pakistani Parliament. 'Pakistan has paid a heavy price in combating terrorism. The fight against terrorism should not be linked with any religion or ethnic group and there should be no double standards,' said the Chinese leader as lawmakers burst into applause. Mr Wen continued, 'The international community should affirm that and give great support, as well as respect the path of development chosen by Pakistan.'[27]

---

[23] James Lamont and Farhan Bokhari, 'A history of military and commercial ties', *Financial Times* (20 December 2010), p.3.

[24] Karin Brulliard and Haq Nawaz Khan, 'As drone strikes have increased, so have assassinations, Pakistanis say', *The Washington Post* (24 December 2010), pp.A1-A6.

[25] *Ibid.*

[26] 'Overview of the Afghanistan and Pakistan Annual Review', *The White House*, www.whitehouse.gov/erach/site/Pakistan. Accessed on 25 December 2010.

[27] Salman Masood, 'China praises Pakistan's fight against terrorism and vows to bolster partnership', *The New York Times* (20 December 2010), p.A8.

Mr Wen’s address to the Parliament was meant to send important signals to both Washington and Delhi. He said that China wanted to forge ‘deeper, closer, and stronger ties with Pakistan, and the two will remain brothers forever.’ While these words pleased the Pakistanis, they also caused some worry. ‘Yusuf Raza Gilani, Pakistan’s Prime Minister, careful not undermine efforts to secure peace with India, said the warmth of the relationship with neighbouring China was not “directed against any country”.’[28]

Conclusion

While the Chinese Premier, on his back-to-back visits to India and Pakistan, advanced the presence of his country in both nations, the greater success was in Pakistan. This was to be expected, since he did not face the kinds of challenges in Pakistan that he had to deal with in India. Despite his emphasis on friendship rather than competition and rivalry, he made fewer advances in New Delhi than he did in Islamabad. In Pakistan, he continued to promote what the two sides have begun to call an ‘all-weather friendship,’ distinguishing it from the relationship the country had with the US. The friendship with America followed the waning and waxing of Washington’s strategic interests in Pakistan and the region in which it was located. At the same time, it became clear that China wished to bring the Pakistani economy to orbit around its own. In Pakistan, Beijing visualises a geographic space that it can use to gain access to the mineral and energy riches of the Middle East and West Asia. China seems confident that the American involvement, in what Washington once called the AfPak region, will not endure beyond the year 2014, the deadline that both Kabul and Washington had agreed upon for America’s departure from Afghanistan. Once the Americans exit, China will be left with a lot of space within which to play the new ‘Great Game.’ To Beijing, India appears the only other contender in this much trodden field.

. . . . .

[28] James Lamont and Farhan Bokhari, ‘Wen seals $35 billion pact in Pakistan friendship’, *Financial Times* (20 December 2010), p.3.

ISAS Working Paper

No. 121 – 1 February 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

India's 'Look East' Policy: The Strategic Dimension

S.D. Muni[1]

Abstract

India's 'Look East' Policy (LEP) did not begin in the 1990s. It has evolved in four different waves over centuries. The first wave of cultural and commercial engagement between India and its extended eastern neighbours lasted until the 12th /13th century. To this was added a strong strategic dimension by the British Empire in India during the second wave. The leaders of independent India, particularly Nehru, took the lead in launching the third wave by focussing on East Asia as an important part of India's policy of Asian resurgence. However, the imperatives of the Cold War, intra-Asian conflict and rivalries, and India's weaknesses on economic and military fronts did not let its Asia policy blossom.

What is identified as India's LEP since the early 1990s constitutes the fourth wave of India's eastward (re)engagement. Under the strategic thrust of this policy, India has not only reinforced its economic and cultural relations with the countries of ASEAN and East Asia, but also firmed

[1] Professor S.D. Muni is a Visiting Research Professor at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He can be reached at isassdm@nus.edu.sg. The views reflected in this paper are those of the author and not of the institute.

up strategic relations with them through extensive consultations on regional and global security issues and consistent cooperation in defence sectors involving military supplies and naval exercises. India's strategic vision for the East extends to the whole of Asia-Pacific region as India has manifested both its willingness and capability to play a critical role in the emerging strategic dynamics and architecture for this region.

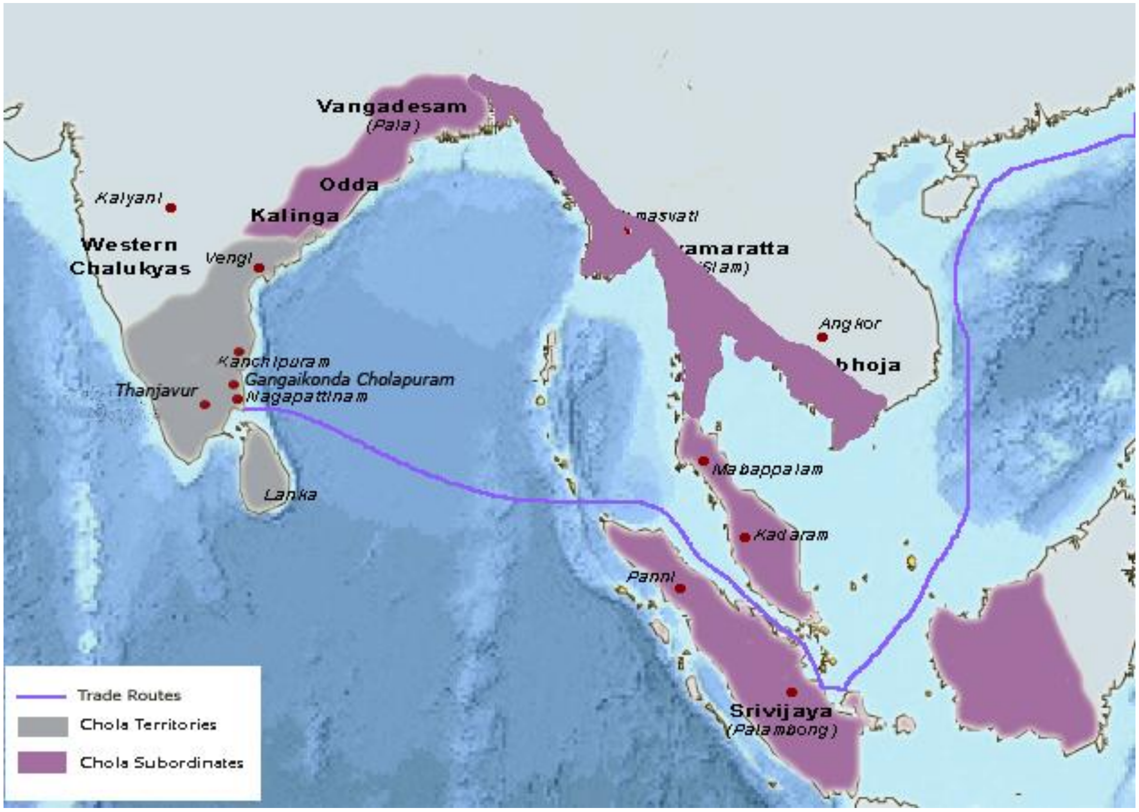
Introduction

India is an old civilisation of sun worshippers. It has, therefore always been looking east. In this respect, it may not be correct to trace India's LEP to the beginning of the nineties, when the Cold War ended as is usually done. For a proper perspective on India's substantial engagement with the east, one can clearly identify four different waves of such engagement namely, historical or pre-colonial, colonial, post-colonial and contemporary.

Historical Evolution

In the pre-colonial period, there is evidence of India's dynamic and extensive relations with its eastern neighbours since the first century. This phase lasted until the 12^{th} century and can be described as the first wave of 'look east' in cultural and commercial engagement. During this period, the first Hindu Empire (in what later became the Indo-China region) flourished based entirely on cultural and philosophical contacts with India. No military missions were launched and no wars took place, save the South Indian emperor Rajendra Chola's periodic encroachments into the Srivijiya Empire in Malaya and Indonesia in the 10^{th} and 11^{th} century, as illustrated in figure one.

<u>Figure 1</u>: The Chola Empire (1050 A.D)



<u>Source</u>: http://3.bp.blogspot.com/_ugQUGrg2Qo8/TMCE6hcaChI/AAAAAAAAA-8/Lez9CPZM3vM/s1600/Chola+Empire+Map.png. Accessed on 24 January 2011.

The expansion of Hinduism was followed by the spread of Buddhism to the east. The religious and cultural messages travelled directly from India as well as through China. This led to the emergence of a cultural synthesis of these two major systems of faith and belief, the imprint of which is evident even today. The popularity of the *Ramayana* (with varying nuances from one country to another) in the Buddhist heartland of Southeast Asia may be seen as an unmistakable imprint of this synthesis. It is no wonder that the images of Ganesha, Garuda, Shiva, Parvati, Rama and Sita are adored and worshiped in many parts of Southeast Asia, along with those of Buddha. This imprint is also visible in languages, where Pali and Sanskrit provide the texture and base of many Southeast Asian languages. The cultural synthesis is also reflected in the names of the people and places, lifestyles and festivities, patterns of old architecture and temples like Borobudur in Indonesia, Angkor Wat in Cambodia and Wat Phu in Laos. The Angkor Wat in Cambodia and the Luang Prabang temples in Laos have episodes of the Hindu epics, *Ramayana* and *Mahabharata*, engraved on their walls. It was in this period that Nalanda

University in Bihar, India, emerged as the principal centre of learning based on philosophical and religious (Buddhist) discourses for the whole Southeast and East Asian region. It facilitated the spread of Buddhism in China and Southeast Asia.

In a very significant way, one of the couriers of culture from India to Southeast Asia during this period was commerce. The spice trade route from West Asia and the Persian Gulf stretched over to Indonesia and even beyond, bringing in traders and travellers from one part of Asia to the other. This commercial link also facilitated the spread of Islam in Southeast Asia. In India, Orissa's annual festival of 'Bali Jatra' commemorates the adventures of innumerable traders who braved rough seas across the Bay of Bengal, Straits of Malacca and South China Sea to carry commerce and culture to the eastern shores of the Indian Ocean.[2]

Colonial Period

The advent of Islam after the 12th century and then the colonial expansion that followed Muslim rule in India disrupted these cultural and commercial links. During the colonial period, the Second World War engulfed East Asia rather extensively. The war added a strategic dimension to India's (then British) links with Southeast Asia. The British grasped the strategic centrality of India in Asia and sustained their colonial presence 'east of the Suez' including in Southeast Asia, on the basis of their Indian empire.[3] They built India as the bastion of their power and influence in Asia that protected their colonial holdings as far in the east as possible, up to Hong Kong. This period may be considered as the second wave of India's LEP when strategic interests were brought upfront along with the commercial interests, at the cost of cultural and civilisational links. The legacy of India's colonial sway persists in many subtle and diverse ways. It alerts East Asian countries and interested major powers to project and even exaggerate India's possible 'expansionist' and adventurist intents even when there is no evidence to support such intents. It also imbibes Indian policymakers to a wider strategic perspective that enhances the critical significance of the Indian Ocean and the eastern sea board in its security calculus, as was evident in the thought of Nehru and his associates, like Panikkar.

2 Lokesh Chandra, *India's Cultural Horizon* (New Delhi: Aditya Prakashan, 1969). Also see, Sarita Dash, 'Roots of India's Cultural Diplomacy in Southeast Asia', MPhil Dissertation, (New Delhi: Jawaharlal Nehru University, 2003).

3 Dieter Braun, *The Indian Ocean: Region of Conflict or Peace Indian Ocean* (C. Hurst: London, 1983).

Post-Independence Period

It was natural for India's historical eastward orientation to reassert itself with the withdrawal of a western colonial presence. The third wave of India's LEP was set in motion with the advent of independence. The eastern neighbours constituted one of the priority areas in India's commitment to work for Asian resurgence. Nehru called the Asian Relations Conference in March 1947 even before the formal beginning of 'India's tryst with destiny.' He, as the philosopher and architect of independent India's foreign policy, in general and its Asia policy, in particular, articulated this commitment while underlining the rationale and significance of Asian resurgence in India's worldview. Speaking at the Asian Relations Conference in New Delhi, Nehru said:

> 'We are of Asia and the peoples of Asia are nearer and closer to us than others. India is so situated that she is the pivot of Western, Southern and Southeast Asia. In the past her culture flowed to all these countries and they came to her in many ways. Those contacts are being renewed and the future is bound to see a closer union between India and Southeast Asia on the one side and Afghanistan, Iran and the Arab world on the west. To the furtherance of that close association of free countries, we must devote ourselves. India has followed with anxious interest the struggle of Indonesians for freedom and to them we send our good wishes.'[4]

Nehru's vision of a 'closer union' with the East was shaped by the strength of India's geographical proximity, similarity of historical experiences, cultural identity, economic interests and common strategic concerns in relation to the countries of the East. The vast stretch of Indian Ocean and its economic and strategic significance in links with eastern neighbours was not lost on Nehru and his associates.[5]

The emphasis on geography and culture in Nehru's early eastward policy was aimed at building Asian solidarity. He took into account the aspirations of a new, independent and resurgent Asia. Accordingly, he put India in the forefront of mobilising international support on issues ranging from Indonesia's freedom struggle and Burma's internal security and stability, to that of peace and freedom of Indo-China states. Delhi served as a host, in 1947 and 1949, to the conferences on Asian Relations and Indonesia. Indian policymakers and diplomats forcefully articulated the cause of decolonisation and development of Asian countries in all possible international forums.

---

4 Asian Relations, Report of the Proceedings and Documentations of the First Asian Relations Conference, New Delhi, March 1947. Jawaharlal Nehru, *Speeches, Vol.1 (1946-49) and Vol.2 (1949-53),* Publications Division, Government of India (Delhi: Government of India, 1949 and 1953).

5 See, K.M. Panikkar, *The Strategic Problems of the Indian Ocean* (Allahabad, 1944); K.M. Panikkar, *India and the Indian Ocean: An Essay on the influence of Sea Power on Indian History* (London: George Allen & Unwin, 1945); and Werner Levi, *Free India in Asia* (Minneapolis: University of Minneapolis Press, 1952).

The first Afro-Asian Conference held in Bandung, Indonesia, in 1955, was the culmination of these early Indian initiatives and efforts to promote Asian resurgence. India strongly pleaded for China's integration into the international community in the interest of Asian solidarity and pleaded that China should be treated more as a nationalist country than a communist revolutionary force.

The characteristic feature of the third wave of India's LEP was decolonisation and Asian resurgence. Both of these aspects were primarily emotional and ideological in content. The Nehruvian vision had a strong political content to back them but was bereft of much tangible substance; of commerce, culture and economy, as was evident during the first wave period. Nor was much attention paid, save rhetorical recognition, to the security imperatives of the developments in Indian Ocean, except during the late sixties and early seventies when India encouraged and backed the proposals for reducing the great powers' arms race in the Indian Ocean by getting it recognised as a 'Zone of Peace'. Therefore, India's efforts and initiatives with regard to Asian resurgence and Asian solidarity, though appreciated, could not be sustained as desired. The Bandung Conference was the first and last of its type. No Asian Relations Organisation, as envisioned in the Asian Relations Conference, could take shape. The Cold War powers suspected any move towards Asian solidarity as contrary to their strategic moves and interests, and ensured that such moves did not succeed. In fact the whole of Asia got divided along the Cold War lines. The Asian leaders failed to forge a common front to emerge as a powerful balancing force in the global divide due to their economic dependence on the former colonial powers and their inherent political and military vulnerabilities. There were also internal conflicts and insurgencies that became proxy wars in the Cold War ideological divide. The unfolding Asian conflicts, some of which were the continuation of the colonial control in different forms such as in the Indo-China region and others that proved to be persistent (also involving India with Pakistan and China) facilitated the machinations of all those who worked to keep Asia divided.

But India did not completely give up on its eastward orientation. It played a very constructive role, in working for peace and stability in the Indo-China region, under the UN (United Nations) auspices and as Chairman of the International Control Commission, following the Geneva Agreement of 1954. This difficult assignment delivered by India with passion and perseverance for peace is still appreciated and fondly remembered in Vietnam, Kampuchea (then Cambodia) and Laos. The goodwill earned by India in this region is and can be harnessed even today. Prior to this, India was also involved in the Korean Armistice in 1953 and played a constructive role between China and the West.[6] Very few people know or remember that India under Indira Gandhi also associated itself with the process of the formation of ASEAN (Association of

6 For details of India's role see, Eric Gonsalves, Oral History, 'Resolving the Korean Crisis', *Indian Foreign Affairs Journal*, Vol.2, No.2 (New Delhi: Cambridge University Press-India, April-June 2007).

Southeast Asian Nations) during 1966-67. It worked intensely for evolving a broad-based regional organisation of cooperation, which did not identify itself with any of the superpowers' strategic and Cold War oriented interests. This however, was not acceptable to the powers involved in establishing ASEAN against a strategic backdrop of the messy Vietnam War. The result was an ASEAN representing an ideologically and strategically divided Southeast Asia in which India had no place.[7]

India missed its second chance with the ASEAN in 1980. In May 1980, following a meeting between Indian and ASEAN officials in Kuala Lumpur, a framework for 'step-by-step' cooperation between India and 'ASEAN as a group' was agreed on, covering economic areas, specifically trade, international economic cooperation, industrial cooperation and scientific and technological cooperation.[8] However, the pursuance of this agreement was vitiated when India, ignoring ASEAN's collective position on Kampuchea, recognised the Hang Samrin regime that was seen as a protégé of Vietnam. This recognition was announced soon after Indira Gandhi's return to power in mid-term elections and just weeks before India was scheduled to participate in the ASEAN meeting to firm up its association with this regional grouping. Realising that ASEAN would not approve of this action, India's then foreign minister Narasimha Rao avoided participating in the ASEAN meeting in July 1980. ASEAN also did not bother to invite India subsequently. ASEAN turned cold towards India as a result of its political decision in favour of the Kampuchean regime. But why did the political position of the ASEAN members take precedence in what was proclaimed to be an organisation primarily for economic cooperation? Obviously ASEAN took its collective strategic preference rather seriously. Whether India should have played its cards more cautiously, by delaying the recognition of Hang Samrin regime in order to evolve a balance between its immediate strategic priorities and long-term regional interests in Southeast Asia, would remain a subject of debate among policymakers, analysts and observers. In retrospect, the credibility of India's position on Kampuchea and its stand on ASEAN as an organisation was validated. Not only were the Pol Pot-ist forces then backed by ASEAN, China and the West discredited and defeated, but ASEAN today represents the whole of Southeast Asia. Thus, India's bilateral relations with its eastern neighbours have waned and waxed during all these years.

---

7 Kripa Sridharan, *The ASEAN Region in India's Foreign Policy* (USA: Dartmouth Publishing Co, 1996). Also see 'India-ASEAN Relations: Evolution, Growth and Prospects', in Chandran Jeshurun (ed.), *China, India, Japan and the Security of Southeast Asia* (Singapore: Institute of Southeast Asian Studies, 1993).

8 For the Text of Joint Statement issued on this occasion, see, Kripa, *ibid*.

The Current Fourth Wave of the 'Look East' Policy

The current and fourth wave of India's LEP is credited to Prime Minister Narasimha Rao and is said to have been driven by economic and post Cold War imperatives of India's foreign policy.[9] But this ignores the initiative taken by Prime Minister Rajiv Gandhi during the late eighties in reviving India's relations with its eastern extended neighbours. There was a sudden spurt in diplomatic exchanges between India and the countries of Southeast Asia during the five years (1985-89) of Rajiv Gandhi's rule. The Ministry of External Affairs (MEA) Annual Report for 1985-86 recorded:

> 'There were hardly any high level contacts between India and ASEAN over the previous five years, but of late, a definite trend has emerged, which indicates that the ASEAN nations are interested in bringing bilateral relations back to the old level with the re-establishment of political dialogue.'

The next year, while commenting on Rajiv Gandhi's visit to Indonesia and Thailand in October 1986, the same report said that 'the visit filled the long felt need to give more attention to this region.' The mutual desire on the part of these countries to develop closer bilateral relations with India was 'manifested in the spontaneous and extremely warm reception accorded to [the] Prime Minister…'. During the five years of his rule, Rajiv Gandhi visited, besides Indonesia and Thailand, also Myanmar (Burma), Vietnam and topped these visits by undertaking a 'ice-breaking' visit to China in December 1988. Moreover, he tasked his Minister of State for External Affairs, K. Natwar Singh, to travel to the Southeast Asian capitals for facilitating a resolution of the Kampuchean issue through mutual understanding between ASEAN and the Indo-China states. In return, India hosted a number of Southeast Asian leaders like Suharto of Indonesia, Lee Kuan Yew of Singapore, Mahathir Mohammad of Malaysia, Van Linh of Vietnam and Hun Sen of Kampuchea, besides Foreign and other Ministers as well as junior officials from these countries.[10]

This initiative of opening up to the east was essentially strategically driven. China, under Deng Xiaoping, had launched itself on a dynamic path of economic recovery and was building cooperation and confidence with its neighbours in the region, by withdrawing China's support to

---

9 See some of the studies on the subject: Frederic Grare and Amitabh Mattoo (ed), *The Politics of India's Look East Policy* (New Delhi: Manohar, 2001; Prakash Nanda, *Rediscovering Asia: Evolution of India's Look East Policy* (New Delhi: Lancer Publications, 2003); Sudhir Devare, *India and Southeast Asia: Towards Security Convergence* (Singapore: Institute of Southeast Asian Studies, 2006); and See Chak Mun, *India's Strategic Interest in Southeast Asia and Singapore* (New Delhi: Macmillan Publishers India, 2009).

10 For details, see MEA Annual Reports of 1985-85 to 1989-90. Also *Speeches and Writings of Rajiv Gandhi*, All Volumes (New Delhi: Publications Division, Government of India).

local communist insurgencies and opening economic engagement. India also wanted to change the track of Sino-Indian relations as Rajiv Gandhi's visit opened discussions on the border dispute as well as prospects of bilateral economic cooperation. The message that came out of Rajiv's visit to China was to keep conflicts and disagreements on the back burner and start exploring areas of cooperation and understanding. Then under Gorbachev, there was a strong Soviet desire to normalise relations with China and get out of conflict situations in Afghanistan as well as Kampuchea (through Vietnam). Gorbachev's initiatives eventually also led to the end of the Cold War. India was also concerned regarding suspicion in this region about its naval activities, which called for clarifying things and building mutual confidence. India's naval intentions had been distorted and inflated by media and vested interests in this region as a result of India's proactive role, involving the use of military power, in the internal conflict resolutions in Sri Lanka (1987) and Maldives (1988).

This strategic drive on India's part was not bereft of economic objectives. India maintained a steady growth of around five per cent during Rajiv Gandhi's period and was economically opening up. The idea of 'one window clearance' was introduced to reduce bureaucratic hassle for investment proposals. This was aimed to encourage meaningful economic engagement with the world, particularly the economically dynamic extended eastern neighbours. The political exchanges between India and the Southeast Asian countries during Rajiv Gandhi's period also focused on issues of trade and commerce, avoiding double taxation, the search for energy and cooperation in the field of science and technology. Business delegations led by Federation of Indian Chamber of Commerce and Industry (FICCI) visited ASEAN countries.

After a brief interruption of two to three years due to the changes in governments when the Congress Party lost power and Rajiv Gandhi was assassinated, Narasimha Rao who came to power in June 1991 picked up the threads of Rajiv Gandhi's eastward initiatives. It may be kept in mind that Rao had joined Rajiv Gandhi's government as a foreign minister towards the later years and accompanied Gandhi on his China visit. Other significant changes had also taken place by the time Rao came to power. The government faced a severe balance of payments (BOP) crisis. The Cold War had ended. The uncertainties arising out of the collapse of India's trusted friend and supporter, the Soviet Union and the emergence of a unipolar world dominated by the United States (US) gave a certain jolt to the hitherto prevailing structure of India's foreign policy. India was forced to explore other options, both regionally and globally, in search of preserving and promoting its economic and strategic interests, and there, the eastern neighbours offered a promising area of engagement. The ASEAN, with Japan, Korea and China put together, constituted economically the most dynamic region, not only in Asia but the whole world. Indian policy could not ignore this region particularly under the new situation when India was in dire need and desperate search for new openings for its 'liberalising economy.'[11] India was also looking elsewhere in Asia by the beginning of the 1990s, like towards the newly emerged Central Asian Republics, not only for retaining them as the captive markets of the Soviet period, for its products and services, but also to meet the growing energy needs, as the hitherto prevailing arrangements had been disturbed due to the breakdown of the Soviet Union in 1991. The search of new options had also got India involved in the initiative to build a cooperative structure in the Indian Ocean Rim Region. Southeast and East Asian countries naturally got a priority in this search for Asian partnerships, more so as new economic groupings like Asia Pacific Economic Community (APEC) were taking shape there.

There were other factors as well that strategically triggered India's moves to reactivate its LEP in the post Cold War phase. Two of them may be of particular interest here. One was the developing situation in Myanmar (Burma), where both China and Pakistan were fast expanding their presence and influence with the post-General Ne Win military leadership that assumed power in 1988. On its part, India was isolated from the Myanmarese military regime due to its traditional support for the democratic forces that continued until Rajiv Gandhi's period. The popular forces in Myanmar looked towards India for inspiration and encouragement in their struggle against the military order. China and Pakistan were supportive of Myanmar's new military leadership, which refused to transfer power to the Aung San Suu Kyi-led democratic forces, even after their massive electoral victory in 1989. On China's part, its support for the new junta in Yangon was also a reciprocal gesture for the Myanmar military leadership's endorsement of the Chinese government's position on the Tiananmen Square revolt of 1989. China preferred a non-democratic regime in its close neighbourhood. For Pakistan's military ruler General Pervez Musharraf, Myanmar generals were natural allies. While one can debate the role of ideology and democratic preference in foreign policy pursuit, in Myanmar, the political entrenchment of the military was a fact of life. The long drawn ethnic war in Myanmar and the fragile balance of popular forces between the Burmese and ethnic and tribal communities had tended to provide a certain incentive as well as legitimacy to the military to dominate political space.

A question that arises is whether India's adherence to democratic ideology in strategically sensitive situations is always desirable. Myanmar being India's close and next-door neighbour, should have been dealt with greater resilience and ingenuity, if not utter realism. Later, in 1996, at the ASEAN Ministerial Meeting (AMM) in Indonesia, India was quite impressed by the down to earth practical approach of the ASEAN countries in their discussion of Myanmar's admission into ASEAN, even in the face of strong opposition from the Western powers. There was not much wisdom and justification for the long indifference in India's policy towards Myanmar from

[11] K.K. Katyal, 'Looking Eastward for Capital', *The Hindu* (24 January 1994).

the early sixties to the end of the eighties. There were reports of the Chinese listening posts in Myanmar's Indian Ocean islands to monitor developments in India's missile programme. China had also spread its economic and military presence in Myanmar widely and deeply. Pakistan, with the help and support of China, had started supplying military equipments to Myanmar's new military regime.[12] India shuddered at the prospects of Pakistan consolidating its position in Myanmar in view of strong Pakistani links with Bangladesh's security establishment and its propensity to support insurgencies in India's northeast region. India could not afford to ignore Myanmar anymore in the face of these developments. The urgency for a basic shift in India's Myanmar policy was injected by the deteriorating security situation in India's northeast resulting from tribal insurgencies. Some of the insurgent groups were seeking shelter in Myanmar by exploiting ethnic harmonies across the border. Myanmar's military regime could not care less in view of India's explicit support for their democratic adversaries. Thus a cooperative and congenial relationship with Myanmar was also an imperative of India's internal (in the northeast) security concern.

The second factor that prompted India to look towards the east more seriously and determinedly was to answer growing, but wholly untenable and baseless, allegations and suspicions on India's naval expansion and assertive intentions in the Indian Ocean. Such allegations had been triggered during the Rajiv Gandhi period, by sponsored and ill-informed western and regional media reports.[13] These reports were, perhaps, aimed at camouflaging intense military modernisation programmes of a number of countries in the region including Australia. These developments were also related to the reported reduction of the US military presence in the Asia-Pacific region as the Cold War had ended. India had to monitor these developments on its eastern front in its own long-term strategic interests. It also had to engage with its eastern neighbours strategically and explain its peaceful and non-expansionist disposition towards the region.

Accordingly, India's current LEP has both economic objectives and strategic considerations. What is often not realised is that in a very significant way, Southeast Asia was also inducing India to have greater involvement with the region. This tendency started towards the end of the eighties as witnessed during period of the Rajiv Gandhi administration in India, when a number of ASEAN leaders had consultations with India on the question of resolving the Kampuchean issue. Along with the possibility of a reduction in the US military presence mentioned above, there were also emerging signs of China's growing economic and military presence in the Asia-Pacific region. The ASEAN and other countries have always preferred a multilateral balance of

[12] For more details on this subject, see, S.D. Muni, 'China's Strategic Engagement with the New ASEAN', *IDSS Monograph*, No.2 (Singapore: Institute For Defence and Strategic Studies, 2002).

[13] Sandy Gordon, 'India and Southeast Asia: A Renaissance In Relations?' in Sandy Gordon and Stephen Henningham (eds.), *India Looks East: An Emerging Power and Its Asia-Pacific Neighbours* (Canberra: Canberra Paper No.111, Strategic and Defence Studies Centre, The Australian National University, 1995).

forces in the region in the interest of greater stability and peace. Many of these countries found India a deserving candidate to be involved in this balance, because India had no record of an aggressive or expansionist approach towards this region in the past.

India's LEP was officially defined and articulated in September 1994, by Prime Minister Narasimha Rao in his Singapore lecture. He had stressed the point that India's historical and cultural relations were very old and strong and there was nothing new in India looking towards reinforcing cooperative linkages with its eastern neighbours. He laid emphasis on building strong economic and security relationship between India and its eastern neighbours.[14] The components of India's thus articulated LEP were reiterated and elaborated upon subsequently by various prime ministers and foreign ministers and senior officials of India.

The LEP has not been pursued by India in a well-planned and structured manner. Rao's Singapore lecture in 1994 was a broad articulation of India's desire and rationale for connecting with its eastern neighbours. Since then the policy has evolved in phases and directions gradually. One can clearly discern a greater engagement with ASEAN during the initial years with an emphasis on economic ties and institutional partnership. After almost a decade, the policy assumed a more pronounced strategic flavour and expanded to the countries other than ASEAN members like Australia, Japan and Korea. India's then Foreign Minister Yashwant Sinha heralded the second phase of the LEP in 2003, by saying:

> 'The first phase of India's Look East policy was ASEAN-centred and focused primarily on trade and investment linkages. The new phase of this policy is characterised by an expanded definition of 'East', extending from Australia to East Asia, with ASEAN at its core. The new phase also marks a shift from trade to wider economic and security issues including joint efforts to protect the sea lanes and coordinate counter-terrorism activities.'[15]

The second phase of the policy was clearly marked by greater confidence on India's part in dealing with China as a number of bilateral confidence building measures had been put in place between the two countries. A positive turn had also taken place in India's relations with the US, and 9/11 had made India as well as other countries in the region, acutely conscious of the menace of terrorism. There have been raging Muslim insurgencies and revolts in Philippines, Thailand, Myanmar and Indonesia. There have also been a large number of initiatives in the field of

---

[14] Text of Prime Minister Narasimha Rao's speech, Institute of Southeast Asian Studies, Singapore, 1994.

[15] Yashwant Sinha's Speech at Harvard University (Cambridge: 29 September 2003). The full text of the speech is available at www.meaindia.nic.in/. Accessed on 25 January 2011.

defence cooperation with the countries of the region.[16] Now after almost a decade of the second phase, a third phase of the LEP seems to be unfolding under which India's economic and strategic engagement with the region will be expanded and deepened, and India will be more willing and active to play a larger strategic role.[17]

India's strategy to rebuild cooperative relations with its eastern neighbours in general and ASEAN in particular has had two dimensions namely, strengthening bilateral relations and getting integrated with the regional cooperative organisations in Southeast Asia.

Strengthening Bilateral Relations

With regard to the first, India tried to reach out to its Southeast and East Asian neighbours in many ways. Through various exchanges of official visits, including at the highest political levels, India tried to explain to the eastern neighbours that India was a modern, peace loving, practical and cooperative country. In bilateral discussions, India's attempt was to enhance political understanding, identify areas of mutual interests and initiate moves to harness these interests. The countries specially chosen for greater cooperation could be seen to fall in three categories, two of them from within ASEAN and the third category of countries from East Asia.

Within ASEAN, India has adopted a differentiated approach between the new ASEAN members, namely Myanmar, Laos, Cambodia and Vietnam and the old ASEAN members. The new members joined ASEAN during the nineties and have been not only economically lagging behind the old ASEAN members, but also had a different strategic background and perspective. They have had centralised political systems, were at odds with the Western block during the Cold War due to their respective struggles of independence, which even led to the war in Vietnam, and were all located in the close neighbourhood of China. China's proximity to the US since 1972 drove these countries towards the Soviet Union, where India shared strategic perspective with them in the context of the Cold War. The end of the Cold War has made such strategic divides irrelevant and at present while India has vastly improved its relations with the US, the new ASEAN countries are also being vigorously courted by the US through economic assistance and defence cooperation. The spurt in US-Vietnam defence cooperation evident since 2008 may be seen as an evidence of it.[18] The new ASEAN members also include the countries of the (former) Indo-China region, where India enjoyed a fund of goodwill and close understanding

[16] For initial comments of the second phase of the LEP, see C. Raja Mohan, 'Look East Policy: Phase Two', *The Hindu* (9 October 2003).

[17] Informal discussions with India's National Security Adviser to the Prime Minister in New Delhi (May 2010).

[18] For a brief outline of major developments in US-Vietnam cooperation, see www.photos.state.gov/libraries/vietnam/8621/pdf-forms/15aniv-DAO-factsheet.pdf. Accessed on 25 January 2011. On the same subject also see, *Christian Science Monitor* (12 August 2010), *New York Times* (23 July 2010).

due to its role in the region under the UN Peace and Supervisory Commission established to overlook the implementation of Geneva Agreement of 1954. The deep roots of historical and cultural contacts between these countries and India have already been mentioned.

As noted above, India also adjusted its policy in relation to Myanmar, by accepting the harsh reality of the military junta being firmly in power there. Its ideological commitment to democratic forces had to be balanced with pressing strategic and security interests. The conferring of the Jawaharlal Nehru Award for International Peace on Myanmar's democracy leader Aung San Suu Kyi in 1995 can be seen as an act of maintaining this balance between ideological commitments and security interests. India also tried to maintain a cautious position on the question of the Monks revolt in Myanmar in 2007.[19] Incidentally, Myanmar was also administratively a part for some years, of the British Indian Empire and there existed close relations between the two countries from 1947 until 1964, when military took over power.[20]

The special focus on the new ASEAN countries in India's LEP has, over the past years, also led to the creation of a separate administrative unit, the CLMV (Cambodia, Laos, Myanmar and Vietnam) desk, in the Ministry of External Affairs to deal with them. Special programmes of assistance and cooperation in diverse fields are being initiated and executed in CLMV (Cambodia, Laos, Myanmar and Vietnam) countries through this unit.

Among the older ASEAN members, India has laid greater emphasis on the dynamic economies of Singapore, Malaysia, Thailand and Indonesia. Singapore, on its own has been taking initiatives to harnessing the vast potential of economic growth in India. In recent years, India's relations with Philippines, neglected for a long time, are also picking up. Singapore played an important role in facilitating India's institutional linkages with the regional grouping. Singapore may have seen a greater promise and potential in India's growing and liberalising economy. As a result, India's closest relations are with Singapore in the whole of the region, since the launch of the LEP. This is evident in trade, investments as well as defence cooperation areas.

As for East Asia, special attention is paid to countries like China, Japan and the Republic of Korea. China is more to India than just East Asia. The constraints of time and space do not permit us here to go into the details of India's China policy, but the shift in India's approach, particularly since Rajiv Gandhi's visit in December 1988, is clearly evident. The mutual confidence building measures between the two countries enshrined in the Agreements of 1993 and 1996, as well as the beginning of negotiations to resolve the contentious border issue and build economic cooperation through trade and investments, are reflections of the changed stance

---

[19] S.D. Muni, 'Monks, masses and military', *Frontline*, Vol.24, Issue.20 (6 – 19 October 2007).

[20] For India's relations with the democratic regimes and leadership in Myanmar, see S.D. Muni, *India's Foreign Policy: The Democracy Dimension* (New Delhi: Cambridge University Press-India, 2009).

on the sides of both these giant Asian neighbours. Korea has also enhanced its economic cooperation with India – visible in the auto-industry and consumer durable production – over the past decade and more. President Lee Myung Bak of South Korea was invited as chief guest for India's 61st Republic Day celebrations in January 2010. Political and strategic nuances of Japan's perceptions and its economic slide did not allow the potential of its bilateral relations with India to be harnessed. However, the situation has radically changed towards a more positive direction in the last few years. India and Japan lobbied together for reforms in the UN and their seats in the Security Council as permanent members in 2005. They established a 'strategic and global partnership' in December 2006 during Prime Minister Dr Manmohan Singh's official visit to Japan and since then the bilateral relations are moving fast on various areas of cooperation including in the defence sector. The first ever Two Plus Two Dialogue at the senior defence and foreign affairs officials level was held between the two countries on 6 July 2010.[21]

Institutional Engagement

Institutionally**,** India was accepted as a Sectoral Dialogue Partner by ASEAN in January 1992. The sectors identified for partnership were trade, investment and tourism. By comparison, the areas of cooperation agreed to in May 1980 were much broader than these. The Sectoral Dialogue Partner status was granted by ASEAN to both India and Pakistan at the same time. But soon the ASEAN countries realised that Pakistan had no inclination or potential to get economically engaged with the region. India on the other hand, was very serious in pursuing its economic engagement with the regional grouping. As a result, India soon earned the status of a (full) Dialogue Partner by ASEAN at its fifth summit in December 1995. The areas covered for cooperation and dialogue between India and ASEAN include trade and investment, human resources development, science and technology, transport, tourism and infrastructure, health, small and medium scale enterprises and people to people relations involving cultural and professional exchanges. The full dialogue partner status also enabled India to become a member of the then established unique security forum for the region called the ASEAN Regional Forum (ARF). India's initial apprehensions that it would experience undue pressures within the ARF on account of its conflict with Pakistan and autonomy of its nuclear programme proved to be exaggerated.

From a dialogue partner, India became ASEAN's Summit partner in 2002.[22] ASEAN has instituted the ASEAN + 3 structure of summit level interaction with East Asian countries,

[21] For details of expanding relations between India and Japan see, Rajiv Sharma, 'India-Japan Ties Poised for Advance as Both Nations Eye China,' *The Asia-Pacific Journal: Japan Focus*, www.japanfocus.org/-Rajeev-Sharma/3406. Accessed on 25 January 2011.

[22] See the publication brought out on the occasion of the first summit, 'India-ASEAN: The First ASEAN-India Summit', Cambodia, November 2002, Embassy of India, Phnom Penh, Cambodia.

namely China, Japan and the Republic of Korea. India preferred to join this group by getting the ASEAN + 3 recast as ASEAN + 4 summit. This was not acceptable to some of the ASEAN as well as Plus Three (+ 3) members. The ASEAN + 3 concept had emerged out of the Malaysian initiative to establish an East Asian economic caucus and it was thought that India did not fit into the initially conceived framework. Perhaps, India was also viewed as a competitor for aid and investments by some of the ASEAN members, also under the influence of some of the Plus Three members like China. To further integrate itself with the regional economic structure, India started working on a Free Trade Agreement (FTA) and concluded the same in August 2009 after considerable delay and difficulties.[23] The Agreement has become operational starting in January 2010. This would be encompassed in a broader structure of the ASEAN-India Regional Trade and Investment Area (RTIA). A Framework Agreement on Comprehensive Economic Cooperation between ASEAN and India was concluded in October 2003 during the Bali ASEAN summit. In pursuance of the thrust of this 'Framework Agreement', the two sides are also busy defining an 'ASEAN-India Vision 2020' to give a firm direction and momentum to their joint endeavour towards 'Shared Prosperity'.[24] India was initially kept out of the Asia-Europe Meeting (ASEM) mechanism that started functioning since 1996, but since 2006, India has become a member of this grouping as well.

The institutional integration of India with Southeast Asia has not remained confined to ASEAN alone. In 1997, India along with some of the South and Southeast Asian neighbours, also established a sub-regional grouping called Bay of Bengal Initiative for Multi-sectoral Scientific, Technological and Economic Cooperation (BIMSTEC) to promote rapid economic cooperation in the areas of trade, investment, tourism, fisheries, agriculture, transportation links and human resources development.[25] The initiative for BIMSTEC was taken by Thailand in search of expansion of its market and investment opportunities without competition from its strong ASEAN partners like Singapore and Malaysia as well as larger neighbour like China. It has been mentioned earlier that Thailand called this initiative as a reflection of its Look West policy. India spontaneously responded to this Thai initiative to break out of the rigid South Asian constraints where Pakistan was neither helping SAARC (South Asian Association for Regional Cooperation) to grow nor seeking to normalise bilateral relations. Some observers have looked towards India's participation in BIMSTEC as a move to isolate Pakistan in South Asia. This indeed may sound logical since all the SAARC members except Pakistan were members of BIMSTEC with the joining of Nepal and Bhutan in July 2004. Pakistan has not sought the membership of this organisation and now SAARC has also expanded with the inclusion of

---

[23] For a brief discussion of some of these difficulties see, Shankari Sundaraman, 'India-ASEAN FTA: To be or not to be', *The Asian Age* (New Delhi: 14 April 2009).

[24] RIS, New Delhi has a prepared a draft for this 'Vision' statement (December 2003).

[25] Initially BIMSTEC represented the first letters in the names of all the members, i.e. Bangladesh, India, Myanmar Sri Lanka, Thailand, Economic Cooperation. However, this nomenclature created difficulties when Nepal and Bhutan were asked to join, hence, the change in the name.

Afghanistan as a full member along with a number of observers. The change in name also underlines the growing significance of the Bay of Bengal region where all the original members of the grouping share economic and strategic concerns.

Besides BIMSTEC, India's interaction with its eastern neighbours also take place in the Indian Ocean Rim Association For Regional Cooperation (IOR-ARC), established in 1997, and various forums for Asian cooperation. In 2000, India and the Mekong basin countries of Southeast Asia namely, Thailand, Myanmar, Laos, Kampuchea and Vietnam, established a Mekong-Ganga Cooperation (MGC) Forum with India. Initiative for this forum had also come from Thailand. China is excluded from this group. India is regionally well integrated now with the existing institutional structures to pursue its economic and strategic interests constructively. As and when the Kunming initiative takes a concrete shape, another forum for India to engage with China and other eastern neighbours like Myanmar and Bangladesh for cooperative development would be opened. India may however not be very enthusiastic for this forum as it essentially is driven by China's desire to connect it with the South Asian economies and open prospects for the growth of its landlocked region like Yunnan. Prime Minister Manmohan Singh in continuation of the thrust of 'Look East' policies has also given a call for building an Asian Economic Community.[26] There is a section of Indian opinion that seeks full membership of ASEAN or APEC. It may however, be prudent to make an objective and indepth assessment of India's interests and advantages in doing so, before a policy decision is taken in this respect.[27]

There were initial reservations on India joining the new organisation of the East Asia Summit (EAS), the initiative for which by Malaysia may be traced back to 1991. In the perceptions of Malaysia and some other prospective members of this organisation like China, India did not qualify to be an East Asian country. This was contested by India and other ASEAN members like Singapore and Japan. Eventually, India along with Australia and New Zealand, became its founding member when EAS was established in 2005.[28] ASEAN forged another regional organisation called the ASEAN Defence Ministers Meeting (ADMM) in 2007, to cooperate, to begin with, in the areas of humanitarian and disaster relief. This meeting also adopted a concept paper on the expansion of this organisation (ADMM Plus). At its fourth meeting in Singapore in May 2010, the ADMM became ADMM + 8, by including eight other members namely Japan, Korea, China, Australia, New Zealand, India, Russia and the US. The first meeting of the expanded ADMM took place in Vietnam in October 2010.

---

[26] Prime Minister Manmohan Singh said this while inaugurating the third Conference of Indian Association of Southeast Asian Nations on 19 October 2004, www.globalinsight.com/SDA/SDADetail1269.htm. Accessed on 25 January 2011.

[27] India's institutional integration with ASEAN was outlined by the Cambodian Foreign Minister, Hor Namhong in his India-ASEAN Lecture in New Delhi on 14 March 2002.

[28] S.D. Muni, 'India and the East Asia Summit', Observer Research Foundation, New Delhi, and (Singapore: Institute of South Asian Studies, Unpublished Monograph, 2007).

If one looks closely at India's efforts to integrate itself with the multilateral regional grouping, one can discern an undercurrent of strategic push centred around China. India has welcomed and actively encouraged such regional groupings where China does not figure at all. The examples of BIMSTEC and the GMC may be mentioned here. India has also sought membership and participation where there existed the prospects of China emerging as a major player and using the given organisation to consolidate its presence and influence in Southeast Asia. India's attempts to get the ASEAN + 3 enlarged into 'Plus Four' by its own inclusion were pursued vigorously, though in vain. Subsequently, India keenly lobbied for its inclusion in the EAS in the teeth of opposition from China and Malaysia with the help of Japan and other ASEAN countries as mentioned above. In order to ensure that China does not get to dominate any organisation in the region, India has been supporting the initiatives of the ASEAN and other countries to expand such organisations. The EAS accepting the US and Russia and the expansion of the ADMM to include the US and Russia, besides all other EAS members may be taken note of in this respect. India continues to have strong reservations on the 'Kunming initiative' for instance with proposals that seek to make China a direct participant in South Asian economic activities. India accepted China as an 'Observer' in SAARC after much trepidation and possibly as a bargain for India's acceptance as an 'Observer' in the Shanghai Cooperation Organisation (SCO).

Economic Gains

The biggest benefit of India's LEP has been that India has been re-engaged with its eastern neighbourhood closely and has gradually emerged as a significant player in the strategic dynamics of the region, which is centred around a rising China. In tangible terms, the gains are clearly evident in economic and strategic fields. Economically, India's trade with ASEAN has grown impressively since the pursuance of the LEP – from US$2.3 billion in 1991-92 to US$45.34 billion in 2008-09.[29] Singapore stands out as India's largest trading partner in ASEAN followed by Malaysia and Indonesia. Growth of trade has however been phenomenal between India and China where all the set targets have been broken time and again. By 2008-09, India-China trade in goods recorded a figure of US$41.8 billion, but if the trade in services is also included, it goes beyond US$50 billion.[30] Most of India's trade balance with ASEAN and China is negative and there are concerns about a growing deficit. But the Indian economy is less manufacturing and more service sector based as compared to China and the ASEAN countries. It may be hoped that with the increase in trade in services, India will be able to bridge some of its

[29] Based on Department of Commerce, Government of India.

[30] Archana Pandya and David M. Malone, 'India's Asia Policy: A Late Look East', *Institute for South Asian Studies* Special Report, No.2 (Singapore: Institute of South Asian Studies, 25 August 2010), p.12.

trade gap. India's trade with Japan, Australia and the Republic of Korea is also picking up fast with the increasing momentum in the LEP.

India has also received increasing investments from its East Asian neighbours, reaching a figure of US$13.15 billion by August 2009. Singapore again tops the list of investors accounting for US$8.66 billion. Singapore's share of FDI (foreign direct investments) inflows to India is 8.72 per cent of the total.[31] Singapore is followed by Japan with US$3.30 billion of FDI into India, which constitutes 3.44 per cent of the total inflows. The Chinese companies seem keen to increase their investments into India but the security stigma attached to their operations creates difficulties. India's investments in turn have also been growing into the Southeast Asian region. The highest Indian Direct Investments of US$14.23 billion by 2008-09, have gone to Singapore, followed by Australia where India has invested US$962.3 million by 2008-09. It is interesting to note that India has an investment of US$911.1 million in China, the third largest in the region compared to China's investments of US$14.35 million in India.[32]

India's economic integration with the East Asian region will grow gradually. While projecting a comprehensive economic partnership framework at the regional level, India has been moving on partnerships at the bilateral level. The Comprehensive Economic Cooperation Agreement (CECA) with Singapore was signed in 2005 and now a similar agreement with Malaysia has also been finalised. Such partnerships will go beyond trade in goods and investments. It will cover the services sector in which India has strength, and may also include areas like science and technology, tourism, etc., to consolidate and expand economic cooperation. The pace of economic reforms in India will also give a further boost to not only India's economic growth but also to its relations with the East Asian neighbours.

Strategic Engagement

The emphasis in the first phase of the LEP was primarily on economic engagement. But the area of cooperation in defence and strategic matters was not completely overlooked.[33] India not only supplied defence equipment to the ASEAN countries but also agreed to help upgrade and repair their major weapon systems like MiG (Mikoyan-Gurevich) fighter aircrafts and offer training to their defence personnel. Important agreements in this respect were signed with Vietnam, Malaysia, Laos and Singapore. Some of those agreements, particularly with Malaysia and Laos could not be fully implemented, partly due to the regional economic crisis and payments

[31] *Ibid*, p.11.
[32] *Ibid.*
[33] S.D. Muni, 'Strategic Engagement of the East', *Indian Defence Review*, Vol.20, No.4 (October-December 2005).

difficulties and partly due to inept handling by the concerned Indian defence organisations.[34] Security cooperation was also an important item in the growing India-Myanmar relations. The two countries carried out a joint operation in 1995, code named 'Operation Golden Eagle', to deal with ethnic insurgency on their common border. Myanmar has also started appreciating India's security concerns in relation to the growing presence of China and Pakistan in Myanmar.

However, since the beginning of the second phase in the LEP, the question of strategic engagement and defence cooperation has been stepped up. The parameters of the policy, as noted earlier, have been taken 'beyond ASEAN' and 'beyond economic interests.' There is also renewed and wider (other than ASEAN countries) interest in the region for defence cooperation with India. A typical example of this was evident in the year 2002 when India responded to the US call of escorting its ships in the Straits of Malacca to protect them from sea piracy.[35] India's policy of strategic engagement with the eastern neighbours has developed various aspects. There are high-level political and military exchanges of visits where broader regional and global security issues are discussed. At the level of Ministries of External Affairs and Defence, bilateral dialogues and consultations on regular basis have been institutionalised. Then there were Naval and other services (Air Force, Army) visits and exercises. Indian ships have visited and conducted exercises with almost all the countries of the region, going as far as the South China Sea. There are of course differences in the quality and reach of these visits and exercises. India is also supplying defence equipments and servicing and upgrading them in many Southeast Asian countries and setting up training facilities and military academies there. In August 2008, India offered to setup an Air Force Academy in Laos. India is also slowly moving into the area of defence technology exchanges and joint production. With Singapore, India has the closest special security partnership in the region.[36] The Kalaikunda Air Force Base in India's West Bengal state was leased in October 2007 to Singapore for five years for training purposes. Next to Singapore, Vietnam, Malaysia and Indonesia may be described as the countries having close defence cooperation with India. With Indonesia there has also been a proposal to establish joint production of military hardware.[37]

Beyond ASEAN, India has also developed close strategic understanding and cooperation with Japan, Australia, Korea and even China. Strategic partnerships, in different forms have been established with these countries. India, Japan and Australia had joined hands with the US in

---

[34] The author has firsthand knowledge of this in the case of Laos where he served as India's Ambassador from 1997-99.

[35] Sudha Ramachandran, 'India Signs on as Southeast Asia watchdog', *Asia Times* (5 April 2002),www.atimes.com/ind-pak/DDO5Dfo1.html. Accessed on 25 January 2011.

[36] David Brewster, 'India's security partnership with Singapore', *The Pacific Review*, Vol.22 No.5 (December 2009), pp.597-618.

[37] 'India, Indonesia Mull Joint Defense hardware Production', www.india-defence.com/print/3311, Accessed on 30 January 2011.

coordinating rescue and relief operations to deal with the 2004 tsunami in the region. There is a persisting speculation among strategic analysts that these countries may forge some sort of a united front, a kind of 'Asian NATO' to keep China contained in the region.[38] But such thinking may be a bit far-fetched and also not conducive to regional peace and stability, as it will make China feel insecure and in turn assertive and aggressive. India has, however, made no secret of its desire and capabilities to play an important role in ensuring Asia's regional security. On 28 November 2005, Foreign Secretary Shyam Saran, speaking at Economic Forum in New Delhi said:

> 'India and the United States can contribute to much better balance in the region. ….We believe in terms of managing the emerging security scenario in Asia, we need to bring more and more countries with in the discipline of a mutually agreed security paradigm for the region.'

Again in June 2006, Defence Minister Pranab Mukherjee, speaking at the Fifth Shangri-La Dialogue in Singapore said:

> 'India is one of the important legs of the Asian juggernaut along with China, Japan and Indonesia. In the Asia-Pacific region, India's growing ties with the United States and other countries in North and South America brings with it a commensurate role in the region…India's role is crucial for ensuring and maintaining long-term peace, stable balance of power, economic growth and security in Asia…It straddles the land and maritime space between east and west, and provides potential energy and trade corridors to Central Asia and Indian Ocean region. Responding to the challenges of globalisation is one of the key issues faced by all nations today. As a pluralistic, democratic and English speaking society, India is well place to respond.'[39]

---

[38] See following; Derek Chollet, 'Time for an Asian NATO', *Security Studies*, (Winter 2001); Frank Crass, 'U.S. and India Consider "Asian NATO"', *NewsMax.com Wires* (29 May 2003); www.archive.newsmax.com/archives/2003/5/29/162032.shtml. Accessed on 25 January 2011; Praful Bidwai, 'Five-Nation Naval Drill Presages "Asian NATO"', *Inter Press Service* (7 September 2007), www.ipsnews.net/print.asp?idnews=39175. Accessed on 25 January 2011; D.S. Rajan, 'Suspicion of an "Asian NATO" in the four-nation dialogue', *China Monitor*, Paper No.9, *South Asia Analysis Group*, Paper No.2103, (21 January 2007); Rick Rozoff, 'U.S. Expands Asian NATO Against China, Russia,' www.rickrozoff.wordpress.com/2009/10/16/. Li Hongmei, 'Insidious, Risky Strategy: U.S. Builds Asian NATO Against China', Global Research, *People's Daily Online* (12 August 2010), www.globalresearch.ca/PrintArticle.php?articleId=20593. Accessed on 25 January 2011.

[39] Text of the speech (3 June 2006), www.iiss.org/conferences/the-shangri-la-dialogue/shangri-la-dialogue-archive/shangri-la-dialogue-2006/2006-plenary-session-speeches/second-plenary-session--pranab-mukherjee. Accessed on 25 January 2011.

Thus, India's advantages *vis-à-vis* other regional powers like China and Japan, in the region was clearly underlined.

India's capability to play a balancing strategic role in Southeast Asia will be considerably augmented after the completion of the project upgrading of Andaman and Nicobar 'tri-service command' which was established in 2001, into a 'major amphibious warfare hub' by 2020. It will have fully developed facilities for training and deploying sea and land fighting units. It will become a submarine base and an air force base to station Sukhoi 30 and Mirage 2000 fighting aircrafts. It would be possible to undertake Tactical Ariel Reconnaissance missions from this base to keep an eye on the movements in the Indian Ocean and the strategic Straits of Malacca in its eastern flank. Long back, India's strategic thinker, K.M. Panikkar had said that 'the Gulf of Malacca is like the mouth of a crocodile, the Peninsula of Malaya being the upper and the jutting end of Sumatra being the lower jaw. The entry to the Gulf can be controlled by the Nicobars and the narrow end is dominated by the island of Singapore.'[40] It may be of interest to mention here that India's escort missions for the US ships in 2002 were undertaken by its ships anchored in Singapore. Besides being a full-fledged military base, Andaman and Nicobar will also have major facilities for hosting commercial traffic in the region.[41]

Besides building defence cooperation, the LEP has also helped India to get its own security needs better understood in the region. May 1998, when Pokharan-II (the test explosions of five nuclear devices) took place, the Western members of the ARF as well as Japan and Australia expressed strong reservations and disapproval, and imposed sanctions on India. These reservations have since melted away and both Japan and Australia are trying their best to make for the lost time and opportunities in India. The ASEAN countries showed considerable understanding, at least informally through bilateral diplomatic channels, of India's security predicament. A number of ASEAN members are willing to support India's permanent membership of the UN Security Council (UNSC). Understanding has also been shown to India's position during the Kargil conflict and the persisting challenge of cross-border terrorism to India's stability and political harmony. Thanks to the 9/11 events, today India's concern with regard to cross-border terrorism is also better understood and appreciated among its eastern neighbours. The India-ASEAN Joint Declaration For Combating Terrorism, signed in October 2003, brings the two sides closer in this new area of security and commits them to 'counter, prevent, and suppress all forms of terrorist acts.'[42] Terrorism has since continued to be an important theme in India's discussions with the countries as also in the regional groupings in the Southeast Asian region. It may not be out of place here to mention that the strategic thrust in the

[40] K.M. Panikkar, *The Strategic Problems of the Indian Ocean* (Allahabad, 1944), p.21.
[41] Ravi Velloor, *The Straits Times* (8 September 2010).
[42] Text of 'ASEAN-India Joint Declaration For Cooperation To Combat International Terrorism', ASEAN Secretariat, www.aseansec.org/15276.htm. Accessed on 25 January 2011.

second phase of India's LEP was prompted by not only India's declaration as a nuclear weapons state but also its concern for the growing menace of terrorism.

Challenges and Prospects

Any objective assessment of nearly the past two decades of India's LEP would suggest that while notable progress has been made, there is still a long way to go and tremendous potential remains to be harnessed. The East Asian spread is vital for India's economic progress and security needs. It can be a vehicle for India's greater Asian identity and provide a constructive outlet to such of its energy and aspirations that cannot be absorbed in the South Asian neighbourhood alone. This region is also emerging as the key theatre for the intense interplay of the forces of globalisation that will affect the texture and contours not only of Asian, but even of world politics. The security significance of this region has been further reinforced in the context of '9/11 events' and the global war on terrorism, as India is also one of the most seriously affected victims of this menace. Reports about Al-Qaeda and *Jihadi* forces having links in the whole of Southeast Asia surface frequently. With the Islamic rebellions of differing intensity raging in various countries of the region like Indonesia, Philippines, Thailand and Myanmar, the threat of 'global *jihad*' linking up with regional extremists will continue to loom large on the region. The unfolding nexus between Pakistan and North Korea, with the possible connivance of China, in the nuclear and missile field needs to be watched carefully from India's wider security interests in the region. India's Defence Minister A.K. Antony's visit to South Korea in (2-3) September 2010 has given further momentum to defence cooperation between the two countries. It is of interest to note here that while Pakistan has become a member of the ARF, it is excluded, along with North Korea, from the EAS and the ADMM + 8.

The challenge for India's LEP comes from three areas – (1) the rise of China; (2) the fluid strategic triangle of India, China and the US; and (3) the capabilities and drive of the policy establishments at home. The LEP will accordingly be shaped by the way India deals with these challenges. In many subtle and explicit ways, India's LEP has been driven by China's rise. China has much deeper economic engagements with India's eastern neighbours and these engagements are going to get stronger. Many of these neighbours find their engagement with China to be mutually beneficial, notwithstanding occasional reservations. India is not in a position to match this and can never provide alternative support to them. The countries of Southeast Asia want to keep India, and other countries engaged in the region in order to have a comfortable regional balance. The problem would however arise if and when China starts asserting itself on these countries. The instance of China's gradually growing assertion in South Asia and also in the

South China Sea region may be kept in view.[43] As this assertion increases, India's presence in the region may come under pressure. It must be kept in mind that while economic cooperation between India and China is growing, the strategic competition and rivalry between the two is also getting sharpened as well.

Asia's most critical strategic triangle is the one constituted by India, the US and China. The strategic relationships between these three major Asian players are in a flux, transiting through the realm of uncertainty and anxiety. These relationships cannot be assumed at any time to be completely free from competition and tensions.[44] China is particularly worried about any move towards greater strategic understanding between India and the US aimed at constraining China's emerging strategic presence and stake in the region. Accordingly, China will contest and resist any strengthening of the US-India strategic equation, particularly in the context of Southeast Asia. China will, in that case, exploit the vulnerabilities and weaknesses in India's relations with its neighbours in South and Southeast Asia. Indian Prime Minister Dr Manmohan Singh's worries on China's expanding role in South Asia and the Chinese response to reiterate its interest in South Asia may be seen in this context.[45] Also, as China consolidates its strategic presence in Southeast Asia, it will impinge on the US stakes and influence, which Washington will resist. The sharpening of US-China rivalry for strategic influence will create a dilemma for India in terms of maintaining a proper distance between the two, which seems to be the crux of India's policy at present.

Lastly, the challenge comes from India's own policy front. In order to exploit the full potential of cooperation with the extended eastern neighbourhood, India has to improve its economic performance. The World Bank and other international economic institutions are hopeful of the Asian growth being led by Indian and Chinese economies. But for that, the pace of reform in financial and manufacturing sectors, and bureaucratic procedures has to be streamlined. Inadequate coordination between various concerned departments and ministries, like External Affairs, Commerce, Defence, Finance, etc., has cost India dearly in the past. The Economic Ministries need to develop a strategic perspective in harmony with the broader national strategic profile and interests in different regions of the world. India has to shed whatever hesitation it has on the question of expanding and upgrading transport linkages through air and road with the

---

43 Also, Joshua Kurlantzick, 'Avoiding a Tempest in the South China Sea,' Expert Brief, *Council on Foreign Relations* (2 September 2010), www.cfr.org/publication/22858/avoiding-a-tempest-in-the-south-china-sea.html. Accessed on 25 January 2011. Also see, Annual Report to Congress, Military and Security Developments Involving the People's Republic of China 2010, Office of the Secretary of State, Department of Defence, United States of America (2010).

44 Xiao Xiong Yi, 'Tensions Mount in Asia, as China Rise' (25 August 2010), www.defence.pk/forums/world-affairs/70527-tensions-mount-asia-china-rises.html. Accessed on 25 January 2010.

45 Prime Minister Manmohan Singh expressed these concerns in his briefing to the Indian editors on 6 September 2010, and the Chinese response came from the official spokesman on foreign affairs in Beijing, *The Hindustan Times* (7 September 2010).

eastern Asian region. Then Prime Minister Vajpayee's offer during the Bali Summit of October 2003, of a unilateral 'open skies' policy to selected Southeast Asian airlines, India's proposal to have a railway line connecting India's northeast with Vietnam, and the flagging off of a car rally in December 2004 in the region, are firm indications that India is conscious of the challenge of its LEP. In April 2008, India signed the 'Kaladan Multi-Modal Transport Project' to firm up connectivity with Myanmar. Energy and information technologies are emerging as significant areas of cooperation with some of the Southeast Asian countries. India's economic diplomacy will have to gather dynamism and evolve constructive resilience to reap desirable benefits in these areas. This task cannot be accomplished by solely articulating a sound policy, but will also require concerted and focused action at the administrative as well as entrepreneurial levels. For instance, in defence productions and sales, private sector is being gradually involved and procedures are streamlined to ensure that commitments made to the friendly countries are efficiently executed.

There is considerable scope to activate India's cultural diplomacy to provide necessary backup to its economic initiatives and strategic moves in the region. India's rich cultural heritage can ring many sympathetic cords in the region and its multi-religious, secular and democratic ethos, as well as rich music, arts and architecture, theatre and cinema have huge responsive constituencies in all the near and extended eastern neighbours. In fact Bollywood (cinema) and cultural exchanges, like that of the *Ramayana* troupes can work wonders in pursuing cultural diplomacy. Bollywood presence is extensively evident in Southeast Asian countries, but that is mostly commercially motivated and privately provided without any systematic and planned encouragement from the state. These areas have no conflicting edges. A carefully planned and sustained cultural diplomacy can speed up economic engagement and yield impressive results in the field of people to people relations and mutual political understanding. This cultural diplomacy can also be backed up by promoting cooperation in the field of education, science and technology, where India has notable assets and strengths. In many Southeast Asian countries, Indian diplomacy has not adequately reached educational and cultural establishments and ignored mobilising civil societies in pursuance of India's perceived interests. It is hoped that the projects like the revival of Nalanda University in collaboration with East Asian countries, for which Indian Parliament adopted a Bill in August 2010, will fill some of this gap.[46] Educational links can provide a lasting and powerful stimulus to regional cooperation and integration.

. . . . .

[46] S.D. Muni, 'Nalanda: a soft power project', *The Hindu* (31 August 2010).

ISAS Working Paper

No. 122 – 10 February 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Pakistan after the Floods: Prospects for Stability and Democratic Consolidation

Ian Talbot[1]

Abstract

This paper uses the summer floods of 2010 as a lens to examine Pakistan's worsening economic, security and governance issues since the February 2008 elections. It initially explains the background to the inundations which displaced 20 million people, caused massive damage to infrastructure and threatened to suppress an already sluggish economic rebound from the world recession. The politicisation of the circumstances surrounding flooding is discussed along with its historical significance. The paper then reveals how the natural disaster exacerbated the multi-faceted challenges facing the Pakistan Peoples Party (PPP)-led coalition. It also discusses the political impact of President Asif Ali Zardari's absence from the country at the time of the national calamity. The paper also lays bare the fact that the Government had inherited a declining economic and security situation from the Musharraf era and then that structural economic and governance problems can be traced back to much further in Pakistan's history.

Introduction

The devastating floods that hit Pakistan on the closing days of July 2010 eclipsed all previous natural disasters facing the country. These include the devastating 2005 earthquake in Azad Kashmir and Cyclone 'Bhola', which ripped through East Pakistan in November 1970. While the deaths attributed to the floods were on a much smaller scale with around 1,500 casualties in 2010 compared to the 350,000 in 1970, the extent and scale of the damage brought by the

---

[1] Professor Ian Talbot is Professor of History at the University of Southampton and the Head of Department and Director of the Centre for Imperial and Post-Colonial Studies, United Kingdom. He can be contacted at iat@soton.ac.uk. The views reflected in the paper are those of the author and not the institute.

torrents of the Indus River was unprecedented. The floods affected a fifth of Pakistan's land mass. As the floods made their way southwards, they affected 20 million people, destroyed around 875,000 homes and damaged around US$1 billion in crops.[2] The destruction by Cyclone 'Bhola' had been around US$1 billion in an overall total. Shortly after this disaster followed the political convulsions which culminated in the breakaway of East Pakistan. Some commentators drew parallels between 1970 and 2010 and talked apocalyptically about the collapse of Pakistan.[3]

This was undoubtedly an over-reaction, but the disaster and the response to it not only exacerbated structural economic weaknesses, but laid bare the fragility of governance and the trust deficit existing between the PPP-led coalition government, its own populace and the international community. This was seen in the low take-up of the President's Flood Relief Fund and the channelling of international aid through NGOs (non-governmental organisations) and UN (United Nations) agencies rather than the Pakistan Government and in the slow take-up of the US$460 million UN emergency relief appeal. Moreover, the army's role in meeting the disaster once again revealed that it is the strongest and most effective state institution. Even before the floods, the army had recovered the prestige it had lost during the end of the Musharraf era. A study from the Pew Research Center in the United States (US), revealed growing approval ratings for the army with 84 per cent of those surveyed expressing positive views, compared with 68 per cent in 2007.[4] The recovery in the army's popularity reflected not just the 'professional stance' taken by its Commander-in-Chief Ashfaq Parvez Kayani but its role in combating militancy. On the eve of the floods, President Zardari's poll standing had already declined dramatically from the 2008 high point. His absence from Pakistan as the floods took their grip and the Federal Government's inability to deal with the natural catastrophe made him appear still more aloof from the people, therefore further weakening his standing with respect to the army.

This paper seeks to reveal, firstly, how the flood disaster has laid bare the failures of governance in Pakistan; secondly it assesses its consequences in the context of ongoing political, economic and security problems. Before turning to these issues, however, it is necessary to set the disaster in its context and to reflect briefly on its causes.

The 2010 Floods: Context and Consequences

The Indus and its tributaries overflow in most monsoon seasons as a result of rainfall and glacier melt. The newly renamed Khyber Pakhtunkhwa province (previously the North-West

---

2 This figure was quoted by the World Bank President Robert Zoellick in *Dawn* (14 August 2010), http://news.dawn.com/wps/wcm/connect/dawn-content-library/dawn/news/pakistan/04-crops-destroyed-pakistan-1-bln-qs-11. Accessed on 15 August 2010.

3 For a criticism of this view see, Zubeida Mustafa, 'How Pakistan Survives', *Dawn* (18 August 2010), http://www.dawn.com/2010/08/18/ina-overtakes-japan-by-david-teather.html. Accessed on 19 August 2010.

4 *Dawn* (2 August 2010), http://dawn.com. Accessed on 2 August 2010.

Frontier) is especially vulnerable to flash floods. These have been exacerbated by deforestation in recent years. The floods gush a large volume of water at speed downstream. There have been 12 serious floods since 1973, which have cost over 7,500 lives and drowned roughly 99,000 village settlements.[5] The July-August 2010 floods were so unprecedented that they were regarded as a once in a lifetime occurrence. They came in the wake of erratic monsoon rains, which in the previous year had been 30 per cent below average. The drying up of river beds in Sindh and parts of South Punjab had encouraged encroachment on them which increased the vulnerability to flooding of large populations who did not have the benefit of early warning flood management alarms.[6] The only flood warning system in Pakistan was that installed with Japanese assistance at Nullah Leh in Rawalpindi.[7]

The cause of the flooding was the unprecedented seventy two hours of rain over the Khyber Pakhtunkhwa province and Azad Kashmir at the end of July. Khyber Pakhtunkhwa was to receive four times its average monsoon rainfall in a ten-day period beginning 28 July 2010 (3,462mm of rain). This created flash floods from the Kabul and Swat rivers and the inundation of the Swat valley. It meant that if the system of barrages and barriers did not hold there would be widespread flooding downstream the Indus and Jhelum rivers. The overwhelming of the Taunsa Barrage followed by breaches in the Muzaffargarh and Taunsa-Panjnad (TP) Link canals was a key factor in the disaster in the Muzaffargarh district, the worst affected district of Punjab with over 2.5 million people displaced and hundreds of villages destroyed. This devastation sparked off debate about engineering faults, the desirability for more dams and barrages, the criminality of the Irrigation Department in the failure to keep up embankments and the fact that some flood protection schemes existed only on paper.[8] Much of the debate was about blame displacement and apportionment. It was clear however that the silting of canals and riverbeds raising their height was a factor in the disaster. There were also the usual round of flood time complaints that officials had deliberately breached canals and embankments to save urban centres by directing the waters towards rural localities in Upper Sindh. When the floods encroached further in Sindh, the claim was made that some feudal landowners had directed flood flows away from their own properties even if this meant inundating the fields and homes of poorer populations.[9] Inter-provincial tensions were provoked between Balochistan and Sindh following the flooding of Dera Allah Yar and the surrounding Jaffarabad district, with Baloch authorities claiming that their Sindhi counterparts had breached canals and embankments so that the waters were diverted in their direction.[10]

---

5 *Dawn* (3 August 2010), http://dawn.com. Accessed on 3 August 2010.

6 For more details see, Khawar Ghumman, ‘Occupation of Riverbeds blamed for flood havoc’, *Dawn* (21 August 2010), http://news.dawn.com/wps/wcm/connect/dawn-content-library/dawn/the-newspaper/front-page/occupation-of-riverbeds-blamed-for-flood-havoc-180. Accessed on 22 August 2010.

7 *Dawn* (19 August 2010), http://dawn.com. Accessed on 20 August 2010.

8 See *Dawn* (13 and 16 August 2010), http://dawn.com. Accessed on 17 August 2010.

9 *Dawn* (16 August 2010), http://dawn.com. Accessed on 16 August 2010.

10 See the article by Saeed Shah, ‘New Wave of floodwater threatens Pakistan’, *The Guardian* (15 August 2010), www.guardian.co.uk/world/2010/aug/15/pakistan-floods-ban-ki-moon-response. Accessed on 16 August 2010.

Economic Crisis

The floods not only necessitated a huge rescue and relief operation but, according to economic commentators, threatened to undermine Pakistan's halting recovery from the 2009 recession. Some estimates were that up to two percentage points could be taken off the projected growth rate in GDP (gross domestic product) by 4.5 per cent. In addition to the damage to an already weak infrastructure and the worsening of the power supply situation, standing crops of rice and cotton were destroyed in Punjab and Sindh. In Punjab alone over 1.6 million acres of crops had been inundated.[11] It was reported that in the major cotton growing district of Rahim Yar Khan, the crop could be 20 per cent less for the year 2010-11 than preceding years.[12] This would impact unfavourably on the textile industry, which is crucial to Pakistan's exports. While estimates of a slowdown in the growth of GDP may prove to be exaggerated, it does seem clear that Pakistan's performance in 2010-11 may be barely sufficient to keep pace with the country's projected population increase and additional labour employment demands. The increase in population at around 2.4 per cent is the same as the annual increase in the working-age population.[13] It seems clear that the gap between Pakistan's economic performance and its regional rival India will further widen.

The flood disaster represents yet another setback for the PPP-led government, which had inherited a declining economic situation in 2008. Debt rescheduling and relief together with a massive influx of foreign investment and remittances from overseas Pakistani workers had fuelled an unsustainable consumption-led boom in the post 9/11 period. Pakistan's GDP grew at an annual average rate of 6.1 per cent in the five years up to 2005-06.[14] President Musharraf and his technocratic Prime Minister Shaukat Aziz had taken the credit for the rapid economic growth. While they encouraged external capital flows, they did not address long-term problems such as pathetically low taxation rates, an export sector highly dependent on textiles and low levels of human development. Warning signs of increasing budgetary debt and pressure on foreign exchange reserves were ignored by the Musharraf regime, which faced mounting political opposition and a deteriorating security situation from 2006-07 onwards. The external impact of rising commodity prices increased indebtedness as the state continued to provide fuel and food subsidies. By the time of the February 2008 polls, the economic growth of the earlier Musharraf era was over.[15] Pakistan's security and economic crises were also becoming more closely interlinked. Direct foreign investment was declining, while the rising tide of suicide bombings was not only taking a toll on human life, but on infrastructure and employment opportunities. As the militant writ extended in north-western Pakistan, both boys and girls saw their education disrupted.

---

[11] *Dawn* (13 August 2010), http://dawn.com. Accessed on 13 August 2010.
[12] *Dawn* (18 August 2010), http://dawn.com. Accessed on 18 August 2010.
[13] Hilary Synnott, *Transforming Pakistan: Ways out of Instability* (Abingdon: Routledge, 2009), p.81.
[14] *Ibid.* p.56.
[15] *Ibid*. Pakistan's GDP reached the peak of 8.6 per cent in 2004-05.

The new PPP-led government remained pre-occupied with the post-election political struggle involving the Pakistan Muslim League Nawaz (PML-N) and the role of the President. It underestimated the growing economic crisis. By the autumn of 2008, rising oil prices had created a spike in inflation which peaked at over 25 per cent; foreign investment declined as the international banking crisis hit; the depreciation of the Pakistani rupee and the collapse of exports at a time of increasingly costly food and energy imports raised the prospect of Pakistan defaulting on its external debt.[16] Foreign exchange reserves had fallen by November 2008 to only around US$3.4 billion – that was just one month's worth of imports.[17] President Zardari had to reverse his earlier public stance and seek support from the International Monetary Fund (IMF). Stabilisation occurred with the current account deficit narrowing from 8.5 per cent of the GDP for fiscal year 2007-08 to a projected 2.0-3.0 per cent for 2009-10. The budget deficit also narrowed and inflation dropped from its 25 per cent peak in November 2008 to 13 per cent. The improved economy saw an upturn in portfolio investment.

Nonetheless, even before the major setback of the 2010 flood disaster, the security situation acted as a drag on the economy, which did not match the bounce back of other Asian economies from the world recession. Unless growth accelerates, unemployment and poverty will rise at a time of high interest rates and austerity programmes designed to meet the IMF conditions. This situation resembles that of the last democratic interlude of the 1990s.[18] The IMF mission led by the Assistant Director for Middle East and Central Asia, Adnan Mazeri, in mid-July 2010, expressed concern over uncontrolled expenditure, rising inflation, slow revenue reforms and poor performance in the power sector.[19]

The current economic problems, while they were exacerbated initially by the security situation and the credit crunch and recession and subsequently by the flood disaster, must be understood in terms of the country's long term structural weaknesses. They include the following.

1. A lack of diversification in exports
2. A very low tax base (at present only around two per cent of the population pays direct taxes)
3. Diversion of resources from development to defence

[16] For the rapid decline in Pakistan's 2008 account see, *Dawn* (23 October 2008), http://dawn.com. Accessed on 24 October 2008; and Robert Looney, 'Failed Take-Off: An Assessment of Pakistan's October 2008 Economic Crisis Pakistan', *Pakistan Security Research Unit (PSRU) Brief*, No.46 (21 April 2009), http://spaces.brad.ac.uk:8080/download/attachments/748/Brief+46.pdf. Accessed on 31 January 2011.

[17] In July 2007, they had stood at US$13.3 billion. See Hilary Synnott, *Transforming Pakistan: Ways out of Instability* (Abingdon: Routledge, 2009), p.83.

[18] William B Milam, *Bangladesh and Pakistan: Flirting with Failure in South Asia* (London: C. Hurst and Co, 2009), p.137.

[19] 'IMF Concerned over Rising Expenditure, Inflation', *Dawn* (19 July 2010), http://dawn.com. Accessed on 19 July 2010.

4. The resulting low level of human capital and an uncompetitive labour force
5. Uneven development between social classes, regions and rural-urban centres
6. Deteriorating infrastructure and institutional decay

These long-term structural deficiencies reflect the political and economic trajectory of the country followed since independence. Ayesha Jalal summed this up as a commitment to a political economy of defence, rather than a political economy of development.[20] The resulting economic imbalances feed contemporary ethnic and Islamic militancy.[21] Democratic rule since 2008 has seen an increase in military expenditure rather than it being reined in. The defence budget for 2010-11 has been set at an astronomical 442.2 billion Pakistani Rupee. Rising defence costs have been incurred in the military operations in Malakand and the tribal areas. According to official estimates, Pakistan has faced increased expenditures amounting to US$43 billion in combating militancy and terrorism in the period from 2001-2010.[22]

Today, just as throughout Pakistan's history, the requirements of military expenditure alongside those of debt servicing leave little available for social expenditure in a constrained tax environment. Public expenditure on education as a percentage of the GDP, stands at just two per cent according to the Pakistan Economic Survey 2009-10, and compares poorly with such neighbouring countries such as India (3.3 per cent) and Bangladesh (2.6 per cent).[23]

While low educational expenditure undermines Pakistan's long-term democratic prospects, in the short-term, these are damaged by the high cost of commodities for the common people, with inflation remaining at around 13 per cent, and the continuing interruptions in power supply which have brought people onto the streets. Energy shortages also limit the economic growth required to raise people out of poverty.[24] The flood disaster, with the closing down of the Kot Addu power plant in Muzaffargarh, intensified the problems of energy production. Shortfalls in both electricity and gas supplies, resulting in blackouts, threaten both economic growth and political stability.

The PPP-led government has introduced such populist measures as the Benazir Income Support Scheme, but has not tackled the long-term causes of poverty. The radicalism of the late 1960s has long been abandoned and the party under Asif Ali Zardari's leadership is even more conservative and managerial than it was under his late wife. Necessary measures of

[20] She links this commitment to the responses to the post-partition dislocation and the emerging conflict with India over Kashmir. See Ayesha Jalal, *The State of Martial Rule: The Origins of Pakistan's Political Economy of Defence* (Cambridge: Cambridge University Press, 1990), pp.55, 60, 140-1.

[21] Baloch nationalism is rooted in a sense of economic exploitation and political marginalisation. For the encouragement to shariatisation arising from poverty, corruption and lack of social justice see, Farzana Shaikh, *Making Sense of Pakistan* (London: C. Hurst and Co, 2009).

[22] *Dawn* (13 June 2010), http://dawn.com. Accessed on 13 June 2010.

[23] Khawar Ghumman, 'Only Two Per Cent of GDP Spent on Education', *Dawn* (5 June 2010), http://dawn.com. Accessed on 5 June 2010.

[24] According to the 2009-10 Economic Survey, energy shortages caused a loss of two per cent of GDP during the current fiscal year. Kabir Ali, 'Power Crisis caused over 2pc of GDP Loss', *Dawn* (5 June 2010), http://dawn.com. Accessed on 5 June 2010.

land and agricultural tax reform remain unlikely from a government headed by feudal landowners.

Security Crisis

As with the economy, so with the security situation, the newly elected government inherited a sharply deteriorating position from the Musharraf era. Musharraf's attempt to distinguish between 'foreign' and 'home grown' militants, and between those engaged in the 'freedom struggle' in Kashmir and those committed to other *jihadist* causes, had been modified in the face of US and Afghan Government pressure and in the wake of the Pakistan-based Lashkar-e-Taiba (LeT) and Jaish-e-Mohammad (JeM) attack on the Indian Parliament in Delhi in December 2001.

Sectarian and ethnic violence and insurgencies have occurred throughout Pakistan's post-independence history. Two new developments in the Musharraf era were the rising tide of suicide bombings after 2006 and the engagement of the Pakistan army in the Tribal Areas for the first time. The Pakistan military and security apparatus found itself increasingly fighting erstwhile militant proxies. The conflict intensified following the commitment of Pakistan troops against the militant dominated *Lal Masjid* (Red Mosque) in central Islamabad in July 2007.

The 2008 elections, although preceded by the shocking assassination of Benazir Bhutto, were accompanied by a lull in the suicide attacks and passed off peacefully. The resurgence of the ethnic Pashtun Awami National Party (ANP) raised hopes that more sustained dialogue could bring peace to the tribal areas. There had been short lived peace agreements in the Musharraf era. These hopes were not to be fulfilled as the state became drawn into increasing conflict in the tribal areas. The military intervention from 2009 onwards, however, was on a far greater scale than that of the Musharraf era. The militants responded with increased suicide attacks in Pakistan cities.

The decision to launch a large-scale military offensive was prompted by the deteriorating situation in the Malakand Division. Politicians and public alike began to see that the writ of the state was being undermined and that militancy was not just an external problem – the result of US intervention in Afghanistan – but it posed a threat to Pakistan's existence. One should not however overplay the new national unity of purpose in security matters trumpeted by the PPP-led government. For as later surveys have revealed, while there is widespread hostility to the Tehrik-e-Taliban Pakistan (TTP, or Pakistan Taliban), sectarian groups and militants which have for a long time been associated with the Kashmir *jihad*, continue to enjoy support.[25]

[25] Asad Hashim, 'Public Support for Militancy', *Dawn* (22 June 2010), http://dawn.com. Accessed on 22 June 2010.

The TTP was formed in December 2007 and brought together several groups under the leadership of Baitullah Mehsud who based his power in South Waziristan. Mehsud was claimed by the state to be the instigator of numerous suicide attacks, including the assassination of Benazir Bhutto. The TTP is not a monolithic organisation, but rather coordinated the activities of existing radical Sunni groups. After the post-election lull, a new upsurge in activity began from the end of 2008. It was focused in Swat, a former princely State, which was now part of the settled area of the North-West Frontier Province (NWFP).

As with Pakistan's contemporary economic problems, the problems in Swat can only be fully understand in terms of historical background. It was not the TTP but a local radical Sunni organisation, the Tehrik-e-Shariat-e-Muhammadi (TNSM), created in 1989 by Maulana Sufi Muhammad, which was at the forefront of a violent struggle to impose *shariah* law in the region. The TNSM had engaged the state before in a mini-insurgency in 1994-95. Its cadres had later fought alongside the Afghan Taliban during the US-led invasion in 2001.

The Malakand insurgency included both TTP and TNSM participation. The Swat Taliban was in fact led by Maulana Fazlullah, the son-in-law of Maulana Sufi Muhammad. He made use of a controversial FM radio station to propagate his demands, which included the introduction of *shariah* law. The organisational headquarters of his movement was based in his Inam Dheri seminary. The contemporary insurgency was more ruthless than that of the 1990s but similarly sought to challenge the writ of the state by targeted attacks on government installations. Suicide bombings formed a new element, leading to scores of deaths as for example in the attack on a police station at Charbagh on 23 August 2008.

An agreement was signed between the NWFP government and militants led by Maulana Fazlullah on 21 May 2008. The agreement provided for the establishment of official *shariah* courts. It was hailed as bringing permanent peace, but was seen by the militants as a sign of weakness. Not only was their interpretation of *shariah* law brutally imposed, but Swat was seen as a launching pad for the further extension of a Taliban-run state. The Taliban's violation of the agreement and the movement of militants into the neighbouring districts of Buner and Lower Dir formed the backdrop to the military operation ordered by the PPP Prime Minister Yousaf Raza Gillani on 7 May 2009. Hundreds of thousands of civilians were displaced in fighting which according to government figures claimed over 400 military casualties and 4,000 militants.[26]

Military operations were extended into the South Waziristan base of the TTP in October 2009. Unlike in the earlier half-hearted operations in 2004, which led to the first of a number of peace accords, none of which succeeded, the army made unexpectedly rapid progress in its operation code named Rah-e-Nijaat (Path to Salvation). Success was dependent on isolating

[26] Hilary Synnott, *Transforming Pakistan: Ways out of Instability* (Abingdon: Routledge, 2009), p.94.

the pro-Baitullah group from other militant organisations in the region.[27] The TTP had also been disrupted by Baitullah's death in a US missile attack on 5 August 2009. Within twenty days, the army had seized all the major towns and villages. Militants, rather than choosing to stand and fight, disappeared into neighbouring North Waziristan. At the same time they opened up a new front with a wave of suicide bombings in Peshawar, which by December 2009 had also spread to Rawalpindi and Lahore. These attacks continued into 2010.

According to the National Crisis Management Cell of the Interior Ministry, 1,835 people lost their lives and 5,194 suffered injuries in the 1,906 terror attacks, which occurred in 2009-10.[28] The continuing security crisis led a US index, published in *Foreign Policy* magazine in June 2010, to rank Pakistan as the tenth most failed state in the world, just three places below Afghanistan in a list headed by Somalia.[29] Earlier in the month, the US State Department's Global Peace Index placed Pakistan as the world's fifth most unstable country after Iraq, Somalia, Afghanistan and Sudan, recording a second year's successive fall in scoring and rank.[30] The Pakistan Government increasingly considered an extension of security operations to North Waziristan. This was the base of a number of militant groups including the Haqqanis, who, according to the US, had links with Al-Qaeda and were at the forefront of the insurgency in eastern Afghanistan. It had already undertaken operations in the Bajaur Tribal Agency. More controversially, it also raised the possibility of the army conducting operations in South Punjab as evidence mounted that bombings were being undertaken not just by militant organisations based in the tribal areas, but by members of banned sectarian organisations operating from the latter region.

The PML-N government of Punjab denied the existence of a Punjabi Taliban. But growing terrorist attacks in such cities as Islamabad, Rawalpindi and Lahore led Western and Pakistani journalists to talk of a Punjabi Taliban[31] at the end of 2009. This was linked for example to the suicide attack on the Marriott Hotel in Islamabad in September 2008, which claimed over 50 lives, and the audacious attack on the army's headquarters in Rawalpindi in October 2009.[32] The Punjab Taliban was analysed as a loose network comprising primarily the banned Sipaha-e-Sabha Pakistan (SSP), Lashkar-e-Jhangvi (LeJ), and JeM organisations which had previously focused their activities on Kashmir and domestic sectarian violence.[33]

[27] See Sayed Bokhari, 'The Battle for Waziristan', *Dawn* (18 October 2009), http://dawn.com. Accessed on 18 October 2009.
[28] Iftikhar A. Khan, 'Defence Claims Rs442bn', *Dawn* (7 June 2010), http://dawn.com. Accessed on 7 June 2010.
[29] 'Pakistan Ranks 10th Among "Failed States"', *Dawn* (22 June 2010), http://dawn.com. Accessed on 22 June 2010.
[30] 'Pakistan Ranked Fifth Most Unstable Country', *Dawn* (13 June 2010), http://dawn.com. Accessed on 13 June 2010.
[31] For a discussion of the utility of this term see, Katja Riikonen, '"Punjabi Taliban" and the Sectarian Groups in Pakistan', *Pakistan Security Research Unit (PSRU) Brief*, No.55 (12 February 2010).
[32] See, Mohammad Asghar and Iftikhar A. Khan, 'Brigadier, Lt-Colonel among 6 army-men killed: Hostage Saga Continues: Audacious Attack Rocks GHQ', *Dawn* (11 October 2009), http://dawn.com. Accessed on 11 October 2009.
[33] See Hassan Abbas, 'Defining the Punjabi Taliban Network', *CTC Sentinel* (2-4 April 2009), pp.1-4.

While the 'Punjabi Taliban's' attacks intensified with the commencing of military operations in South Waziristan in October 2009, the new orientation of SSP, LeJ and JeM again must be understood in a longer term historical context. These groups did not attack the state's security apparatus before the 2007 army assault on the Red Mosque in Islamabad.[34] The Punjab-based LeT stood aloof from the network and refrained from attacking the Pakistan security forces. While its headquarters were in central Punjab, SSP, LeJ and JeM traditionally gathered support in the South Punjab region.[35] Like LeT, they had benefited from the support of the country's intelligence services in the context of the 1990s Kashmir insurgency and the Zia regime's earlier sponsorship of Sunni Islam in the wake of the Iranian Revolution.

The five 'core' South Punjab districts of Dera Ghazi Khan, Rajanpur, Bahawalnagar, Bahawalpur and Rahim Yar Khan have all figured prominently in journalistic accounts of the 'Punjabi Taliban'. Dera Ghazi Khan was the scene of a major sectarian bomb blast early in February 2009 where investigations revealed links between local supporters of SSP and the then TTP leader Baitullah Mehsud. Its strategic situation abutting troubled South Waziristan and Balochistan and the presence of nuclear production facilities raised western concerns about the region's 'Talibanisation'.

How can we account for the impact of militancy in South Punjab? This region is undoubtedly poorer than other parts of Punjab. The Dera Ghazi Khan and Rajanpur districts are third and first respectively for caloric poverty in rural Punjab.[36] Nonetheless, their position is relatively good with respect to most of Balochistan, Sindh and the NWFP. If poverty alone was the determinant of militancy, this should have been focused on the interior of Sindh, yet it has no purchase there.

Taking a cue from the connections between Pakistan's religious schools (*madaris*) and militancy, some analysts pointed to the proliferation of Deobandi *madaris* from the 1980s onwards in such districts as Dera Ghazi Khan, Rahim Yar Khan, Bahawalpur and Bahawalnagar.[37] According to 2008 Intelligence Bureau estimates, the Rahim Yar Khan district has 559 *madaris* followed by Bahawalpur (481) and Bahawalnagar (310).[38]

See P.K. Upadhyay, 'From FATA to South Punjab: The Looming leap of Islamic Radicalism in Pakistan', *Institute for Defence Studies and Analyses (IDSA) Comment* (30 November 2009), www.idsa.in/idsacomments/IslamicRadicalisminPakistanFromFATAtoSouthPunjab_pkupadhyay_301109. Accessed on 10 February 2011.

[35] There are a number of differing classifications of the Punjab's regions, depending on such factors as administrative and geographical boundaries, agronomic and cultural zones. The smallest area defined as South Punjab includes the four districts of Bahawalnagar, Bahawalpur, Dera Ghazi Khan and Rahim Yar Khan. The most comprehensive includes along with the previous, the Bhakker, Jhang, Khanewal, Layyah, Lodhran, Multan, Rajanpur and Vehari districts.

[36] Safiya Aftab, 'Poverty and Militancy', *Pips Journal of Conflict and Peace Studies*, Vol.1, Issue.1 (October-December 2008), p.82.

[37] Ayesha Siddiqa, 'Terror's Training Ground', *Newsline* (September 2009), www.newslinemagazine.com/2009/09/terror%e2%80%99s-training-ground. Accessed on 21 January 2011.

[38] *Ibid.*

Bahawalpur has the greatest concentration of mosques of any Punjabi city apart from Lahore. One factor in the mushrooming of these mosques and religious schools in South Punjab is the traditional influence of Sufi Islam in the region. This shrine cult is regarded as un-Islamic by Deobandis who have focused their efforts in the region to counter it. In April 2009, there were press reports of JeM activists attempting to take over Barelvi mosques associated with Sufi Islam in the Bahawalnagar, Bahawalpur and Rahim Yar Khan districts. Sufi shrines have been targeted elsewhere in Pakistan. Sufi shrines have been blown up in the Frontier and the famous Sufi shrine of Hazrat Datta Ganj Baksh in Lahore was the scene of a deadly suicide attack at the beginning of July 2010.

One should not however attribute militancy in this region solely to the rise of Deobandi influence. Work by Andrabi, Fair and Rahman elsewhere in Pakistan has revealed that, as with the linkage between poverty and militancy, so too the *madrassah*-militant connection needs to be nuanced. Existing estimates of enrolment in *madaris* have been inflated; not all of their students are poor and only a small number lend encouragement to militancy; public schools as well as *madaris* foster attitudes supportive of *jihadi* groups.[39]

While recent attention has focused on the spillover of militants from South Waziristan into Dera Ghazi Khan, the early 1947 partition-related migration offers a fascinating, although as yet, unexplored insight into militancy. It is clear that in such localities as Bahawalpur, it is not the indigenous population, but Indian migrants who provide the main support for Deobandi institutions. Work on the SSP in Jhang has shown that in this region of central Punjab, migrant populations who are excluded from power by the Shia feudal landholding elites support the radical Sunni cause.[40] Undoubtedly sectarianism and support for the Kashmir *jihad*, which is popular amongst migrants from India provide the basis for radicalisation. This is in all probability the case in South Punjab, although Sunni radical sectarianism is directed not just against Shias but Barelvis. Militant recruiters have a large pool to work with, as migrants from India make up around 50 per cent of the population of Dera Ghazi Khan City. Much work is required on this, but what we do know at present is that, the founder of JeM in 2000, Maulana Masood Azhar[41] was born in the old city of Bahawalpur. Like Hafiz Muhammad Saeed, the leader of LeT, Masood Azhar's family were partition migrants from India in 1947. Although JeM has been banned since 2001, it maintains a strong presence in the city where it has its Dar al Jihad headquarters.

---

[39] T. Andrabi *et al*, 'Religious School Enrolment in Pakistan: A Look at the Data' (Washington: World Bank, 2005); C. Fair, 'Militant Recruitment in Pakistan: A New Look at the Militancy-Madrasah Connection', *Asia Policy*, Vol.4 (July 2007), pp.107-34; Tariq Rahman, 'Pluralism and Intolerance in Pakistani Society: Attitudes of Pakistani Students towards the Religious "Other"' (30 October 2003), www.aku.edu/news/archives/ismcconf-tr.pdf. Accessed on 21 January 2010.

[40] Tahir Kamran, 'Contextualising Sectarian Militancy in Pakistan: A Case Study of Jhang', *Journal of Islamic Studies*, Vol.20, No.1 (2009), pp.55-85.

[41] Maulana Masood Azhar had originally been active in SSP, before getting involved with the Kashmir *jihad* organisations, Harkat-ul-Mujahadeen (HuM) and Harkat-ul-Ansar (HuA).

Commentators feared that the flood disaster would exacerbate the security situation just as it had done with respect to the weak economy. The floods hit particularly hard the south Punjab and Swat regions, which had been centres of militancy. This not only piled further misery onto their long-suffering populations, but further demonstrated the lack of the state's reach in their aftermath. In the absence of an adequate government response, there was evidence that charities associated with militant organisations were very active in relief efforts. A number of press reports noted the activities of the Falah-e-Insaniyat foundation, which is the charity wing of the militant group Jamaat-ud-Dawa (JuD). While such activities were not designed specifically or likely to recruit fresh *jihadis*, they point to the failure of the state to compete for the 'hearts and the minds' of the local populace.[42] A similar state of affairs with respect to relief had existed in Azad Kashmir in the wake of the 2005 earthquake. A number of leading political figures from both the PPP and PML-N, including the Punjab Chief Minister Shahbaz Sharif warned that, in the absence of an adequate response to relief and rehabilitation, extremist groups would gain a grip on the population.[43] The desperation of people in the Muzaffargarh district was brought home by reports of attacks on a convoy carrying relief goods near Jadeywala, which forced the Pakistan Poverty Alleviation Fund and International Organisation for Migration to temporarily suspend their work.[44]

Militant groups, like the population at large, were affected by the communications collapse in the flood-hit areas. Nonetheless, the suicide bomb attack in the heart of the Peshawar Cantonment which killed Safwat Ghayyur, the commandant of the Frontier Constabulary on 4 August 2010, revealed not only that the TTP's operational network remained intact, but that it had no compunction in continuing its attack on the security forces at the height of a national emergency.

Political Developments Post February 2008

The flood disaster initially saw a recrudescence of the infighting between the PPP-led coalition government and the mainstream PML-N opposition. President Zardari's extended absence while being away in Europe made the already unpopular President an easy target. The spread of the floods from Khyber-Pakhtunkhwa into PML-N governed Punjab and the failure of the civil authorities to cope with the dislocation mitigated criticisms, although Shahbaz Sharif did complain about inadequate federal financial support. The PML-N may also have toned down its attacks because of the realisation that all civilian responses had been overshadowed by the army's capability.

---

[42] *Dawn* (21 August 2010), http://dawn.com. Accessed on 21 August 2010.

[43] 'Shahbaz's Warning About Extremism', *Dawn* (14 August 2010), http://dawn.com. Accessed on 14 August 2010.

[44] *Ibid.*

The initial political blame apportionment reflected the uneasy relations which had existed between the PPP and PML-N since the February 2008 elections. Despite the mounting security crisis, Pakistan's newly elected politicians were focused initially on the position of President Musharraf and then on the tussle for power which saw the PML-N at least temporarily outmanoeuvred. The 2008 polls had generated optimism that Pakistan could break out of its post-independence cycle of poor governance, authoritarianism, regional tensions and instability, not only because of the defeat of the Musharraf loyalists by the mainstream parties, but also because of the hope that there would be sustained cooperation between the PPP and the PML-N. It is widely acknowledged that the prospects for democratic consolidation in the 1990s had been undermined by their infighting.

Benazir Bhutto's assassination brought the party leaderships closer together than ever before. The post-election PPP and PML-N coalition government, however, proved short lived although it had functioned long enough to force President Musharraf to step down on 18 August 2008 under the threat of impeachment. Zardari secured the indirect election to the position of President. The PML-N withdrew from the Government led by Syed Yousaf Raza Gillani because of Zardari's delay in reinstating the judges along with the Chief Justice of the Supreme Court, Iftikhar Muhammad Chaudhry, who had been dismissed by Musharraf during the Emergency of November 2007. Their reinstatement had formed an integral part of the March 2008 Bhurban agreement under which the PML-N had joined the governing coalition. The disagreements between Nawaz Sharif and Zardari over the judiciary at the national level impacted Punjab politics where the PPP was a junior partner in the Government headed by his brother, the PML-N chief Shahbaz Sharif. Months of rising tensions saw President Zardari blunder in imposing Governor's rule in Punjab on 25 February 2009, following the Supreme Court's disqualification of the Sharif brothers from holding office.

The PML-N not only engaged in widespread street protests, but threw itself behind the gathering popular protest movement for the restoration of the judges. In the wake of a widespread breakdown in law and order, the Army Chief General Kayani met Prime Minister Gillani. The tenor of their conversation is unknown, but the PPP government, despite public claims not to give into 'blackmail', reinstated Chief Justice Iftikhar Chaudhry and the other judges in March 2009. This ended the running sore between PPP and PML-N. The lifting of Governor's rule and the return of Shahbaz Sharif to the office of Punjab Chief Minister marked the next stage in the normalisation of relations. Nevertheless, the long-term effects of the PPP's attempt to override the Punjab Government were seen at the end of September 2009, when Shahbaz Sharif held a clandestine meeting in Rawalpindi with General Kayani.[45] When news leaked out, it was seen as an attempt by the PML-N to get onside with the army in anticipation of Zardari's fall from power. During the 1990s, both Benazir Bhutto and Nawaz Sharif had undermined democracy by cultivating the military in this way.

[45] Azaz Sayed, 'Shahbaz and Nisar Secretly Meet Kayani', *Daw*n (3 October 2009), http://dawn.com. Accessed on 3 October 2009.

It would be wrong nonetheless to say that the 1990s were being totally replicated. Some progress in the way of replacing a politics of confrontation with one of accommodation was admittedly made with the implementation of key elements in the Charter for democracy which had been agreed in May 2006 between Benazir Bhutto and Nawaz Sharif with the passage of the 18th Amendment in April 2010. The removal of the President's power to dismiss the Prime Minister and dissolve the assembly represented a major triumph for parliamentary democracy. Although the accompanying renaming of NWFP as Khyber Pakhtunkhwa generated controversy and violence in the Abbottabad and Mansehra districts of Hazara Division.

President Zardari's watchword, despite his blunder in intervening in Punjab politics in February 2009, has been 'reconciliation'. Nevertheless it became clear even before the flood disaster that tensions were once again rising between the PPP and PML-N over the issue of disqualification of legislators who held 'fake degrees.' There were growing rumblings of the possibility of mid-term polls.

Relations with coalition allies at the centre and in the provinces had not always been smooth, let alone with the PML-N. Conflicts, especially with MQM (Muttahida Quami Movement), led to the dropping of the tabling of the controversial National Reconciliation Order in Parliament. This left the fate of the indemnity bill promulgated during the Musharraf era to the Supreme Court which nullified it. The MQM also opposed the Shariah Regulation for the Malakand Division which was introduced in an attempt to secure peace in the Swat Valley. Government delays in the restoration of the judges and the introduction of the 18th Amendment negated any positive effects flowing from Zardari's 'consensus democracy.'

Democracy in the 1990s had been undermined by the party's weak institutionalisation as well as by the zero sum game approach to politics. Since the February 2008 elections, little has changed with respect to the former. Pakistan political parties continue to be undemocratic institutions with power flowing top down from their leaderships. The Sharif brothers' firm grip on the PML-N is mirrored by Zardari's control of the PPP. He has surrounded himself with loyal supporters and in the process has replaced many of Benazir Bhutto's allies.

Parliamentary life has also remained as unchanged as lack of party democracy. Parliamentarians see the reward of allies and supporters and the provision of development funds for their constituencies as far more important than the scrutiny of legislation. Most members of the National and Provincial assemblies see election as a means of making money and securing their local power and influence, rather than in terms of public service. The continuing dominance of landholders in the assemblies has meant that it is hardly surprising that periods of democratisation are no more likely than those of military rule to see attempts to address Pakistan's glaring inequalities of income, power and access to education, although their continuation is a threat to democratic consolidation. Ten per cent of the population possesses 26.3 per cent of the national income; the poorest ten per cent of the population possesses only four per cent of national wealth. The PPP will continue to disillusion its supporters if it does not tackle these issues by matching rhetoric with action. The question remains, however, whether under its current institutional arrangements, it would have both the will and the ability to do so. The party's debacle during the floods emergency makes it extremely unlikely that it would be able to win a subsequent general election.

Democratic Consolidation and External Relations

India's offer of a US$5 million donation for flood victims masked the fact that democratisation had not brought about an improvement in the relations of the South Asian 'distant neighbours.' Similarly, the US financial support, which by mid-August 2010 was promised at US$150 million, was indicative of concerns in Washington regarding Pakistan's stability, rather than evidence of growing trust between the two allies in the conflict against Islamic militancy.

Pakistan's democratic travails have been historically linked not only with its elitist political culture and uneven socio-economic structure, but also with its external relations. It is well established that the state's geopolitical significance has encouraged long-term ties with the US, which have bolstered the military and their allies drawn from the bureaucracy and the feudal elites. The US has historically maintained close relations with all three of Pakistan's military rulers, Ayub, Zia and Musharraf, despite the pro-democracy rhetoric, especially of Democrats on Capitol Hill. Pakistan's military rulers have however found it increasingly difficult to escape demands to display democratic credentials and legitimacy.

Benazir Bhutto in particular used her Washington contacts to strengthen the growing belief in the West that democracy alone could deliver the legitimacy and structural changes to the political and economic processes necessary for long-term stability. It was well known that both London and Washington worked hard behind the scenes to enable her return to Pakistan on 19 October 2007.[46] Her assassination removed the hope that she might work in tandem with Musharraf to ensure stability in the frontline state in the 'War on Terror.' Her widower had neither the standing nor the contacts that she possessed. The West has however sought to bolster President Zardari and encourage him to resolutely oppose extremist pressures. Channels to the Pakistan army via the Pentagon have not been abandoned and it is known that Kayani was in discussions with Admiral Mike Mullen, US Chairman of the Joint Chiefs of Staff at the time of the March 2009 Punjab crisis. The new democratic government has not overcome the trust deficit with respect to Pakistan's performance in combating militancy. This focuses on:

1. Pakistan's strategic engagement with the Afghan Taliban groups, such as the Haqqani.

[46] Hilary Synnott, *Transforming Pakistan: Ways out of Instability* (London: Routledge, 2009), pp.71-2.

2. Claims made primarily by the Afghan security services that Inter-Services Intelligence (ISI) was supporting cross-border terrorism.
3. The Indian perspective that the Pakistan state was not pursuing vigorously enough the LeT that masterminded the 26 November 2008 Mumbai attacks.

The transition to democracy has not impacted favourably on Indo-Pakistan relations. This is despite the fact that some in Pakistan see Zardari as taking a soft tone towards India and the long held view that New Delhi will engage more with civilian than military leaders. In reality, Musharraf produced more innovative suggestions for ending the Kashmir dispute than most elected leaders could countenance. India, as the status quo power in Kashmir, however, wanted to keep Kashmir on the backburner throughout the period of what was termed Composite Dialogue.[47] The Indian charge that the bombing of its embassy in Kabul on 7 July 2008 had the mark of support from the ISI sent a further signal that the advances in relations of the past five years were not irreversible. Some commentators have noted that India's growing influence in Afghanistan post-2001 could become a new source of tension with Pakistan in addition to the long running Kashmir flashpoint.[48] The Composite Dialogue had already stalled before the terrorists set out by boat from Pakistan to launch a wave of killings in Mumbai which left 164 people dead and 308 wounded on 26 November 2008. New Delhi has constantly pressed for greater Pakistan efforts against the LeT, which allegedly masterminded the attacks.

The issue of terrorism-dominated relations between the two countries before talks resumed at Foreign Secretary level in June 2010. These were conducted in an atmosphere of low expectations. Indeed it was clear that US pressures arising from the shifting strategic tide in Afghanistan, rather than any change of outlook in New Delhi were the main factors in their resumption. The issues of terrorism and the future of Afghanistan as much as the long running Kashmir dispute will determine Indo-Pak relations. If Pakistan is sure footed, it may well be able to regain some of the ground it has lost in Afghanistan to India as the US winds down its operation in the country. At the same time, if there is any redirection of *jihadist* activities from Afghanistan to Kashmir, tensions between the distant South Asian neighbours will escalate to dangerous levels.

It is certain however that the military's overweening influence in Pakistan can only be scaled down if there is a normalisation of relations with India. The next section examines the issue of civil-military relations which have dominated Pakistan's post-independence history.

---

[47] This was originally set up in 1997 to discuss in separate working parties, eight outstanding issues which hindered a normalisation of relations. It had been halted by the Kargil War in 1999 and the 2001 attack on the Indian Parliament in New Delhi.

[48] India, since 2001, has contributed US$750 million for reconstruction in Afghanistan, has 4,000 civilian and security personnel working in the country, and has provided vital assistance in road-building and training of the Afghan police and civil servants. Pakistan has claimed that the Indian presence is directed against its interests not only in the country, but in the sensitive Balochistan Province. See Hilary Synnott, *Transforming Pakistan: Ways out of Instability* (London: Routledge, 2009), p.137.

Civil-Military Relations

The sense that the military is crucial to Pakistan's survival and is the main functioning institution has been part of its 'mythology' and popularity throughout six decades of independence. This perception received further reinforcement during the floods disaster. The military provided the sole means of communication as bridges and roads were washed away. The army ran relief camps and provided medical facilities for huge numbers of people who escaped to dry land. The army's long-term links with Islamic parties were reinforced as it worked alongside volunteers from such Islamist parties as Jamaat-e-Islami. The power relationship between the army and the elected politicians tipped still further in the former's advantage. None of this signals an imminent military coup, but it does make the prospect of a re-ordering of civil-military relations even more unlikely than it was in February 2008. Yet civilian control over the military, rather than abdication of large areas of governance to an army pulling the strings behind the scenes is crucial for Pakistan's democratic consolidation.[49]

Successive bouts of martial law have increased the Army's influence in all areas of Pakistan's life, as Ayesha Siddiqa has so expertly revealed.[50] This entrenched power reduces the scope for political leaders, especially those like Zardari who are well aware of the military establishment's mistrust. The picture which emerged even before the floods was thus unsurprisingly one of limited progress in establishing political control since February 2008.[51] The Chief of Army Staff (COAS) who replaced Musharraf on 18 November 2007, General Ashfaq Parvez Kayani has certainly not displayed any personal political ambition. Moreover, he signalled the army's willingness to withdraw from its political engagement by instructing serving officers to distance themselves from contacts with politicians and by calling back officers who were working in the highly controversial National Accountability Bureau.[52] The army, however, continued to jealously guard its institutional interests.

When President Zardari attempted to place the ISI under civilian control in July 2008 this was quickly squashed. Similarly, Prime Minister Gillani's promise to despatch the Director General of ISI, Lt-General Ahmed Shuja Pasha to India, to investigate claims of Pakistan involvement in the Mumbai bombings in November 2008 was blocked. Tensions between the Government and the Army bubbled to the surface over the Kerry-Lugar Bill. Its proposal to authorise US$1.5 billion of civilian aid to Pakistan for five years predated the Obama administration, but fitted into his new strategy for Afghanistan and Pakistan. The conditions

[49] For an authoritative historical perspective see, H.A Rizvi, *The Military and Politics in Pakistan, 1947-86* (Lahore: Progressive Publisher, 1986).

[50] Ayesha Siddiqa, *Military Inc: Inside Pakistan's Military Economy* (London: Pluto, 2007).

[51] For a useful overview see, Ishtiaq Ahmed, 'The Pakistan Military: Change and Continuity under General Ashfaq Parvez Kayani', *ISAS Working Paper,* No.90 (18 September 2009).

[52] Nevertheless, General Kayani denied his own ordinance regarding military non-involvement with politicians by meeting Aitzaz Ahsan in July 2009 and Punjab Chief Minister Shahbaz Sharif in late September. Azaz Syed, 'Shahbaz and Nisar Secretly Meet Kayani', *Dawn* (3 October 2009), http://dawn.com. Accessed on 3 October 2009.

for this material assistance were clearly designed to increase civilian oversight of the military.[53] Zardari called the passage of the Bill in Congress as the greatest foreign policy success of his year in office. The sniping of parliamentary opponents that it infringed Pakistan's 'sovereignty' was of little concern to him. The Government was, however, put firmly on the back foot, when the army publicly aired its objections following a meeting of the powerful Corps Commanders on 7 October 2009. While General Kayani may be a benign figure, parallels remain with the 1990s in respect of the army's resistance to any attempts by elected governments to secure greater control over it.

It would be wrong to understand the post-May 2009 military offensives against the Taliban in Swat, the Khyber and Waziristan Agencies as evidence of increased civilian control over security policy. These were the result of a combination of US pressure[54] and the overreach of militant groups. National opinion regarding the Taliban shifted dramatically when video footage of the public flogging of a seventeen year old girl in Swat surfaced on 2 April 2010. Previously Pakistanis had regarded military action against militants as 'fighting Washington's war'. General Kayani in his previous role as Director General of ISI undoubtedly had links with militant groups, but these would not stand in the way of resolute action if professional interests demanded so. Since 9/11, the Pakistan army has developed a calibrated approach to dealing with former militant protégés. It distinguishes between 'foreign' and 'indigenous' elements and those militants who may be useful to Pakistan's regional strategic interests and those who have become uncontrollable threats to both state and army security.[55] Operation *Rah-e-Rast* (Operation Black Thunderstorm) in Swat in fact strengthened the Army's position in two key areas – firstly it renewed its longstanding claim to be the protector of the nation and secondly it restored its credibility with US critics who were questioning it effectiveness and commitment to the 'War on Terror.' At the beginning of July 2008, there were growing signals from Washington that 'hot pursuit' into Pakistan and unilateral action against militant strongholds in the tribal areas were a possibility. Moreover, these gains have been achieved without the army having to modify its understanding that India remains the country's main security threat. Finally, by increasing the value of its cooperation for the achievement of US strategic aims in the Federally Administered Tribal Areas (FATA), the army has secured an expedient reassessment of the Obama administration's pro-democracy agenda as enshrined in the Kerry-Lugar Bill.

Democratic consolidation in the long-term needs the army's exposure to the same levels of accountability as elected politicians. This would not only involve the pursuit of corruption cases, but full parliamentary scrutiny of military expenditure. However, the army will

---

[53] They included greater civilian control over promotions and appointments and parliamentary oversight of military budgets along with certification that the security forces were not subverting the political and judicial processes.

[54] Admiral Mike Mullen, US Chairman of Joint Chiefs of Staff, paid a number of important visits to Islamabad in 2008-09.

[55] For an extended assessment of the army's 'Faustian' dealings with Islamic militants see, chapter five of Farzana Shaikh, *Making Sense of Pakistan* (London: C. Hurst and Co, 2009).

continue to seek to safeguard its entrenched economic interests[56] and will always be able to call on a section of Pakistan's privileged political elites to work with it in the event of its seizing power. The army may choose in the aftermath of the floods not to intervene directly, but its already considerable power over the Government and the mainstream opposition has been further augmented.

Conclusion

Even before the national calamity of the July-August 2010 floods, Pakistan's third democratic transition was beset by crises. Some of these were of the Government's making, others were external and revealed the fragility of the state's economy and main institutions aside from the army. Inevitably the euphoria generated by the 2008 polls could not be sustained. The Parliament alone is insufficient to introduce structural economic and institutional reforms conducive to democratic consolidation. With respect to traditionally 'backward' areas such as FATA, where literacy rates, access to healthcare and safe drinking water are well below the Pakistani average, a generation of developmental activity is required.[57] In the short-term, the best that can be achieved alongside improved security is the establishment of job-creation schemes in neighbouring settled areas, which would increase the economic prospects of FATA residents.[58] Militancy in South Punjab is rooted not only in poverty and political marginalisation of the lower classes by feudalism but in the long-term hold of sectarianism in the region. These are issues which cannot be tackled overnight and require long-term institution building, and a steep change in political culture.

In a number of ways, the pre-flood situation possessed parallels with the 1990s transition, which ultimately represented a missed opportunity for democracy. Party politics remained personalised with little intra-party democracy. Political culture was dominated by conflict, rather than cooperation and tensions were endemic at both state and societal levels arising from skewed resource distribution and an absence of social justice. The military remained a dangerously overdeveloped institution, which continued to exercise influence over elected governments. The army's public stance on the Kerry-Lugar Bill graphically illustrated that it would not easily submit to greater civilian oversight through such mechanisms as an empowered Defence Committee of the Cabinet. Its security wing (ISI) remained only nominally under prime ministerial control.

The floods exacerbated the low standing of the President and pointed up the weakness of civilian responses in comparison with the military efforts. They threaten the rate of economic recovery required to alleviate poverty. Pakistan's indebtedness and dependency on

---

[56] On these, see Ayesha Siddiqa, *Military Inc: Inside Pakistan's Military Economy* (London: Pluto, 2007).

[57] The literacy rate in FATA is for example 17.5 per cent compared with the Pakistani average of 44 per cent. For an assessment on the future prospects of FATA see, Ian Talbot, 'Future Prospects for FATA', *Pakistan Security Research Unit (PSRU) Brief,* No.41 (22 September 2008).

[58] Hilary Synnott, *Transforming Pakistan: Ways out of Instability* (London: Routledge, 2009), p.170.

international financial support has been further increased. While fears that extremism may be further encouraged as a result of the large-scale human misery may be exaggerated, the continued actions of the TTP and ethnic violence in Karachi at the height of the flood crisis revealed the multi-layered crises besetting the Pakistan state. The daunting security challenges could in future encourage further military rule.

Just as individuals survived the flood through their own resourcefulness and toughness, Pakistan has throughout its six decades of existence displayed a resilience that has confounded its critics. This has been rooted in the energy of the population, despite the depredations of natural disasters, war and misgovernment. Less remarked upon in the international press than the role of hardliners in relief, were the activities of concerned citizens and NGOs including such organisations as the Pakistan Medical Association, the Citizen's Foundation, and the Indus Resource Centre.[59] They form part of an emerging civil society which was dramatically announced to the world by the unprecedented lawyers' movement which undermined President Musharraf and forced President Zardari to back down in his struggle with the PML-N. Its emergence has led some analysts to see the possibility of intellectual and political realignment in Pakistan.[60] At present, this process is in its infancy and Pakistan is a fragile state. The political system and not just the Zardari-led government remains at risk in the aftermath of the floods. Uncertainties continue to haunt Pakistan's third democratic transition. What can, however, be said with confidence is that its outcome will not only be of immense significance for the 170 million Pakistani people but its effects will be felt throughout the region and the international community.

. . . . .

[59] For mention of their activities see, Zubeida Mustafa, 'How Pakistan Survives', *Dawn* (18 August 2010), http://dawn.com. Accessed on 18 August 2010.

[60] See Farzana Shaikh, *Making Sense of Pakistan* (London: C. Hurst and Co, 2009). Synnott links civil society's ability to 'bring positive changes to Pakistan's political culture' with electoral, constitutional, institutional and security sector reform and 'real progress on public health and education. See Hilary Synnott, *Transforming Pakistan: Ways out of Instability* (London: Routledge, 2009), p.169.

ISAS Working Paper

No. 123 – 7 March 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

'Same but Different?': Comparing the ASEAN and SAARC Frameworks

Syeda Sana Rahman[1]

Asia has experienced an explosion of regional trade agreements (RTAs) in recent years particularly in East and Southeast Asia. Production and institutions across these regions have become further integrated due to these RTAs. The domain of integration now extends to South Asia with India and other South Asian economies getting connected to East and Southeast Asia through formal trade arrangements. Proliferation of RTAs has revived the debate on multilateralism and regionalism. While most regional economies figure in the multilateral framework of the World Trade Organization (WTO), their pursuit of RTAs has raised questions over whether they repose greater faith in regional trade networks. The Economics and Trade Policy research cluster at ISAS organised a workshop at Singapore on 20 October 2010 on 'Trade Policies in South Asia and Southeast Asia: Encouraging Regionalism?' that examined different aspects of the theme including comparative dimensions of trade frameworks, bilateral trade relations and country perspectives on regional trade. The papers are being brought out by ISAS as a working paper series. This paper is the second in this series.

Abstract

When the Association of Southeast Asian Nations (ASEAN) was founded in 1967, its members existed in a state of mutual suspicion and uncertainty. As new nation-states, its founding members, Indonesia, Malaysia, the Philippines, Singapore and Thailand, were also concerned with protecting their sovereignty and political and economic development. Nevertheless, over time, ASEAN developed informal diplomatic mechanisms to manage their bilateral tensions. While tensions continue to flare up between neighbours, ASEAN states

[1] Syeda Sana Rahman is Research Associate at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). She can be reached at isasssr@nus.edu.sg. The views reflected in the paper are those of the author and not of the institute.

appear to have successfully avoided the outbreak of armed conflict between states in the region. Similarly, when the South Asian Association for Regional Cooperation (SAARC) was founded in 1985, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka had long running disputes with each other. However, unlike ASEAN, SAARC's record at managing regional conflicts has not been as successful. This paper examines the factors that account for this difference between ASEAN and SAARC in managing conflict.

Introduction

ASEAN was founded by Indonesia, Malaysia, the Philippines, Singapore and Thailand in 1967. At that time, Southeast Asian countries existed in a state of mutual suspicion and uncertainty. Not only had Indonesia, under President Suharto, just ended its *Konfrontasi* (Confrontation) of Malaysia but post-separation tensions existed between Singapore and Malaysia, while Malaysia and the Philippines were embroiled in a territorial dispute over Sabah. At the same time, most of the Southeast Asian states had just gained independence and were thus focused on protecting their sovereignty and political and economic development.

In this light, it is telling that the founding document of the ASEAN Declaration (also known as the Bangkok Declaration) stressed the association's determination to 'ensure...stability and security from external interference...in order to preserve...national identities in accordance with the ideals and aspirations of their people' and also clarified that 'all foreign bases are temporary...and are not intended to be used directly or indirectly to subvert the national independence and freedom of States'.[2] To this end, the Declaration called for the promotion of 'regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries of the region and adherence to the principles of the United Nations Charter' while further emphasising the need for economic and social cooperation.[3] Hence, conflict management was dealt with in the most general of terms.

Similarly, the countries in South Asia have also existed in a state of mutual suspicion since India and Pakistan gained independence in 1947. Apart from the enduring Kashmir dispute between the two, India also has had long-running disputes over water sharing, border problems, illegal immigrants and other issues with neighbouring countries like Bangladesh, Nepal and Sri Lanka. Additionally, Bangladesh and Pakistan continue to wrangle over the repatriation of Pakistanis stranded in Bangladesh since the 1971 civil war that resulted in the birth of Bangladesh. Nepal and Bhutan too spar over the status of the Nepali origin minority in Bhutan, a number of whom have been forced to flee into India and Nepal. Thus the conditions in South Asia in 1985, when the SAARC was founded by Bangladesh, Bhutan,

---

2 'The ASEAN Declaration', *ASEAN* (08 August 1967), www.asean.org/1212.htm. Accessed on 23 February 2011.

3 *Ibid.*

India, Maldives, Nepal, Pakistan and Sri Lanka, were somewhat similar to the conditions extant in Southeast Asia when ASEAN was formed.

SAARC's founding document, like the ASEAN Declaration, emphasised 'strict adherence to the principles of the United Nations Charter and...respect for the principles of sovereign equality, territorial integrity, political independence, non-interference in the internal affairs of other States' and advocated 'economic, social and technical cooperation', while eschewing formal mechanisms for conflict management.[4]

This paper compares ASEAN's ability to manage inter-state conflicts in Southeast Asia to SAARC's ability to do the same in South Asia. The paper argues that ASEAN has succeeded in creating a largely effective, if tenuous, conflict management norm in the 'ASEAN Way', relative to that of SAARC.

Conflict management is the 'way in which a society attempts to deal with its inter-party conflicts' and comprises three board categories – conflict avoidance, conflict prevention and conflict resolution.[5] Accordingly, conflict avoidance consists of 'any processes operating to avoid the development of contentious issues and goal incompatibilities', while conflict prevention refers to processes 'which contribute to the prevention of undesirable conflict behaviour [like violence] once some situation of goal incompatibility has arisen'.[6] Finally, at its most successful, conflict management 'bring[s] hostilities to a satisfactory conclusion through settlement or resolution'.[7] Thus, the prevention of violence is 'an initial step of prevention...essential to engendering a hospitable environment for negotiation'.[8] Accordingly, one could say that a party or organisation has successfully managed conflict(s) if it is able to prevent a *violent conflict* from occurring, even if tensions persist and there is no final resolution to the dispute.

This paper identifies the major factors that have helped or hindered ASEAN and SAARC in tackling inter-state conflicts in Southeast and South Asia. The paper first examines ASEAN's establishment and growth during the Cold War. In this period, ASEAN comprised of the first five countries (Indonesia, the Philippines, Malaysia, Singapore and Thailand) until 1985, when Brunei joined the association. These nations shared a common desire to pursue a market-friendly economic model that inspired the Southeast Asian countries to use this regional organisation as a bulwark in the face of a perceived Communist threat. This is followed by an examination of ASEAN's second phase. As the regional organisation expanded in the post-Cold War era, events such as the 1997 economic crisis and the 1999

4 'Charter of the South Asian Association for Regional Cooperation', *SAARC* (08 December 1985), http://saarc-sdmc.nic.in/pdf/charter.pdf. Accessed on 23 February 2011.
5 C.R. Mitchell, *The Structure of International Conflict* (London: Macmillan Press, 1981), pp.256-79.
6 *Ibid.*
7 Muthiah Alagappa, 'Regionalism and Conflict Management: A Framework for Analysis', *Review of International Studies*, Vol.21, No.4 (1995), p.369.
8 Ho-Won Jeong, *Conflict Management and Resolution: An Introduction* (New York: Routledge, 2010), p.25.

East Timor crisis exposed some key weaknesses of the ‘ASEAN Way’, the organisation’s informal conflict management norm. In the face of these challenges, ASEAN appears to have reinvented itself to lead the move towards ‘Asia-Pacific’ regionalism through its participation and leadership in the Asia Pacific Economic Cooperation (APEC) and ASEAN Regional Forum (ARF).

The third section of the paper assesses the first phase of SAARC’s existence, from 1985-2005, when it comprised the seven founding members – Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The nascent regional organisation remained hostage to the various bilateral tensions amongst its member states during this time. Not only was SAARC unable to prevent armed conflict in the region, its economic efforts were also stymied due to the acrimonious political relations of its key members.

The fourth section reviews SAARC’s second phase from 2005 onwards, when the organisation gets the opportunity to reinvigorate itself with the inclusion of Afghanistan as a full member, and China and Japan as observers. While SAARC continues to lack a ‘conflict management’ norm, in this period, the presence of extra-regional players appears to have reduced the chances of an open conflict between the member states. The paper then briefly examines the factors that have helped ASEAN achieve success, including, the presence of a common threat, the role of the pivotal state and the role of extra-regional powers.

ASEAN One: Formation and Establishment (1967-1990s)

In the first phase of its existence, from 1967 to the mid-1990s, ASEAN succeeded in establishing a specific conflict management norm that confirmed its place as a functional regional organisation. Initially, after the signing of the Bangkok Declaration (ASEAN Declaration), the organisation stayed largely defunct. It was only nine years later, in 1976, that the organisation held its first summit. It is telling that the first summit came just after the Communist North Vietnamese victory in 1975.[9] This combined with the communist-inspired insurgencies in the region, led to the perception of a ‘Communist threat’ inching its way into maritime Southeast Asia.[10] This common threat perception inspired regional leaders to play down their bilateral tensions, and instead focus ways to create a stable ‘market-friendly’ regional environment that was insulated from the ‘Communist threat’.[11] This shared vision also meant that the ASEAN countries were able to agree on the United States (US) as an

---

9 Russell H. Fifield, ‘ASEAN: Image and Reality’, *Asian* Survey, Vol.19, No.12 (1979), p.1200; David B.H. Denoon and Evelyn Colbert, ‘Challenges for the Association of Southeast Asian Nations (ASEAN)’, *Pacific Affairs*, Vol.71, No.4 (1998-99), p.506.

10 Vincent K. Pollard, ‘ASA and ASEAN, 1961-1967: Southeast Asian Regionalism’, *Asian Survey*, Vol.10, No.3 (1970) pp.244-55; Amitav Acharya, ‘Ideas, Identity and Institution-building: The “Asia-Pacific’ Way”’, *The Pacific Review*, Vol.10, No.3 (1997), p.323; Sheldon W. Simon, ‘ASEAN’s Strategic Situation in the 1980s’, *Pacific* Affairs, Vol.60, No.1, (1987), p.74.

11 David B.H. Denoon and Evelyn Colbert, ‘Challenges for the Association of Southeast Asian Nations (ASEAN)’, *Pacific Affairs*, Vol.74, No.4 (1998-99), p.507.

external security guarantor, albeit to varying degrees.[12] Thus, at their first summit, ASEAN leaders signed the Declaration of ASEAN Concord and the Treaty of Amity and Cooperation (TAC) to promote a stable region in which all states focused on economic growth as a bulwark against Communism.

Both the Declaration of ASEAN Concord and the TAC enshrined the principles of non-intervention in domestic affairs.[13] Additionally, the former noted the importance of national and regional stability and the need to promote economic growth.[14] It also declared that ASEAN members were to ‘rely exclusively on peaceful processes in the settlement of intra-regional differences’.[15] The TAC dealt more specifically with the ‘Pacific Settlement of Disputes’ and enjoined members to ‘refrain from the threat or use of force... [and] settle...disputes...through friendly negotiations’.[16] It also provided for the establishment of a ‘High Council’ comprising ministerial-level representatives of the signatory states to recommend pacific ways of settling disputes.[17] However, it also stated that none of these measures could be applied to a dispute ‘unless all parties to the dispute agree[d] to their application’ and also ‘encouraged [the parties of a dispute] to take initiatives to solve [the dispute] by friendly negotiations before resorting to the other procedures provided for in the Charter of the United Nations’.[18] These then set the tone for the informal norms of dispute settlement employed by the ASEAN states.

While the High Council has never been invoked, ASEAN member states have evolved an informal dispute prevention mechanism or norm that is often called the ‘ASEAN Way’. The ‘ASEAN Way’ comprises processes of consultation and consensus. These are processes which involve quiet diplomacy, where often disputes are set aside for some time before an attempt is made to resolve them.[19] In this way conflicts are either avoided or prevented by downplaying or seemingly ignoring contentious issues that could otherwise lead to an open conflict. A notable principle ensconced in the ‘ASEAN Way’ is the principle of ‘consensus minus X’.[20] Thus decisions do not necessarily require unanimity; rather, a member is allowed

---

[12] Vincent K. Pollard, ‘ASA and ASEAN, 1961-1967: Southeast Asian Regionalism’, *Asian Survey*, Vol.10, No.3 (1970), p.254; Sheldon W. Simon, ‘ASEAN’s Strategic Situation in the 1980s’, *Pacific Affairs*, Vol.60, No.1 (1987), p.75.

[13] ‘Declaration of ASEAN Concord’, *ASEAN* (24 February 1976), www.aseansec.org/1216.htm. Accessed on 23 February 2011; and ‘Treaty of Amity and Cooperation in Southeast Asia’, *ASEAN* (24 February 1976), www.aseansec.org/1217.htm. Accessed on 23 February 2011.

[14] ‘Declaration of ASEAN Concord’, *ASEAN* (24 February 1976), www.aseansec.org/1216.htm. Accessed on 23 February 2011.

[15] *Ibid.*

[16] ‘Treaty of Amity and Cooperation in Southeast Asia’, *ASEAN* (24 February 1976), www.aseansec.org/1217.htm, Accessed on 23 February 2011.

[17] *Ibid.*

[18] *Ibid.*

[19] Ramses Amer, ‘Conflict Management and Constructive Engagement in ASEAN’s Expansion’, *Third World Quarterly*, Vol.20, No.5 (1999), p.1036; Amitav Acharya, ‘Culture, Security, Multilateralism: The “ASEAN Way” and Regional Order’, *Contemporary Security Policy*, Vol.19, No.1 (1998), p.55-84.

[20] Rajshree Jetly, ‘Conflict Management Strategies in ASEAN: Perspectives for SAARC’, *The Pacific Review*, Vol.16, No.1 (2003), p.57.

to abstain from participation in a scheme without hindering others from participating in the same.[21] The utility of the norm was clearly illustrated in negotiations to establish the ASEAN Free Trade Area (AFTA), where economies like Indonesia, Malaysia and Singapore went ahead with the FTA while less developed economies like Cambodia, Laos, Myanmar and Vietnam were given longer time frames to implement the reforms required to participate.[22]

The 1980s solidified ASEAN's reputation as a successful regional organisation when the ASEAN countries successfully pressured Vietnam to reverse its 1978 invasion of Cambodia (*Kampuchea*) during the third Indochina War.[23] The constant diplomatic pressure from ASEAN, along with the end of the Cold War and loss of Soviet support eventually led Vietnam to retreat from Cambodia in 1989.[24] This success along with the notable economic growth of ASEAN countries during this period marked ASEAN as the most successful regional organisation in the developing world.

ASEAN Two: Expansion and Reinvention

It was with understandable confidence that ASEAN then entered the post-Cold War era looking to expand its membership to create a united Southeast Asia. Thus, Vietnam joined the regional organisation in 1995 followed by Myanmar (1997), Laos (1997) and Cambodia (1999). However, as the 1990s unfolded it brought with it events that exposed some of ASEAN's key weaknesses. The organisation proved slow or unable to respond in a series of regional crises, starting with the collapse of the Thai *baht* and the subsequent economic crisis in 1997. At the same time, the ASEAN decision to defer Cambodia's entry into the regional organisation due to the 1997 coup in the country clearly challenged the ASEAN ideal of domestic 'non-interference'.[25] ASEAN also proved ineffectual in dealing with regional environmental issues like the haze, caused by forest fires in Indonesia.[26]

---

21 *Ibid.*

22 *Ibid.* For more details, see 'Agreement On The Common Effective Preferential Tariff (CEPT) Scheme for The ASEAN Free Trade Area', *ASEAN* (28 January 1992), www.aseansec.org/1164.htm. Accessed on 23 February 2011; 'Protocol to Amend The Framework Agreement on Enhancing ASEAN Economic Cooperation', *ASEAN* (15 December 1995), www.aseansec.org/2083.htm. Accessed on 23 February 2011; 'Protocol for the Accession of Socialist Republic of Vietnam to the Agreement on the Common Effective Preferential Tariff Scheme for the ASEAN Free Trade Area', *ASEAN* (15 December 1995), www.aseansec.org/2083.htm. Accessed on 23 February 2011.

23 Amitav Acharya, 'Regional Military-Security Cooperation in the Third World: A conceptual Analysis of the Relevance and Limitations of ASEAN (Association of Southeast Asian Nations)', *Journal of Peace Research*, Vol.29, No.1 (1992), p.11; Russell H. Fifield, 'ASEAN: Image and Reality', *Asian* Survey, Vol.19, No.12 (1979), p.1202.

24 Leszek Buszynski, 'ASEAN: A Changing Regional Role', *Asian Survey*, Vol.27, No.7 (1987), p.765; David B.H. Denoon and Evelyn Colbert, 'Challenges for the Association of Southeast Asian Nations (ASEAN)', *Pacific Affairs*, Vol.71, No.4 (1998-1999), p.508; Lau Teik Soon, 'ASEAN and the Cambodian Problem', *Asian Survey*, Vol.22, No.6 (1982), pp.548-60.

25 David B.H. Denoon and Evelyn Colbert, 'Challenges for the Association of Southeast Asian Nations (ASEAN)', *Pacific Affairs*, Vol.71, No.4 (1998-99), p.511.

26 James Cotton, 'The "Haze" over Southeast Asia: Challenging the ASEAN Mode of Regional Engagement', *Pacific Affairs*, Vol.72, No.3 (1999), pp.331-51. The recurrence of haze in Southeast Asia also clearly

Most tellingly, ASEAN proved inadequate during the East Timor crisis of 1999, where ASEAN members were not even able to agree on what stance or action to take. While Thailand, the Philippines, Malaysia and Singapore joined the Australia-led International Force for East Timor (INTERFET), Cambodia, Vietnam, Laos and Myanmar stayed away from the issue entirely.[27] This clearly illustrated the limitations and challenges inherent in the principles of 'non-interference' and 'informal dispute settlement'.

Nevertheless, ASEAN did manage to ameliorate some tensions in the region, such as the territorial disputes in the South China Sea. The disputes involve a number of Southeast Asian states (Malaysia, the Philippines, Brunei and Vietnam), along with China, which has claimed the entire region as its sovereign territory.[28] In order to restrain Chinese moves into the region, the ASEAN countries banded together and succeeded in establishing the non-binding Declaration on the Conduct of Parties in South China Sea, which was adopted in 2002.[29] Thus far the agreement appears to have kept all parties involved from resorting to the use of force and has also nudged China away from its preference to deal bilaterally with each disputing state to a multilateral setting.

However, even as academics and observers started to predict the organisation's death, ASEAN began to reinvent itself and lead the Asia-Pacific regionalism. It accomplished this by spearheading two 'Asia-Pacific' regional organisations – the Asia Pacific Economic Cooperation (APEC) and the ASEAN Regional Forum (ARF). Proposed by then Australian Prime Minister Bob Hawke in 1989, the APEC eventually became a way for ASEAN economies to position themselves at the core of a larger regional project. At this time, however, several external developments created the incentive for the ASEAN economies to join a larger economic forum. First, the future of the world trading system seemed uncertain as the Uruguay Round faltered, which in turned fuelled fears that the Southeast Asian economies may face discrimination from trading blocs in Europe and North America.[30] APEC thus became a way to provide major economies like Japan and the US an incentive to strengthen their ties with ASEAN.[31]

---

illustrates the organisation's continued struggle with the regional issue. Nopporn Wong-Anan, 'Q+A – Why has Southeast Asia's haze returned?', *Reuters* (22 October 2010), http://in.reuters.com/article/idINIndia-52379020101022. Accessed on 23 February 2011.

[27] Donald E. Weatherbee, *International Relations in Southeast Asia: The Struggle for Autonomy*, 2nd ed. (Lanham: Rowman & Littlefield Publishers, 2009), pp.258-60; 'UN approves Timor Force', *BBC News* (15 September 1999), http://news.bbc.co.uk/2/hi/asia-pacific/447639.stm. Accessed on 23 February 2011; Sonny Inbaraj, 'ASEAN's commitment to East Timor faces tough test', *Asia Times Online* (1 February 2000), www.atimes.com/se-asia/BB01Ae01.html. Accessed on 23 February 2011.

[28] S.P. Seth, 'ASEAN and Regional Security', *Economic and Political Weekly*, Vol.34, No.33 (14-20 August 1999), p.2304.

[29] 'Declaration on the Conduct of Parties in the South China Sea', *ASEAN* (4 November 2002), www.aseansec.org/13163.htm. Accessed on 23 February 2011.

[30] Amitav Acharya, 'Ideas, Identity and Institution-building: The "Asia-Pacific' Way"', *The Pacific Review*, Vol.10, No.3 (1997), p.323.

[31] *Ibid.*, p.324.

At the same time, ASEAN has also been successful in embedding the 'ASEAN Way' into the APEC. Like ASEAN, APEC depends on consensus to arrive at decisions and does not require legalist commitments from its members, and instead, 'commitments are undertaken on a voluntary basis'.[32] Thus, APEC describes itself as a 'cooperative, multilateral economic and trade forum... [which] is the only international intergovernmental grouping in the world...[that does not require] its members to enter into legally binding obligations. APEC achieves its goals by promoting dialogue and arriving at decisions on a consensus basis, giving equal weight to the views of all members'.[33]

In the security realm, the ARF, which was established in 1994, arguably represents a successful attempt to institutionalise how big powers – most notably the US and China – operate and interact in the region. It has been noted that the 'ARF has...extended ASEAN diplomatic leverage to the wider region and...it may have helped manage the demise of the Soviet Union, the rise of China, and the draw-down of U.S. military forces'.[34] It is notable that the US, 'which initially opposed multilateralism in Asia-Pacific security...now welcomes the formation of the ARF'.[35] Similarly, 'China's policy toward the ARF has become noticeably more positive, attesting at least partly to the effects of socialisation and learning within the ASEAN-sponsored dialogue activities'.[36]

The objectives of the ARF, as laid out at the time of its founding, have been to 'foster constructive dialogue and consultation on political and security issues of common interest and concern' and 'to make significant contributions to efforts towards confidence-building and preventive diplomacy in the Asia-Pacific'.[37] In its 1995 ARF Concept Paper, it also stated that the ARF intended to move from confidence-building to preventive diplomacy and eventually towards conflict resolution.[38] This resolve took a still more positive turn in 1997 when the ARF agreed to work towards developing mechanisms for Preventive Diplomacy.[39] Unfortunately, since then the project has floundered as ARF members have been unable to agree on a common understanding of what comprised Preventive Diplomacy.[40] Nevertheless,

---

32 'About APEC', *APEC* (14 January 2009), www.apec.org/About-Us/About-APEC.aspx. Accessed on 23 February 2011.

33 'How APEC Operates', *APEC* (14 January 2009), www.apec.org/About-Us/How-APEC-Operates.aspx. Accessed on 24 February 2011.

34 John Garofano, 'Power, Institutions, and the ASEAN Regional Forum: A Security Community for Asia?', *Asian Survey*, Vol.42, No.3 (2002), p.513.

35 Amitav Acharya, 'Ideas, Identity and Institution-building: The 'Asia-Pacific' Way"', *The Pacific Review*, Vol.10, No.3 (1997), p.340.

36 *Ibid.*

37 'The ASEAN Regional Forum: About Us', *ARF* (2005), www.aseanregionalforum.org/AboutUs/tabid/57/Default.aspx. Accessed on 23 February 2011.

38 Amitav Acharya, 'Ideas, Identity and Institution-building: The "Asia-Pacific" Way"', *The Pacific Review*, Vol.10, No.3 (1997), p.335; 'Terms of Reference and Concept Papers: Concept Paper of ARF', *ARF* (2005), www.aseanregionalforum.org/PublicLibrary/TermsofReferencesandConceptPapers/tabid/89/Default.aspx. Accessed on 23 February 2011.

39 John Garofano, 'Power, Institutions, and the ASEAN Regional Forum: A Security Community for Asia?', *Asian Survey*, Vol.42, No.3 (2002), p.513.

40 *Ibid.*, pp.513-17; For more information, see 'Terms of Reference and Concept Papers: ARF Concept Paper of Preventive Diplomacy', *ARF* (2005),

while it is important not to overstate the ARF's success, it is equally important to note its continued contribution to the security and stability of the region. As observed above, the ARF has extended ASEAN's reach into the larger region and appears to have socialised both the US and China into an 'ASEAN-style' multilateral interaction in the security realm. Its continued relevance is also indicated by the number of countries joining the forum. Currently it comprises 27 countries including the ASEAN-10.

At the same time ASEAN has also moved towards creating a more rules-based regime for itself. In 2003, ASEAN member states signed the Declaration of ASEAN Concord II. Accordingly, ASEAN endorsed the creation of an ASEAN Community, including an ASEAN Security Community to 'bring ASEAN's political and security cooperation to a higher place'.[41] Additionally, in 2007 ASEAN also adopted the ASEAN Charter, the purpose of which was to make ASEAN 'a rules-based and people-oriented organisation with its own legal personality'.[42] The ASEAN Charter came into force in December 2008, after being ratified by all member states.[43] Still more recently, at the April 2010 ASEAN Summit, the ASEAN Foreign Ministers signed the Protocol to the ASEAN Charter on Dispute Settlement Mechanisms. This protocol not only aims to establish mechanisms to help resolve disputes concerning the interpretation or application of the ASEAN Charter, but also applies to other ASEAN instruments which do not specifically provide for dispute settlement mechanisms.[44] While it remains to be seen whether these ASEAN attempts to move towards a more rules-based regime will be successful, they certainly do signal the ASEAN states' desire to move towards a more formal and legalistic structure.

SAARC One: Formation and Establishment (1985-2005)

Since 1947, intra-regional conflict has abounded in South Asia. Apart from the major bilateral conflict over Kashmir between India and Pakistan, there exist various other conflicts ranging from border disputes to resource sharing, trade and migration issues amongst others

www.aseanregionalforum.org/PublicLibrary/TermsofReferencesandConceptPapers/tabid/89/Default.aspx. Accessed on 23 February 2011.

41 'Declaration of ASEAN Concord II' (7 October 2003), www.aseansec.org/15159.htm. Accessed on 23 February 2011.

42 'ASEAN Charter set to be enforced next month', *The Brunei Times* (16 November 2008), www.bt.com.bn/asia_news/2008/11/16/asean_charter_set_to_be_enforced_next_month. Accessed on 23 February 2011.
See also: 'The ASEAN Charter', *ASEAN* (January 2008), www.asean.org/publications/ASEAN-Charter.pdf. Accessed on 23 February 2011.

43 *Ibid.*

44 'Statement of the ASEAN Chair on the Signing of the Protocol to the ASEAN Charter on Dispute Settlement Mechanisms by the Foreign Ministers of ASEAN', *ASEAN* (8 April 2010), www.aseansec.org/24506.htm. Accessed on 23 February 2011; 'ASEAN: Protocol on Dispute Settle Mechanisms Signed', *UNPAN* (12 April 2010), www.unpan.org/PublicAdministrationNews/tabid/115/mctl/ArticleView/ModuleID/1467/articleId/21548/default.aspx. Accessed on 23 February 2011.

between various states in the region. One set of these bilateral conflicts involves India and its smaller neighbours, while a second (smaller) set involves the other South Asian states.

Bangladesh alone has a variety of disputes with India including India's alleged involvement in Bangladesh's ethnic tensions in the Chittagong Hill Tracts, Bangladesh's alleged involvement in India's Northeast problem, and a border dispute.[45] Indo-Sri Lankan relations have not been any better. India's failed intervention into Sri Lanka's civil war in 1987, has led subsequent Sri Lankan governments to look at Delhi with some suspicion.[46] India also has a trade and transit rights dispute, and a border dispute with Nepal.[47] Additionally, some tensions over the repatriation of Pakistanis refugees in Bangladesh and the status of the Nepali-origin minority in Bhutan exist between Pakistan and Bangladesh, and Nepal and Bhutan, respectively.[48]

However, India's most intractable disputes are with the second largest state in the region, Pakistan. These include disputes over Kashmir, the Siachen glacier, nuclear rivalry and accusations of cross-border terrorism.[49] These mutual suspicions amongst South Asian countries led some, like Pakistan, to seek external security guarantors against the perceived Indian threat. Hence, in this period, American and Chinese presence in South Asia further contributed to the instability of the region. The US' and China's support of Pakistan in particular led India to regard both powers with suspicion.[50]

It is thus not surprising that when SAARC was first proposed by Bangladesh, it was never mooted as a formal means of conflict management in the region. Instead, SAARC was largely conceived as a vehicle to foster economic and social/cultural cooperation in South Asia, and it was agreed that all decisions were to be made on the basis of unanimity and that all

---

[45] James Heitzman and Robert L. Worden (eds), *India: A Country Study* (Washington: GPO for the Library of Congress, 1995), http://countrystudies.us/india/. Accessed on 23 February 2011; Chitra K. Tiwari, 'South Asian Regionalism: Problems and Prospects', *Asian Affairs*, Vol.12, No.2 (1985), p.5; Border dispute is India's key debate with Bangladesh', *Deccan Chronicle* (10 November 2010), www.deccanchronicle.com/national/border-dispute-indias-key-debate-bangladesh-868. Accessed on 23 February 2011; 'ISI trains north-east militants in Bangladesh', *Express India* (11 September 2004), www.expressindia.com/news/fullstory.php?newsid=36020. Accessed on 23 February 2011.

[46] 'Misgivings Reinforced', *Economic and Political Weekly*, Vol.30, No.30 (1995), p.1889.

[47] James Heitzman and Robert L. Worden (eds), *India: A Country Study* (Washington: GPO for the Library of Congress, 1995), http://countrystudies.us/india/, Accessed on 23 February 2011; 'India's Boundary Disputes with China, Nepal, and Pakistan', *International Boundary Consultants* (15 May 1998), www.boundaries.com/India.htm. Accessed on 23 February 2011.

[48] 'Misgivings Reinforced', *Economic and Political Weekly*, Vol.30, No.30 (1995), p.1889; Lok Raj Baral, 'Bilateralism Under the Shadow: The Problems of Refugees in Nepal-Bhutan Relations', *CNAS Journal*, Vol.20, No.2 (1993), pp.197-212.

[49] James Heitzman and Robert L. Worden (eds), *India: A Country Study* (Washington: GPO for the Library of Congress, 1995), http://countrystudies.us/india/. Accessed on 23 February 2011; 'India raises cross-border terrorism with Pak', *CNN-IBN*, 24 June 2010, http://ibnlive.in.com/news/india-raises-crossborder-terrorism-with-pak/125199-2.html. Accessed on 23 February 2011.

[50] C. Raja Mohan, 'India and the Balance of Power', *Foreign Affairs*, Vol.85, No.4 (2006), p.19; William J. Barnds, 'Friends and Neighbors', *Foreign Affairs*, Vol.46, No.3 (1968), p.559.

contentious bilateral issues were to be kept out of the SAARC forum.[51] However, unlike ASEAN, the SAARC states were unable to work out an informal conflict avoidance norm, and the region experienced some armed conflict, most notably the Kargil War between India and Pakistan in 1999. This then led the 11th SAARC Summit to be postponed for three years.[52] The war also foiled negotiations for a potential India-Pakistan energy deal.[53] Border spats, like the armed clashes between Indian and Bangladeshi border guards in April 2001, also added to the instability of the region.[54]

SAARC's economic development also remained hostage to mutual suspicions. Thus, while the SAARC Preferential Trading Arrangement (SAPTA) was signed in 1993 and brought into force by 1995, no great progress was made on the economic front.[55] An attempt to circumvent the slow progress, the South Asia Growth Quadrangle between Bangladesh, Bhutan, India and Nepal launched in 1997, was also undone due to domestic suspicion of India in Bangladesh.[56]

SAARC Two: Expansion and Reinvention?

At the 13th SAARC Summit in 2005, SAARC members agreed to include Afghanistan as the eighth member of the regional grouping.[57] At the same summit, SAARC also granted observer status to China and Japan. Subsequently, Australia, the European Union (EU), Iran, Republic of Korea, Mauritius, Myanmar and the US have also joined the regional organisation as observers.[58] The inclusion of Afghanistan as a full member and international observers like the US and China arguably represents an opportunity for SAARC to reinvigorate itself. It created an opportunity for the South Asian states to interact with each

---

[51] 'Charter of the South Asian Association for Regional Cooperation', *SAARC* (08 December 1985), http://saarc-sdmc.nic.in/pdf/charter.pdf. Accessed on 23 February 2011; 'Misgivings Reinforced', *Economic and Political Weekly*, Vol.30, No.30 (1995), p.1889.

[52] Rajshree Jetly, 'Conflict Management Strategies in ASEAN: Perspectives for SAARC', *The Pacific Review*, Vol.16, No.1 (2003), p.63.

[53] Smruti S. Pattanaik, 'Making Sense of Regional Cooperation: SAARC at Twenty', *Strategic Analysis*, Vol.30, No.1 (2006), p.152.

[54] 'Fresh Bangladesh border clash', *BBC News* (19 April 2001), http://news.bbc.co.uk/2/hi/south_asia/1284789.stm. Accessed on 23 February 2011.

[55] 'SAARC Preferential Trading Arrangement (SAPTA)', *SAARC* (2009), www.saarc-sec.org/areaofcooperation/detail.php?activity_id=4, Accessed on 23 February 2011; Dushni Weerakoon, 'Does SAFTA Have a Future?', *Economic and Political Weekly*, Vol.36, No.34 (2001), pp.3214-16; Kalyan Raipuria, 'ASEAN and SAARC: Select Futuristic Scenarios', *Economic and Political Weekly*, Vol.37, No.35 (2002), p.3581.

[56] Such sub-regional groupings are allowed under Article VII of the SAARC Charter. The attempt to establish the growth quadrangle was supported by the traditionally 'pro-India' ruling Awami League. However, the proposal was cried down by the traditionally 'anti-India' BNP (Bangladesh National Party)-led opposition, which accused the proposal as a device to sideline SAARC as a whole. The BNP also termed to move as a way to 'establish Indian expansionism'. See Md Nuruzzaman, 'SAARC and Subregional Co-operation: Domestic Politics and Foreign Policies in South Asia', *Contemporary South Asia*, Vol.8, No.3, (1999), pp.311-22.

[57] Afghanistan officially joined SAARC as a member in 2007 at the 14th SAARC Summit.

[58] Myanmar also applied for full membership in 2008. Currently, its application is under consideration.

other in the presence of extra-regional states that could potentially reduce some of the mutual suspicions in the region. Moreover, the expansion also represents an opportunity for SAARC, as an economic bloc, to develop beneficial trade relationships amongst these external observers.

The clarity of this successful relationship is still not determined. Certainly, economic cooperation in the region is still subject to some impediments. The more recent South Asian Free Trade Area (SAFTA), which was first signed in 2004 and came into force in January 2006, has faced hurdles in terms of long 'sensitive lists' and other barriers.[59] Indeed, Article 14 of the SAFTA agreement states that '[n]othing in this Agreement shall be construed to prevent any Contracting State from taking action and adopting measures which it considers necessary for the protection of its national security', while leaving some room in the interpretation of what might constitute an issue of 'national security'.[60] That economic development in SAARC has been held hostage to politics is also clear in Pakistan's declared intention to have limited bilateral trade with India, until such time that progress is made on the Kashmir issue.[61] Pakistan has also denied Most Favoured Nation (MFN) status to India.[62] On the other hand, while India granted MFN status to Pakistan in 1996, it maintains 'an array of hidden barriers [which] leave little wriggle room for Pakistani exports to India'.[63] Apart from banning products from each other, the two also 'restrict transport links and business contact with each other'.[64]

However, cooperation in other areas has progressed further. In this regard, the recently established SAARC University in Delhi is a notable achievement.[65] Similarly, the SAARC Development Fund (SDF), which was officially launched during the 2010 SAARC summit, is a positive development.[66] Much like the now defunct South Asian Development Fund

---

59 Pradumna B. Rana and J. Malcolm Dowling, 'Economic Integration in South Asia and Lessons from East Asia of Trade and Investment' in Joseph Francois, Pradumna B. Rana and Ganeshan Wignaraja (eds), *Pan-Asian Integration: Linking East and South Asia* (Hampshire: Palgrave Macmillan, 2009), p.214.

60 'Agreement on South Asian Free Trade Area (SAFTA)', *SAARC* (06 January 2004), www.saarc-sec.org/userfiles/saftaagreement.pdf. Accessed on 23 February 2011.

61 Smruti S. Pattanaik, 'Making Sense of Regional Cooperation: SAARC at Twenty', *Strategic Analysis*, Vol.30, No.1 (2006), p.159.

62 Aparna Sawhney and Rajiv Kumar, 'Rejuvenating SAARC: The Strategic Payoffs for India', *Global Economy Journal*, Vol.8, No.2 (2008), p.4.

63 Muhammad Najeeb, 'MFN eludes India, Pak Inc cries foul', *The Economic Times* (09 September 2003), www.hvk.org/articles/0903/121.html, Accessed on 23 February 2011; Shaheen Rafi Khan, Faisal Haq Shaheen and Moeed Yusuf, 'Managing Conflict Through Trade: The Case of Pakistan and India' in Shaheen Rafi Khan (ed.), *Regional Trade Integration and Conflict Resolution* (New York: Routledge, 2009), pp.118-49.

64 Pradumna B. Rana and J. Malcolm Dowling, 'Economic Integration in South Asia and Lessons from East Asia of Trade and Investment', in Joseph Francois, Pradumna B Rana and Ganeshan Wignaraja (eds), *Pan-Asian Integration: Linking East and South Asia* (Hampshire: Palgrave Macmillan, 2009), p.220.

65 'SAARC University to start functioning in New Delhi by August', *The Economic Times* (27 April 2010), http://economictimes.indiatimes.com/news/politics/nation/SAARC-University-to-start-functioning-in-New-Delhi-by-August/articleshow/5864515.cms. Accessed on 23 February 2011.

66 'SAARC Development Fund (SDF)', SAARC (2009), www.saarc-sec.org/areaofcooperation/cat-

(SADF), the SDF is to ‘serve as a regional funding mechanism to fund various social, economic and infrastructure projects in the region’, much like the International Monetary Fund or the Asian Development Bank.[67]

Finally, while SAARC has yet to devise a conflict management norm – informal or otherwise – the presence of extra-regional powers in the organisation and region appears to have reduced the chances of armed inter-state conflict in South Asia. Much of this also has to do with the rapprochement between India, the largest member of the regional organisation, and the US. Traditionally, India has regarded the superpower with suspicion, given its close alliance with Pakistan.[68] However, in the early 21st century some factors have brought the US and India closer together. Apart from India’s growing economic openness, a mutual suspicion of China’s rise and an interest in countering terrorism have changed Indian perceptions of the US and the latter is increasingly seen as a fair arbiter.[69] Certainly, the US’ interest in stabilising Afghanistan and fighting the Taliban in the region has resulted in increased pressure on Pakistan to actively secure its borders. Thus, while Pakistan continues to receive aid from the US, the aid has been made conditional on Islamabad’s ‘success in fighting terrorism and extremist elements in the country’.[70] Moreover, the US also pressured Pakistan to ‘take firmer action against militants thought to be involved in [the 2008] Mumbai bombings’, which led the Pakistani forces to close down facilities that belonged to Jamaat-ud-dawa, a group thought to be a front for the Lashkar-e-Taiba (LeT)¸ who India blamed for the bombings.[71] At the same time, the US also ‘actively tr[ied] to negotiate an end to prevailing frictions between India and Pakistan’.[72] The US and India also coordinated their response to the crisis in Nepal in 2006.[73] As a result, the recent rapprochement between India and the US appears to have led the US to contribute a more stabilising influence in the region.

detail.php?cat_id=58. Accessed on 23 February 2011; ‘SAARC development fund launched in Bhutan’, *People’s Daily Online* (29 April 2010), http://english.peopledaily.com.cn/90001/90777/90851/6967797.html. Accessed on 23 February 2011.

[67] *Ibid.*

[68] Baldev Raj Nayar, ‘United States and India: New Directions and Their Context’, *Economic and Political Weekly*, Vol.12, No.45/46 (1977), p.1906.

[69] Christophe Jaffrelot, ‘The India-US Rapprochement: State-driven or Middle Class-driven?’, *India Quarterly*, Vol.65, No.1 (2009), pp.5-8.

[70] ‘Increased aid conditional to fighting terror: US to Pak’, *Express India* (27 March 2009), www.expressindia.com/latest-news/Increased-aid-conditional-to-fighting-terror-US-to-Pak/439772/. Accessed on 23 February 2011. Also see, K. Alan Kronstadt, ‘International Terrorism in South Asia’, *CRS Report for Congress* (3 November 2003), www.fas.org/irp/crs/RS21658.pdf. Accessed on 23 February 2011.

[71] Farhan Bokhari, ‘US Ups Pressure on Pakistan’, *CBS News* (22 December 2008), www.cbsnews.com/8301-503543_162-4681704-503543.html, Accessed on 23 February 2011.

[72] *Ibid.*

[73] ‘The United States and South Asia: An Expanding Agenda’, House of Representatives (17 May 2006), www.foreignaffairs.house.gov/archives/109/27646.pdf. Accessed on 23 February 2011.

Factors Determining Effectiveness of Conflict Management in ASEAN and SAARC

While tensions between states in ASEAN continue to exist – evident in such bilateral spats as those between Singapore and Malaysia in regards to their water treaties, Singapore and Thailand over Temasek Holdings' investment in the Thai telcom Shin Corp, and the ownership of the historic Preah Vihear temple in Thailand and Cambodia – it is clear that the informal and quiet diplomacy encompassed in the 'ASEAN Way' has successfully managed conflict in Southeast Asia, albeit at its most basic level, that is, the prevention of a violent conflict. Four major factors help explain ASEAN's relative success, and SAARC's inability, thus far, to manage conflict in their respective regions. These are: a common threat perception; role of the key state; role of extra-regional powers; all of which facilitate the creation of the fourth major factor, a common norm.

1. <u>Common Threat Perception</u>

During its formative years, the core ASEAN members – Indonesia, the Philippines, Malaysia, Singapore and Thailand – all saw the 'Communist threat' especially as embodied by the fall of South Vietnam to North Vietnam and the Soviet-backed Vietnamese invasion of *Kampuchea* as a threat to their 'market-friendly' model of economic growth. This common external threat perception thus provided the impetus for these countries to set aside their bilateral issues and work towards establishing a stable region conducive to export-oriented economic growth. Consequently, the ASEAN states developed informal diplomatic mechanisms to manage their bilateral tensions, which then evolved into the consultative and consensus-oriented 'ASEAN Way'.

Unlike ASEAN, SAARC states did not share a common threat perception at the time of its founding. Indeed, for many of the smaller countries in the region, India is not only seen as a regional hegemon but also as a potential threat. India's perceived activism in South Asia in the past has led some of its smaller neighbours to regard it with suspicion. It does not help that Indian rhetoric at times does appear to portend potential 'activist' moves in the region.[74] Additionally, the other South Asian states also have several, albeit less acrimonious, bilateral

[74] 'Foreign Secretary Mr Shyam Saran's speech on "India and its Neighbours" at the India International Centre (IIC)', (Washington, D. C.: *Embassy of India*, 14 February 2005), www.indianembassy.org/prdetail1124/download_file.php?action=download&mainfolder=form_files/&filename=Form_Pdf_29.pdf. Accessed on 24 February 2011.
For example, in 2005, in a speech at the India International Centre, the Indian Foreign Secretary said, 'India would like the whole of South Asia to emerge as a community of flourishing democracies... [w]e believe that democracy would provide a more enduring and broad-based foundation for an edifice of peace and cooperation in our sub-continent' and that 'India would certainly welcome more democracy in [its] neighbourhood' and that was something India 'may encourage and promote'. While these apparently activist comments were mediated with an acceptance of the status quo and the understanding, '[w]hile democracy remains India's abiding conviction, the importance of our neighbourhood requires that we remain engaged with whichever government is exercising authority in any country in our neighbourhood,' It is easy to see how such comments may cause some consternation in the region.

disputes with each other. These mutual suspicions have thus inhibited the development of a common conflict management norm in South Asia.

2. Role of the Key State

In 1967, Indonesia, under Suharto, was keen to mitigate the effects of the *Konfrontasi* with Malaysia. Thus, Indonesia was willing to take up the role of a benign regional leader. At the same time, the smaller ASEAN states were also eager to socialise Indonesia into a less hostile position, and were thus careful to accord it some deference as the regional leader. For example, Indonesia's reaction to the hanging of two Indonesia commandos in 1968 by Singapore was relatively restrained despite public demonstrations in Jakarta. In turn, as a reconciliatory gesture, during a 1973 visit to Indonesia, then Singaporean Prime Minister, Lee Kuan Yew, scattered flower petals on the graves of the commandos.[75]

On the other hand, while India, as the largest state and economy, occupies a similar position in South Asia, it did not regard the proposed regional organisation with the same optimism. Indeed, at the time of SAARC's founding, it was ambivalent towards the organisation, seeing it as a forum where the smaller states may 'gang up' against it.[76] India's various disputes with its neighbours have also led to it being seen as highhanded, which without doubt colours its interactions with its neighbours and vice-versa. To be sure, South Asian states, like Pakistan, have not toned down their rhetoric towards India. Nevertheless, India's recent pledge to operate on the principle of non-reciprocity in its economic relations with its neighbours is a step towards taking up a benign regional leadership role.[77] This also represents a return to the short lived 'Gujral Doctrine', first articulated in 1997 by then Prime Minister, I.K. Gujral, who stated that India would not ask for reciprocity, but conduct its relations with its neighbours on the basis of good faith and trust.[78] However, once Gujral left office in 1998, the doctrine died a natural death. In spite of this, India has also seemingly 'bypassed' its immediate region and has actively engaged with extra-regional multilateral organisations like ASEAN, the ARF and the East Asia Summit (EAS).[79] Hence, while India's recent iteration of

[75] Rajshree Jetly, 'Conflict Management Strategies in ASEAN: Perspectives for SAARC', *The Pacific Review*, Vol.16, No.1 (2003), p.64.

[76] Thomas Perry Thornton, 'Regional Organizations in Conflict Management', *ANNALS of the American Academy of Political and Social Science*, Vol.518, No.1 (1991), p.136.

[77] 'Foreign Secretary Mr Shyam Saran's speech on "India and its Neighbours" at the India International Centre (CII)', (Washington, D. C.: *Embassy of India*, 14 February 2005), www.indianembassy.org/prdetail1124/download_file.php?action=download&mainfolder=form_files/&filename=Form_Pdf_29.pdf. Accessed on 23 February 2011.

[78] 'The Gujral Doctrine: Text of "Aspects of India's Foreign Policy", a Speech by I.K. Gujral at the Bandaranaike Center for International Studies in Colombo, Sri Lanka on January 20, 1997', (Washington, D. C.: The Henry L. Stimson Center, 20 January 1997), http://apps.stimson.org/southasia/?sn=sa20020116302. Accessed on 23 February 2011.

[79] Smruti S. Pattanaik, 'Making Sense of Regional Cooperation: SAARC at Twenty', *Strategic Analysis*, Vol.30, No.1 (2006), p.140; Nagesh Kumar, Rahul Sen and Mukul Asher, 'India-ASEAN Partnership in an Era of Globalization: An Overview' in Nagesh Kumar, Rahul Sen and Mukul Asher (eds), *India-ASEAN Economic Relations: Meeting the Challenges of Globalization* (Singapore: ISEAS, 2006), pp.1-14.

non-reciprocity is a positive development for SAARC, its commitment to the regional project is not necessarily absolute.

3. Role of Extra-Regional Players

At the time of its inception, Southeast Asian states faced what appeared to be an existential threat in Communism. Additionally, as new nation-states, none of them possessed the resources to 'counter' this threat indigenously. This led the ASEAN nations to then solicit external security guarantors – in particular, but not exclusively, the US. The ASEAN states have also demonstrated a willingness to subject themselves to international arbitration in their disputes. For instance, Malaysia and Singapore took their dispute over Singapore reclamation projects to the International Tribunal for the Law of the Sea in 2003. Subsequently, the matter was resolved with Singapore agreeing to review its reclamation plans to protect sea currents.[80]

On the other hand, in South Asia, because India itself is perceived to be a major threat, other regional states like Pakistan and Bangladesh have sought help from outside powers – like the US and China – against India. For instance, in 1983, when ethnic violence broke out in Sri Lanka, the Sri Lankan government approached the US for military assistance against the perceived possibility of an Indian intervention.[81] Moreover, in the milieu of the Cold War, the US' support for Pakistan and China, both regional rivals to India, led India to regard the superpower with suspicion, just as India's close relationship to the Soviet Union (USSR) led the US to regard India with equal suspicion.[82] Thus, '[f]rom the early 1950s…[India] became the target of American containment through the mechanism of building up Pakistan militarily as a counterpoise against India', while the US' support of West Pakistan during the 1971 civil war only solidified India's misgivings vis-à-vis the superpower.[83] Additionally, Indian quest for (and subsequent acquisition in 1998) nuclear weapons and opposition to the Non-Proliferation Treaty (NPT) only added to Indo-US tensions, and led the US to regard India as a 'revisionist state destined to be at odds with the United States'.[84] Similarly, Washington's 'hyperactive, prescriptive approach to Kashmir' kept Indian reservations alive.[85]

---

80 'Singapore, Malaysia end sea dredging dispute', *China Daily* (26 April 2005), www.chinadaily.com.cn/english/doc/2005-04/26/content_437666.htm. Accessed on 23 February 2011.

81 P. Venkateshwar Rao, 'Ethnic Conflict in Sri Lanka: India's Role and Perception', *Asian Survey*, Vol.28, No.4 (1988), p.420.

82 C. Raja Mohan, 'India and the Balance of Power', *Foreign Affairs*, Vol.85, No.4 (2006), p.19; William J. Barnds, 'Friends and Neighbors', *Foreign Affairs*, Vol.46, No.3 (1968), p.19.

83 Baldev Raj Nayar, 'United States and India: New Directions and Their Context', *Economic and Political Weekly*, Vol.12, No.45/46 (1977), p.1906.

84 Deepa Ollapally and Raja Ramanna, 'US-India Tensions: Misperceptions on Nuclear Proliferation', *Foreign Affairs*, Vol.74, No.1 (1995), p.13.

85 C. Raja Mohan, 'India and the Balance of Power', *Foreign Affairs*, Vol.85, No.4 (2006), p.19; William J. Barnds, 'Friends and Neighbors', *Foreign Affairs*, Vol.46, No.3 (1968), p.20.

India's relations with China were equally tense. A border dispute led to a full scale war between the neighbours in 1962 and subsequent rounds of talks have yet to resolve the issue.[86] Also, since the 1960s, China '[r]econgnising that strategic-rival, India, has the size, might, numbers, and above all, the intention to match China, Beijing has long followed *hexiao, gongda* policy in South Asia', that is, a policy of 'uniting with the small (Pakistan, Bangladesh, Burma, Nepal, and Sri Lanka) to counter the big (India)'.[87] Finally, the extant of mutual suspicion in South Asia (and of extra-regional actors) have prevented states from seeking international arbitration.[88]

However, this situation is changing. Not only has India's economic performance led to a growing interest amongst key extra-regional players to engage with India, it has also given India the confidence to both act more benignly in its own region and to engage (with reduced suspicion) with extra-regional players. The burgeoning Sino-Indian economic ties – bilateral trade is expected at around US$60 billion at the end of 2010 – appear to have given both states the incentive to set aside contentious issues and concentrate on mutually beneficial economic development.[89] At the same, the convergence of interests between India and the US has also helped alleviate tensions in the region.

4. Common Norm

Their common threat perception, the presence of a regional leader favourable to the establishment of a regional organisation and the presence mutually agreeable and equally favourable external power, set the conditions for ASEAN states to successfully develop norms to help them manage conflict in Southeast Asia. That there was a preference for an informal, non-legalist style of conflict management is not surprising given that all ASEAN states were relatively new nation-states, and were as a result disinclined to subject themselves to a structure/norm that seemed to impinge on their individual sovereignty. Nevertheless, in the 'ASEAN Way', Southeast Asian states have found a way to avoid/ignore contentious issues that could destabilise the region and the regional economies. The 'consensus minus X' approach also allowed ASEAN states to accommodate differing stances that could otherwise lead to glaring stalemates.

Unlike the ASEAN, at the time of SAARC's founding, there was no common threat perception in South Asia to motivate its founding members to push aside their bilateral squabbles with each other. Moreover, because of their bilateral tensions, some states, like

[86] Mohan Malik, 'India-China Relations', *APCSS Brief Analytical Reports* (2009), p.1145.
[87] *Ibid.*
[88] Rajshree Jetly, 'Conflict Management Strategies in ASEAN: Perspectives for SAARC', *The Pacific Review*, Vol.16, No.1 (2003), p.68.
[89] 'Indo-China trade will touch USD 60-bn by 2010-end: Sr. diplomat', *The Economic Times* (13 May 2010), http://economictimes.indiatimes.com/news/economy/foreign-trade/Indo-China-trade-will-touch-USD-60-bn-by-2010-end-Sr-diplomat/articleshow/5927477.cms. Accessed on 23 February 2011.

Pakistan and Sri Lanka, sought the help of external powers to secure themselves against a perceived threat from another founding member, India. Given this situation, it is then unsurprising that India was both unwilling and unable to take up the role of a benign regional leader. As a result, SAARC floundered and its members were unable to create any mutually agreeable conflict management norm. Consequently, SAARC countries have not been able to 'de-couple' their political frictions from their economic development. Pakistan's refusal to move forward on trade, failing a resolution on the Kashmir issue, clearly illustrates that members even disagree on whether regional cooperation is possible without addressing bilateral conflicts. Moreover, SAARC decisions are based on unanimity, which has made accommodating differing viewpoint difficult. This lack of flexibility has made moving forward on projects – such as the South Asia Growth Quadrangle – a challenge.

Conclusion

Conditions at the time of the ASEAN's founding provided Indonesia, Malaysia, the Philippines, Singapore and Thailand with the impetus to set aside bilateral tensions and create a regional organisation that could stabilise the region. Hence, these states were able to formulate an informal conflict management norm in the ASEAN Way. While this conflict management norm has thus far been geared more towards conflict prevention in the most basic sense, that is, the prevention of an armed inter-state conflict in the region, it is clear that at this basic level ASEAN (and its 'ASEAN Way') has been successful in managing conflict in the region, as there has been no armed conflict between states in Southeast Asia since 1967.

This is not to say that bilateral tensions do not exist. Singapore and Malaysia continue to spar occasionally, most recently over the water treaties. Singapore and Indonesia also had a diplomatic spat over Singapore's acquisition of sand for its reclamation project and the Thai state's approach to the insurgency in its south caused some tensions with Malaysia. However, despite indulging in some heated rhetorical exchanges, Southeast Asian states have demonstrated a commitment to the quiet diplomacy of the 'ASEAN Way', and have successfully avoided armed conflict in the region, by downplaying and/or ignoring bilateral issues until such time a mutually acceptable resolution can be found or by successfully subjecting disputes to international arbitration.

ASEAN's success on this score has also facilitated its economies' growth. Intra-ASEAN trade grew from 17.9 per cent in 1980 to 26.9 per cent (of total trade) in 2007.[90] Thus, while much of the economic growth in the region is due to growth at the national level, ASEAN's ability to create a region free of armed conflict arguably created a stable environment that

[90] Michael Plummer and Ganeshan Wignaraja, 'Integration Strategies for ASEAN: Alone, Together, or Together with Neighbours?', in Joseph Francois, Pradumna B. Rana and Ganeshan Wignaraja (eds), *Pan-Asian Integration: Linking East and South Asia*, (Basingstoke, UK: Palgrave Macmillan, 2009), p.165.

enabled for individual state to pursue economic development. Here it is telling that intra-regional trade in South Asia, despite India's growth and its bilateral trade agreements with other South Asian states like Sri Lanka and Nepal, stands at around five per cent.[91]

In South Asia, conflicting threat perceptions, the disruptive role of extra-regional players and India's ambivalence towards the SAARC, at its founding, largely scuppered the emergence of a regional conflict management norm. However, recent changes in India's view towards the regional organisation and its neighbourhood (while still ambivalent) may lead to the provision of the sort of regional leadership needed to establish SAARC as an organisation relevant to South Asia. Moreover, India's improving relationship with external stakeholders, and their changing role in the region, also appear to have reduced the likelihood of another armed conflict in South Asia. As with Southeast Asia, it is unlikely that South Asian states will be comfortable with any arrangement/norm that appears to impinge on their sovereignty. However, given these changes, there exists a possibility that this extra-regional influence may slowly transfer into the institutional arrangement and lead to the development of an informal conflict management norm.

[91] Pradumna B. Rana and J. Malcolm Dowling, 'Economic Integration in South Asia and Lessons from East Asia of Trade and Investment' in Joseph Francois, Pradumna B. Rana and Ganeshan Wignaraja (eds), *Pan-Asian Integration: Linking East and South Asia* (Hampshire: Palgrave Macmillan, 2009), p.216; Aparna Sawhney and Rajiv Kumar, 'Rejuvenating SAARC: The Strategic Payoffs for India', *Global Economy Journal*, Vol.8, No.2 (2008), p.7.

ISAS Working Paper

No. 124 – 14 March 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

India, Afghanistan and the 'End Game'?

Shanthie Mariet D'Souza[1]

Abstract

New Delhi, in recent times, has been confronted with some hard choices in Afghanistan. A decade-long policy of providing huge humanitarian and developmental assistance, which has accrued tremendous goodwill among the Afghans, is now perceived to be in imminent danger of being disrupted and overwhelmed by the United States (US) decision of conditional withdrawal. This is in addition to the recently shifting discourse of negotiating with the Taliban, which is interpreted as an upsurge of Pakistani influence in Kabul. The choice for India was never whether it should stay engaged in Afghanistan or not. Even in the face of repeated onslaughts on its personnel and mission, India was committed to staying the course. However, decision making to that extent has become even more difficult given that the West appears to be in a hurry to bring its ominous gamble in Afghanistan to a close. It is thus timely to take stock of India's role and interests in Afghanistan. It is also useful to explore various policy options in the evolving scenarios of limited downsizing or even complete withdrawal of international troops from the conflict-ridden country.

---

[1] Dr Shanthie Mariet D'Souza is Visiting Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. She can be reached at isassmd@nus.edu.sg. The views reflected in this paper are those of the author and not of the institute. This paper is based on interactions, interviews, discussions with policymakers, senior government officials, key interlocutors, embassy personnel, academia, think tanks, security and media personnel, international organisations (local and international) and 'person on the street' narratives during a field visit to Afghanistan in October 2010. The author wishes to thank her Afghan interlocutors.

Introduction

India’s role in post-9/11 Afghanistan has been a subject of intense pedantic policy deliberations, at times bordering on speculations. On one hand, India is seen to play a critical role in the reconstruction of the war-ravaged country, and on the other, India’s growing influence in Afghanistan as a result of its aid diplomacy is said to have increased Pakistan’s real or imagined concerns of encirclement in what it perceives to be its ‘strategic backyard’. This ‘zero-sum’ geopolitical rivalry between India and Pakistan, dubbed by Western analysts as the ‘new great game’, is seen as a source of further instability.

India’s interests in post-9/11 Afghanistan have centred on three broad objectives – security concerns, economic interests and regional aspirations. In understanding India’s strategic thinking on Afghanistan, it would be useful to locate India’s strategic mind within the broad parameters of three schools of thought/paradigms: (1) Realist, (2) Neo-liberal, and (3) Nehruvian-Marxist. [2] The Realist perspective envisions India’s aid and development assistance as a useful tool directed at supporting the nascent democratic regime, the strengthening of which denies the space for return of the Taliban to the seat of power. The Neo-liberals prod India to take a more proactive role as a major regional and economic power with ambitions of extending its influence beyond its immediate neighbourhood for tapping enormous energy and trade potential in the region. India has worked towards this objective by reviving the role of Afghanistan as a land bridge, which connects South Asia with energy-rich Central Asia for economic and energy interests. By linking stability with greater economic integration, India has been actively promoting greater trade and economic integration of Afghanistan with South Asia through the regional mechanism of South Asian Association of Regional Cooperation (SAARC). The thinkers in the Nehruvian tradition, while arguing against interference in internal affairs, emphasise the need for regional cooperation and restoring ‘peace and neutrality’ in Afghanistan, preferably under the aegis of the United Nations (UN).

To achieve these objectives, as indicated by various strands of Indian thinking, India adopted the ‘soft power’, reviving its historical, traditional, socio-cultural and civilisational linkages with the war-ravaged country. This ideational and enabling role which has been well received by the Afghans, has important lessons for the international community for the long-term stabilisation of Afghanistan. However, as the discourse on the ‘end game’ gains momentum, whether India’s interests and role can be sustained or even expanded to protect its core

[2] It is, however, important to note that any attempt to compartmentalise Indian strategic thinking into these three schools of thought would be simplistic and futile given the significant overlapping and mixed motives these thinkers represent in reacting to fluid geopolitical environment in Afghanistan and Pakistan. Some of the noted scholars belonging to these three schools are: K. Subrahmanyam, Brijesh Mishra, G. Parthasarathy and Gurmeet Kanwal (Realist); Montek Singh Ahluwalia, Sanjaya Baru (Neoliberal); Mohammed Hamid Ansari, Chinmaya Gharekhan, Bhabani Sen Gupta and Mani Shankar Aiyar (Nehruvian). See Shanthie Mariet D’Souza, ‘India’s Strategic Approach towards Afghanistan’ (8-10 September 2010). Paper presented at the Oslo *IFS-IDSA Conference* on ‘India’s Grand Strategic Thought’.

national security concerns emanating from the region, has emerged as a subject of immediate academic and policy importance.

India, Afghanistan and the Cold War

Most of the commentators on India's foreign policy bemoan the absence of a 'grand strategy'[3] as a factor which has impeded India's rise as a major power on the global stage. Contrary to such perceptions, a brief survey of India's relations with Afghanistan would indicate that there has been a constant search for 'the right balance between force and diplomacy, functional and political criteria.'[4] Peace and stability in Afghanistan have remained important foreign policy objectives for India. Being members of the Non-Aligned Movement (NAM), both countries maintained 'neutrality' in the Cold War atmospherics. Afghanistan maintained neutrality by adhering to its traditional policy of *bi-tarafi* in its efforts to balance the great power rivalry.[5] The signing of a 'Friendship Treaty' in 1950 paved the way for development of India's friendly relations with King Zahir Shah's regime which continued till the late 1970s.

The Soviet intervention in Afghanistan, which brought the Cold War to India's doorsteps, spurred immense diplomatic activity in New Delhi. According to a well-known commentator, 'Never before in the history of Indian diplomacy was there so much groping for ideas and directions. Never before was India's foreign policy an act of sterner choice.'[6] There were serious concerns of great power confrontation and militarisation in the region with increased arms supplies to Pakistan by the US. J.N. Dixit, former Indian Ambassador to Afghanistan noted Indian Prime Minister Indira Gandhi's, 'reservations about the Soviet intervention in Afghanistan in December 1979 was tempered by the valid perception that this intervention had taken place only because Pakistan and Saudi Arabia, backed by the US, were trying to subvert a critical exercise being undertaken by a segment of Afghan society to transform their country from its semi-medieval predicament into a modern society.'[7]

---

[3] George K. Tanham, 'Indian Strategic Thought: An Interpretive Essay' (Santa Monica: RAND, 1992), www.rand.org/pubs/reports/2007/R4207.pdf. Accessed on 20 August 2010.

[4] Srinath Raghavan, 'Virtues of being vague', *Asian Age* (7 January 2010), www.deccanchronicle.com/dc-comment/virtues-being-vague-973. Accessed on 20 August 2010.

[5] For much of the 20th century, the rulers of Afghanistan highlighted the approach of neutrality, as expressed by King Nadir Shah in 1931: 'The best and most fruitful policy that one can imagine for Afghanistan is a policy of neutrality. Afghanistan must give its neighbours assurances of its friendly attitudes while safeguarding the right of reciprocity.'

[6] Bhabani Sen Gupta, *The Afghan Syndrome: How to Live with Soviet Power* (New Delhi: Vikas Publishing House, 1982).

[7] Author's discussion with former Indian Ambassadors to Afghanistan, Ambassador J.N. Dixit, (1980-85) in New Delhi (October 2001) and Ambassador I.P. Khosla in New Delhi (January 2011). Also see, J.N. Dixit, *India's Foreign Policy 1947-2003* (New Delhi: Picus Books, 2003), p.137; and *An Afghan: Diary-Zahir Shah to Taliban* (New Delhi: Konark Publishers, 2000).

Historical anecdotes, however, suggest that despite India's muted public opposition to the Soviet intervention in Afghanistan, India did register its displeasure at various private forums.[8] According to former Foreign Secretary, M.K. Rasgotra, 'There was no international support for the Soviet intervention. In fact, Moscow's intentions and motives were suspect even in friendly countries … Indira Gandhi telling Brezhnev in Moscow in October 1982 that he should withdraw Russian troops from Afghanistan; the sooner the better.'[9]

During the Soviet intervention, ensuring peace and stability in Afghanistan remained important foreign policy objectives for India. Criticising the external powers, for jeopardising peace and development in the region, Indian Prime Minister Rajiv Gandhi, at a joint session of Congress in June 1985, said, 'Outside interference and intervention have put in jeopardy the stability, security and progress of the region. We stand for a political settlement in Afghanistan that ensures sovereignty, integrity, independence and non-aligned status, and enables the refugees to return their homes in safety and honour.'[10] He asserted, 'India could not remain indifferent to the developments which had brought the confrontation of major powers to its doorstep.'[11]

Despite the deterioration of political situation in the region, relations between India and Afghanistan, especially on trade, banking, industry, sports, education and cultural exchanges continued uninterrupted. The signing of an agreement on 20 February 1984 in Kabul between the two countries envisaged several 'measures for expanding and diversifying bilateral trade and for establishing direct contacts between the banks of the two countries.'[12] A cultural exchange programme planned for 1985-87 between the two countries was signed in New Delhi on 7 August 1985. India agreed to provide ten scholarships to Afghan nationals for doctoral studies and other fellowships for visiting scholars for training in public cooperation and child development. India also agreed to impart training to Afghan nationals in repair and preservation of historical monuments and rare manuscripts. Further, both the countries agreed to undertake joint research and teaching programmes. India promised to strengthen the programme of Afghan studies, hold film weeks and supply textbooks.[13] India further agreed to assist Afghanistan in the expansion of its health institutions and provide equipment worth

---

8 G.S. Bhargava, *South Asian Security after Afghanistan* (Lexington: Lexington Books, 1983).

9 Brezhnev had said Taraki had been asking him for ten thousand Russian troops, that for a time he had repeatedly rejected the request but finally sent ten thousand troops and now there were one hundred thousand of them there. He added, 'I do not know what they are doing there, I want to get out of Afghanistan, you know the area better, show me a way.' Indira Gandhi had responded, 'Mr Secretary General, the way out is the same as the way in.' Maharajakrishna Rasgotra, 'Afghanistan: The way out; Give guarantees for its neutrality', *The Tribune* (31 December 2009), www.tribuneindia.com/2009/20091231/edit.htm#4. Accessed on 25 August 2010; Maharajakrishna Rasgotra, 'Afghanistan: The March of Folly', *The Hindu* (11 June 2010).

10 Quoted in Shelton U. Kodikara, 'Role of Extra-Regional Powers and South Asian Security', in Sridhar K. Khatri (ed.), *Regional and Security in South Asia* (Kathmandu: Centre for Nepal and Asian Studies, Tribhuvan University, 1987).

11 Satish Kumar (ed.), *Yearbook on India's Foreign Policy 1989* (New Delhi: Sage Publications, 1990), p.31.

12 Satish Kumar, 'India and the World-Trends and Events', in Satish Kumar (ed), *Yearbook on India's Foreign Policy 1983-84* (New Delhi: Sage Publications, 1986), p.25.

13 'Cultural Exchanges with Afghanistan', *Asian Recorder*, Vol.31, No.44, (29 October - 4 November 1985), p.18580.

₹2 million, which included setting up a 300-bed maternity hospital and expanding the India-aided Institute of Child Health in Kabul. India promised to supply medicine worth ₹200,000 every year and assured to add ten more sheds to an industrial estate in Kabul.[14]

As the political reconciliation began to take place in Afghanistan, Foreign Minister Abdul Wakil visited New Delhi on 7 February 1987 and briefed Indian leaders including Prime Minister Rajiv Gandhi on the national reconciliation moves.[15] Three months later, in May 1987, the eighth session of the Indo-Afghan Joint Commission was held in Kabul. Both countries decided to establish direct banking arrangements, closer cooperation between trading organisations and intensify industrial cooperation. In addition, India also agreed to set up a cultural centre in the Indian Embassy in Kabul.[16] The Afghan Government endorsed India's role as an important stakeholder in the conflict resolution. On 3 March 1989, Afghanistan's Ambassador to the UN, Shah Mohammad Dost, said in his address to the press at the UN, 'India is a leading country of the region and has a vital stake in what happens there. It has an important role in ensuring that the problems of the region are resolved.'[17]

Following the Soviet withdrawal from Afghanistan, India continued to support the Soviet-backed Najibullah Government in Afghanistan.[18] On 4 May 1989, Afghan President Dr Najibullah visited India and held discussions on the Geneva Accords with India's Prime Minister Rajiv Gandhi, culminating on the calls for implementation of the Geneva Accords. During the visit, an agreement for the supply of 2,000 tonnes of tea packets from India to Afghanistan was finalised. On 5 September 1989, an agreement to establish a Joint Business Council was signed between the Federation of Indian Chambers of Commerce and Industry (FICCI) and the Afghan Chamber of Commerce and Industry (ACCI) with a view 'to provide for an institutional framework for augmenting India's trade with Afghanistan.'[19]

Regular high level exchange visits between India and Afghanistan continued throughout the 1990s. Agreements signed between the two countries included cooperation between agricultural institutes, telecommunications and cultural exchanges and the prevention of trafficking in narcotics drugs and psychotropic substances.[20] With the objective of rebuilding the social and economic fibre of war-ravaged Afghanistan, India announced a slew of new projects, such as the construction of a 300-bed gynaecological and obstetrics hospital, and

---

14 *Ibid.* Also see, Fahmida Ashraf, 'India-Afghanistan Relations: Post-9/11', *Strategic Studies* 27, No.2 (2007), http://catalogo.casd.difesa.it/GEIDEFile/INDIA%C3%90AFGHANISTAN_RELATIONS_POST-9-11.HTM?Archive=191494691967&File=INDIA%ADAFGHANISTAN+RELATIONS+POST-9-11_HTM. Accessed on 8 November 2010.

15 Annual Report 1986-87 (India: Ministry of External Affairs), p.9.

16 Satish Kumar, 'India and the World: Survey of Events', in Satish Kumar (ed.), *Yearbook on India's Foreign Policy1987/1988* (New Delhi: Sage Publications, 1988), p.45.

17 Satish Kumar (ed.), *Yearbook on India's Foreign Policy 1989* (New Delhi: Sage Publications, 1990), p.31.

18 Barbara Crossette, 'India to Provide Aid to Government in Afghanistan', *The New York Times* (7 March 1989), www.nytimes.com/1989/03/07/world/india-to-provide-aid-to-government-in-afghanistan.html. Accessed on 12 August 2010.

19 Satish Kumar (ed.), *Yearbook on India's Foreign Policy 1989* (New Delhi: Sage Publications, 1990), pp.31-2.

20 *Ibid*, p.IV.

additional industrial sheds together with enhanced cooperation in agriculture, cartography, metrology and tourism.[21]

The increased bonhomie between the two countries continued until the march of the Taliban onto the Afghan political scene. India shut down its diplomatic mission in Kabul in September 1996, as the Taliban captured the seat of power in the capital. Like most countries, India did not recognise the Taliban's assumption of power. Only Saudi Arabia, Pakistan and the United Arab Emirates recognised the Taliban regime. After the Taliban consolidated their hold on Afghanistan, India maintained minimal contact, mostly through support to the internationally recognised United Islamic Front (UIF), popularly known as the Northern Alliance.[22]

India's brief interaction with the Taliban during the hijacking of the Indian Airlines Flight IC 814 on 24 December 1999, which had landed in Kandahar after originating from Kathmandu, left behind unsavoury memories. The ensuing eight-day saga of hostage swap negotiations was made contingent on the release of the three Pakistani terrorists held in Indian prisons to the Taliban. The protracted negotiation ended with Indian Foreign Minister Jaswant Singh personally delivering the three terrorists in exchange for the passengers.[23] Incidentally, one of the released terrorists, Maulana Masood Azhar, went on to establish the Jaish-e-Mohammad (JeM). The JeM is said to be involved in several terrorist activities in Jammu and Kashmir and beyond, including the attack on Indian Parliament in December 2001.[24]

India's Renewed Interests in Post-9/11 Afghanistan

Following the ouster of the Taliban due to the military action initiated by the US-led coalition in response to the 9/11 attacks, India renewed its diplomatic ties with Kabul and reopened its mission and the four consulates in Mazar-e-Sharif, Jalalabad, Kandahar and Herat. India adopted the 'soft power approach'[25] in the reconstruction process of Afghanistan. Steering clear of a military role, India's ideational approach included reviving its humanitarian, historical, social, cultural and civilisational linkages for the long-term stabilisation of the war-

---

21 *Ibid*, p.75.

22 The United Islamic Front (UIF) included forces and leaders from different political backgrounds as well as from all Afghan ethnicities including Tajiks, Pashtuns, Uzbeks, Hazaras or Turkmens. From the Taliban conquest in 1996 until November 2001, the UIF controlled roughly 30 per cent of Afghanistan's population in provinces such as Badakhshan, Kapisa, Takhar and parts of Parwan, Kunar, Nuristan, Laghman, Samangan, Kunduz, Ghōr and Bamyan. For further details on the rationale behind India's support to the Northern Alliance, see C. Christine Fair, 'India in Afghanistan and Beyond: Opportunities and Constraints' (Washington, D.C.: A Century Foundation Report, 2010), http://tcf.org/publications/2010/9/india-in-afghanistan-and-beyond-opportunities-and-constraints/pdf. Accessed on 11 January 2011.

23 John Cherian, 'Failure of Diplomacy', *Frontline* (New Delhi), Vol.17, No.1 (8-21 January 2000).

24 Praveen Swami, 'Terrorism in Jammu and Kashmir in Theory and Practice', *India Review*, Vol.2, No.3 (July 2003), pp.55-88.

25 Sashi Tharoor, 'Indian Strategic Power: Soft', *The Huffington Post* (26 May 2009), www.huffingtonpost.com/shashi-tharoor/indian-strategic-power-so_b_207785.html. Accessed on 24 June 2010.

ravaged country (Nehruvian). India's interests in Afghanistan have centred on supporting the nascent democratic regime thereby denying space for the return of the Taliban (Realist). As a major regional and economic power, with ambitions of extending its influence beyond its immediate neighbourhood, India has worked towards reviving the role of Afghanistan as a land bridge thereby connecting South Asia with Central Asia to tap on energy resources and augment trade (Neo-liberal). India has also been promoting economic integration with Afghanistan through SAARC.[26]

With the establishment of an interim government in Afghanistan under President Hamid Karzai and following India's well-received role in the Bonn Conference of 2001[27], India announced US$100 million in reconstruction aid to Afghanistan. Since then, India has followed a policy of high-level engagement with Afghanistan characterised by political, humanitarian, capacity-building, cultural, economic rebuilding and infrastructure development projects. Then, Indian Prime Minister Atal Bihari Vajpayee told the Indian Parliament that India is making efforts to have a 'maximum possible' role in the establishment of a broad-based, non-aligned and fully representative post-Taliban regime in Afghanistan.

In December 2001, India moved in with humanitarian assistance by reopening the Indira Gandhi Children's Hospital in Kabul and sending in medical missions to assist in humanitarian work, donating three Air Buses to enable the state run airline, Ariana, to resume operations and hundreds of city buses for public transit facilities. Subsequently, India expanded its aid coverage to other crucial areas through both short- and long-term projects. India is the sixth largest bilateral donor country having pledged US$1.3 billion and invested in diverse areas including infrastructure, communications, education, healthcare, social welfare, training of officials including diplomats and policemen, economic development, and institution-building.[28] It would be important to note that compared to India's US$1.3 billion in aid, Pakistan has invested US$300 million towards reconstruction and development of its war-ravaged neighbour.[29]

---

[26] These views and perceptions were gathered from interactions and discussions with senior Indian government officials in New Delhi and Kabul in October 2010. Also see, Gautam Mukhopadhaya, 'India' in Ashley J. Tellis & Aroop Mukharji (eds), 'Is a Regional Strategy Viable in Afghanistan?' (Washington, D.C.: Carnegie Endowment for International Peace, 2010), http://carnegieendowment.org/files/regional_approach.pdf. Accessed on 23 July 2010; C. Christine Fair, 'India in Afghanistan and Beyond: Opportunities and Constraints' (Washington, D.C.: A Century Foundation Report, 2010), http://tcf.org/publications/2010/9/india-in-afghanistan-and-beyond-opportunities-and-constraints/pdf. Accessed on 11 January 2011.

[27] Author's discussions with Ambassador Satinder K. Lambah, Prime Minister of India's Special Envoy on Afghanistan (New Delhi, October 2010). See also, 'India seeks larger role', *Asia Times Online* (28 November 2001), www.atimes.com/ind-pak/CK28Df03.html. Accessed on 12 September 2010.

[28] External Affairs Ministry, Government of India. Author's field visit to the provinces in Afghanistan in May-June 2007 and October 2010 brought to light the challenges of aid delivery that India faces in the complex, conflict-ridden circumstances of Afghanistan, particularly of increasing aid effectiveness.

[29] *Donor Financial Review*, Ministry of Finance, Islamic Republic of Afghanistan, Report 1388 (November 2009), www.undp.org.af/Publications/KeyDocuments/Donor'sFinancialReview%20ReportNov2009.pdf. Accessed on 25 September 2010.

During the two-day visit to Kabul in August 2005, by the Indian Prime Minister Manmohan Singh, leaders of both countries reiterated their commitment towards building a new partnership for the 21st century. These included expanding bilateral cooperation to wide-ranging areas such as development, defence, education, energy, trade, fighting terrorism and working towards greater economic and cultural integration of South Asia. The visit highlighted the edifice of a new democratic beginning in Afghanistan with the foundation laying ceremony of the Afghan Parliament building, a symbolic gesture that the world's largest democracy envisions a crucial role as a catalyst in rebuilding the youngest democracy. India's ongoing support in training and capacity building of newly elected legislators, parliamentary staff and diplomats has been viewed as positive gestures in rebuilding the political sector.

India's Strategic Interests and Challenges

India's interests in Afghanistan need to be viewed in the security paradigm, in the context of India's concerns of terror emanating from the extremely volatile Pakistan-Afghanistan border spilling into India. A strong, stable and democratic Afghanistan would reduce the dangers of extremist violence and terrorism destabilising the region. The Realist line of thinking is driven by 'fear' of security considerations. This could be real or perceived fear of Pakistani military and intelligence agencies regaining their 'strategic depth' by reinstalling a pliant Taliban regime in Afghanistan much to the detriment of India's security imperatives. Thus, this stream of thinking emphasises on the need for India to use military and diplomatic tools to secure its 'outer periphery' or 'extended neighbourhood'.[30]

Since 9/11, New Delhi's policy has broadly been in congruence with the US objectives of decimating the Taliban-Al Qaeda combine and instituting a democratic regime in Kabul. However, nine years later, the Taliban has been able to regroup and resurge, in addition to further intensification of its linkages with Pakistan based anti-India groups. A worrisome development has been expansion of the Lashkar-e-Taiba's (LeT) activities beyond Kunar and Nooristan provinces to other parts of Afghanistan, which could emerge as a base of anti-Indian and anti-Western operations.[31]

While there is no denying the fact that India's strategic interests lie in the long-term stabilisation of Afghanistan, India has invested substantially in power generation, infrastructure development, capacity building and small development projects. One of the

[30] This stream of thinking is evident in the writings of K. Subrahmanyam, Brajesh Mishra, Ambassador G. Parathasarthy, Brigadier Gurmeet Kanwal and others. For more details see, Shanthie Mariet D'Souza, 'India's Strategic Approach Towards Afghanistan' (8-10 September 2010). Paper presented at the Oslo *IFS-IDSA Conference* on 'India's Grand Strategic Thought'.

[31] Increasingly, as military operations and drone attacks intensify in Pakistan's tribal areas, there has shift in the base of such groups to other parts of Afghanistan. Based on author's discussions with officials and locals from Nuristan province during a field visit to Afghanistan (October 2010).

most visible and strategic projects that has been completed is the 218 kilometre-long Zaranj-Delaram highway connecting landlocked Afghanistan to the Iranian Port of Chabahar. The road reduces Afghanistan's dependence on Pakistan by providing a potential alternate route connecting Iran to Central Asia.

One of the crucial foreign and economic policy focuses for India has been the development of a southern trade corridor linking India with Iran, Afghanistan, Central Asia and Russia. The establishment of a bilateral Trade and Transit Agreement between Tehran and Kabul, leading to the creation of the Chabahar Free Zone Authority (CFZA) in 2002, was an important benchmark for the southern trade corridor and in consonance with the Neo-liberal thinking of 'the flag following the trade'. While it provides economic opportunities for India in those countries, it also provides Afghanistan with an alternative in reducing its dependence on Pakistan for transit facility. This is of particular significance given the difficult trade and transit arrangements and bilateral relations between Afghanistan and Pakistan.[32] Additionally, it provides the international community an alternative supply route through the north as the present routes through Pakistan are increasingly targeted by the insurgents.

To meet India's burgeoning energy needs, the Neo-liberals emphasise on the need to connect Afghanistan as a potential route for access to rich energy resources in Central Asia. With this objective, India has been seen to be pursuing better relations with Central Asian states. It has provided a US$17 million grant for the modernisation of a hydropower plant in Tajikistan, and has signed a memorandum of understanding with Turkmenistan for a natural gas pipeline that will pass through Afghanistan and Pakistan.[33]

While India's involvement in Afghanistan has accrued huge costs, it has generated tremendous goodwill among the locals.[34] Unlike other international donors, who have relied on their own agencies and subcontracting, thereby creating parallel structures of governance while doing little to extend the writ of the Afghan Government, most of India's aid is currently channelled through the Afghan Government and works in conjunction with local needs. Whereas most of the Western aid resources have thus returned to the donor countries,

---

[32] The recognition of the Durand Line has remained problematic between Afghanistan and Pakistan. See Ralph H. Magnus and Eden Naby, *Afghanistan: Mullah, Marx and Mujahid* (Boulder, Co.: Westview Press, 2002); Barnett Rubin, *The Fragmentation of Afghanistan* (New Haven: Yale University Press, 2002); Mohib Ullah Durani and Ashraf Khan, 'Pakistan-Afghan Relations: Historic Mirror', *The Dialogue*, Vol.IV No.1. (Winter 2009), www.qurtuba.edu.pk/thedialogue/The%20Dialogue/4_1/02_ashraf.pdf. Accessed on 18 August 2010.

[33] Jayshree Bajoria, 'India-Afghanistan Relations', *Backgrounder* (Washington, DC: Council on Foreign Relations, 22 July 2009), www.cfr.org/publication/17474/indiaafghanistan_relations.html. Accessed on 25 August 2010.

[34] Author's interviews and discussions with the Afghan Government officials and locals in various Afghan provinces (May-June 2007 and October 2010) indicated an appreciation of India's role in rebuilding their country. Also see, Tom A. Peter, 'India outdoes US aid efforts in Afghanistan', *GlobalPost* (9 September 2010), www.globalpost.com/dispatch/afghanistan/100908/india-outdoes-us-aid-efforts-afghanistan. Accessed on 12 September 2010. For further details see, Shanthie Mariet D'Souza, 'India's Aid to Afghanistan: Challenges and Prospects', *Strategic Analysis*, Vol.31, No.5 (September 2007); Shanthie Mariet D'Souza, 'Change the Pattern of Aid to Afghanistan', *IDSA Strategic Comments* (28 June 2007), www.idsa.in/profile/smdsouza?q=taxonomy/term/57. Accessed on 10 August 2010.

through the phenomenon of 'phantom' aid, India's wide-ranging assistance programme provided directly to the Afghan Government is designed to maximise Afghan participation both at the government and community levels while maintaining low visibility. Moreover, India has actively provided assistance to women's groups either through self employment generation schemes, health and capacity building not only in Kabul but also in the western province of Herat. Being long-term stakeholders in the rebuilding the social and economic fabric of the war-ravaged society, this mode of aid delivery through women's groups and tribal organisations has proved to be effective in sustaining and even expanding such programmes.

In the difficult and insurgency prone areas of the south and east, India is investing in small development projects (SDPs) in tandem with the local needs, thereby ensuring greater local participation and ownership. This method of aid delivery finds roots in the Gandhian way of doing things at a local and community level. India's assistance has broad cultural acceptance given the way aid is delivered within the socio-cultural milieu having shared history, culture and tradition. The Nehruvian school maintains the need to stay out of internal politics of Afghanistan while helping Afghanistan stand on its own feet. Unlike western countries, India avoids taking a judgemental or normative stance on issues of corruption, nepotism, cronyism or ineffectiveness of the Afghan Government, while continuing to aid the Afghan Government in terms of capacity and institution building. Of late, India has been active in reviving the historical and cultural ties with Afghanistan. As a part of cultural diplomacy, Indian musicians have been training young Afghans in musical instruments like the *tabla* and the *sitar*. Such joint musical performances have been occurring both in Kabul and places like Jalalabad, cementing the cultural ties and historical traditions of the region.[35]

Indo-Pak Rivalry: 'Zero-Sum' Game

Geopolitical rivalry continues to shape Pakistan's response to the increasing bonhomie between India and Afghanistan. While Afghanistan looks towards India for greater cooperation, Pakistan appears determined not to allow such a scenario and is continually in search of ways and means to regain its 'strategic depth' in Afghanistan. It typically sees any Indian presence and influence in Afghanistan, even those acquired through legitimate means, as inimical to its interests. It views the activities of India's developmental assistance and goodwill it has generated among the local Afghans with a suspicion bordering on paranoia.[36]

---

[35] Author's interview with Gul Agha Sherzai, Governor of Nangarhar Province, and interactions with locals at the India-Afghan musical concert (Jalalabad: 12 October 2010).

[36] Gautam Mukhopadhaya, 'India', in Ashley J. Tellis and Aroop Mukharji (eds.), *Is a Regional Strategy Viable in Afghanistan?* (Washington, DC: Carnegie Endowment for International Peace, 2010). http://carnegieendowment.org/files/regional_approach.pdf. Accessed on 23 July 2010.; Sumit Ganguly & Nicholas Howenstein, 'India Pakistan Rivalry in Afghanistan', *Journal of International Affairs*, Vol.63, No.1., (New York: Columbia Universty, Fall/Winter2009), http://jia.sipa.columbia.edu/files/jia/Ganguly_Howenstein.pdf. Accessed on 21 July 2010. Also see, Fahmida Ashraf, 'India–Afghanistan Relations: Post-9/11', *Strategic Studies*, 27, No.2 (2007),

Pakistan's military and intelligence establishment has always approached the various wars in and around Afghanistan as a function of its main institutional and national security interests, 'first and foremost, balancing India.'[37] For Pakistan, a pliant regime in Afghanistan under Pakistani influence, or at least a benign Afghanistan, is a matter of overriding strategic importance.[38] For fears of increased Indian influence in Afghanistan and beyond, Pakistan denies any overland trade and transit facilities for Indian goods to Afghanistan thereby compelling India to rely on the Iranian alternative.

The confidential report by former US top commander in Afghanistan, General Stanley McChrystal summarised, 'Indian political and economic influence is increasing in Afghanistan, including significant development efforts and financial investment.' While acknowledging, 'Indian activities largely benefit the Afghan people', the report pointed out 'increasing Indian influence in Afghanistan is likely to exacerbate regional tensions and encourage Pakistani countermeasures in Afghanistan or India.'[39] Such thinking finds resonance among western analysts, who posit that 'the road to peace in Afghanistan runs not just through Kabul and Islamabad, but Delhi as well.'[40] This, in turn, works well into the Pakistani threat perception that India's presence in Afghanistan is intended to encircle Pakistan.

The Realist school of thought perceives the Indo-Pakistan competition in Afghanistan to be a 'zero-sum' game. Pakistan's quest for 'strategic depth' in the 1970s and its role in the Taliban's advance to seat of power in Kabul (in the 1990s) have been continued with its present policy towards regaining its lost 'strategic depth' by providing sanctuary to the Afghan Taliban leadership in its territory. Its attempts to use its 'strategic assets' by brokering talks between the Afghan Government and sections of the Taliban which could place a pro-Pakistan dispensation in the seat of power Kabul in a scenario of the withdrawal of the western coalition forces from that country, has confounded such fears.

The recurring and lethal attacks by the Taliban and its affiliates on Indian personnel and the resultant insecurity scenario poses a major challenge for investing in large developmental

---

http://catalogo.casd.difesa.it/GEIDEFile/INDIA%C3%90AFGHANISTAN_RELATIONS_POST-9-11.HTM?Archive=191494691967&File=INDIA%ADAFGHANISTAN+RELATIONS+POST-9-11_HTM. Accessed on 8 November 2010.

37 Barnett R. Rubin, 'Saving Afghanistan', *Foreign Affairs* (January/February 2007), www.cfr.org/publication/12363/saving_afghanistan.html. Accessed on 25 August 2010.

38 George Friedman, 'WikiLeaks and the Afghan War', *STRATFOR* (27 July 2010), www.stratfor.com/weekly/20100726_wikileaks_and_afghan_war. Accessed on 25 August 2010.

39 Stanley A. McChrystal, 'COMISAF Initial Assessment' (Kabul: ISAF Headquarters, 30 August 2009), www.globalsecurity.org/military/library/report/2009/090830-afghan-assessment/090830-afghan-assessment.pdf. Accessed on 25 August 2010.

40 Pakistan is trying to actively project this perceived Indian threat to the coalition through private and public diplomacy and linking the Afghan issue with India-Pakistan relations and the issue of Jammu and Kashmir. See C. Christine Fair, 'India in Afghanistan and Beyond: Opportunities and Constraints' (Washington, D.C.: A Century Foundation Report, 2010), http://tcf.org/publications/2010/9/india-in-afghanistan-and-beyond-opportunities-and-constraints/pdf. Accessed on 11 January 2010. Also see, Jeremy Kahn, 'India is Key Player in Afghan Conflict', *Newsweek* (19 October 2009), www.newsweek.com/blogs/wealth-of-nations/2009/10/19/india-is-key-player-in-afghan-conflict.html. Accessed on 25 August 2010.

projects in insurgency-affected provinces in south and east Afghanistan. The killing of Kasula Suryanarayana, an Indian telecommunications engineer in the Zabul Province in April 2006, and the previous abduction and subsequent killing of Maniappan Kutty, a driver working with the Border Roads Organisation (BRO) project of building the Zaranj-Delaram Highway in 2005, are a few examples. Although such incidents have only been sporadic, they continue to raise concerns about the safety of Indians working on reconstruction projects in Afghanistan.[41]

The gruesome and high profile symbolic attacks on the Indian Embassy in Afghanistan, in July 2008 and October 2009, continue to highlight the challenges and vulnerabilities of India's involvement in Afghanistan.[42] Intended as a warning to India to downsize its role, these attacks are in a way aimed at raising the costs of such a policy of winning the hearts and minds of the local Afghans. After a brief hiatus, India is now set to resume its much-acclaimed medical mission work in Afghanistan which was scaled down following the February 2010 terror attack in Kabul that left nine Indians dead.[43]

With Afghanistan emerging as a potential theatre of rivalry, India signalled that it was ready to discuss the larger Afghan situation with Islamabad during foreign secretary-level talks. During the 1980s, the two sides discussed Afghanistan regularly. However, with the changing geopolitical situation in the region, especially after the ouster of the Taliban regime in 2001, Pakistan has repeatedly questioned India's growing profile in Afghanistan and has launched a diplomatic campaign aimed at reducing New Delhi's influence in that country. While India pursues its aid policy, it has steered clear from any military involvement in Afghanistan, in spite of interest expressed by Afghanistan. In April 2008, Afghanistan's Defence Minister, Abdul Rahim Wardak visited New Delhi and met with his Indian counterpart, A.K. Antony, to discuss possible military cooperation.[44]

---

41 According to the Ministry of External Affairs estimates, there are approximately 3,500 to 4,000 Indian nationals working in various private and public sector reconstruction projects in Afghanistan.

42 The growing bonhomie between New Delhi and Kabul, coupled with the increased presence of India's development projects in Afghanistan, remains the target of the Taliban-led insurgency, which includes a huge array of insurgent and anti-government forces operating in tandem beyond south and east Afghanistan, with increased symbolic and high-profile attacks around Kabul. While the Taliban-affiliated Haqqani network, aided by Pakistan's Inter-Services Intelligence (ISI), was blamed for the July 2008 attack on the Indian Embassy, the Taliban claimed responsibility for the October 2009 attack. See Shanthie Mariet D'Souza, 'Securing India's interests in Afghanistan', *The Hindu* (23 October 2009); Emily Wax, 'India's eager courtship of Afghanistan comes at a steep price', *The Washington Post* (3 April 2010), www.washingtonpost.com/wp-dyn/content/article/2010/04/02/AR2010040204313.html. Accessed on 2 September 2010.

43 India launched the medical missions in Afghanistan in 2001-02 and was operating five such missions in Kabul, Herat, Kandahar, Jalalabad and Mazar-e-Sharif. These missions reportedly have treated over 300,000 patients for free, mostly women and children. Though the Mazar-e-Sharif medical mission is functioning normally, the other four missions spread around the war-torn Afghanistan have been temporarily suspended. The Taliban suicide attacks in two Kabul hotels killed six doctors of the 11-member medical team of these missions. 'India to resume medical mission work in Afghanistan', *The Times of India* (20 July 2010).

44 Wardak also visited the headquarters of the Indian Army's 15th Corps located in Srinagar. STRATFOR reported that Wardak was seeking India's assistance in maintaining the Soviet-era helicopter gunships. 'Afghanistan: Why India's Cooperation is a Problem for Pakistan', *STRATFOR* (11 April 2008), www.stratfor.com/memberships/114567/analysis/afghanistan_why_india_s_cooperation_problem_pakistan. Accessed on 15 January 2010.

Challenges to India's 'Aid Policy' in Afghanistan

India's 'aid policy' has generated intense domestic debate, given the vulnerabilities its projects and personnel face in Afghanistan. While some advocate the need to put 'boots on ground', others propound continuation of the present aid policy vis-à-vis those who call for downsizing in case of US withdrawal. While the latter option would not be in India's long-term strategic interests, an outright military response of troop deployment, apart from its limited utility, would work straight into propaganda of the Taliban and lead to evaporation of the goodwill among the locals. Having steered clear of the military option and provided huge assistance, India is seen as a friendly and neutral country with no ethnic affinities, unlike neighbouring countries who have actively exploited the ethnic affiliations through shared borders to wage proxy wars and subversion.

As the talks of 'end game' intensify, there have been calls from various quarters for India to play a more active role as a 'first tier global economic power, India needs to accept the responsibilities and risks that come with that stature.'[45] Afghanistan is in some ways the test case of the extent to which India is willing to use its hard power to advance its strategic and commercial interests. Rahul Roy-Choudhury of the International Institute for Strategic Studies, London says, 'As India's influence grows it will become increasingly involved in the local politics of a foreign country. It cannot afford to see itself as an innocent bystander anymore.'[46] Similarly, former Indian diplomat Rajiv Sikri, criticising India's soft power approach, notes in his writing, 'Although India's security remains deeply affected by what happens in Afghanistan, India's disadvantage is that it is not involved in Afghanistan's security in any meaningful way.'[47]

On the other end of the spectrum, are those who warn India getting into a 'reputation trap' and being overstretched in a region which is perceived as Pakistan's backyard. Western analysts who have internalised Pakistan's concerns do call for downsizing of India's presence to assuage Pakistan's fear and concerns.[48] In Indian diplomatic circles, India's role is increasingly being seen as of 'negative interests' given that Pakistan will continue its proxy war against India from Afghanistan. There have been calls for redefining India's interests in Afghanistan and formulating strategies of engaging Pakistan and using leverages to elicit responsible behaviour given that India's security concerns stem from Pakistan.[49]

---

[45] Frank Schell, 'The U.S. Needs a New Af-Pak Strategy', *The Far East Economic Review* (10 November 2009). www.feer.com/international-relations/20098/november53/The-U.S.-Needs-a-New-Af-Pak-Strategy. Accessed on 11 January 2011.

[46] Quoted in Somini Sengupta, 'Afghan Bombing Sends Stark Message to India', *The New York Times* (9 July 2008).

[47] Rajiv Sikri, *Challenge and Strategy: Rethinking India's Foreign Policy* (New Delhi: Sage Publications, 2009).

[48] Barnett R. Rubin and Ahmed Rashid, 'From Great Game to Grand Bargain: Ending Chaos in Afghanistan and Pakistan', *Foreign Affairs* (November-December 2008).

[49] Author's discussion with senior Indian government officials and diplomats in New Delhi (October 2010).

In Search of a Political Solution: Reintegration vs Reconciliation

As instability and violence in Afghanistan intensifies and talks of exit among various western nations gather momentum, the Afghan Government and international community have initiated parallel efforts of reconciliation and reintegration processes. While there is a lack of clarity on the international community's attempts at finding a political solution to the Afghan War, New Delhi has indicated support for the Afghan-led reintegration process. In an interview with the Wall Street Journal on the sidelines of the UN General Assembly in New York in September 2009, Indian External Affairs Minister, S.M. Krishna said India did 'not believe that war can solve any problem and that applies to Afghanistan too.'[50] This line of thinking is indicative of New Delhi's recognition of the Afghan Government's efforts to build an inclusive political order as the Indian government has been involved in various such dialogues, negotiation and reintegration mechanisms dealing with myriad insurgencies and conflicts.

There have also been some recent indications that New Delhi is supportive of President Karzai's recent overtures of reintegration of the tribal fighters. India's Foreign Secretary Nirupama Rao, addressing a closed door international seminar on Afghanistan in October 2009, declared that India would support the process of reintegrating individuals into the national mainstream, code for dialogue with the moderate Taliban who agree to renounce violence. The Foreign Secretary stated, 'We support the Afghan Government's determination to integrate those willing to abjure violence and live and work within the parameters of the Afghan constitution.'[51] This change in stance, however, came with a qualification. Pakistan, which is widely believed to support the Taliban and provide shelter in Quetta to its leaders, would need to cease assistance to the Taliban. The concerns of New Delhi stem from the fact that the Pakistan military's continued support to the Afghan Taliban leadership, as a 'strategic asset', would make any meaningful reconciliation an exercise in futility.

Recent media reports, however, indicate that New Delhi is keeping its door open towards a reconciliation effort to various elements of the Taliban-led insurgency[52] and is said to have reached out to a faction of Gulbuddin Hekmatyar's Hezb-e-Islami (HIG). Given that many HIG members are now part of the Afghan Government, such gestures might not be entirely misplaced. New Delhi in its attempt to revive its traditional relations with Pushtuns in the

[50] 'Indian Minister Urges Afghan Political Settlement', *Wall Street Journal* (23 September 2009), http://online.wsj.com/article/SB125364105273431343.html. Accessed on 2 September 2010.

[51] Ajai Shukla, 'India supports reconciliation with Taliban', *Business Standard* (8 October 2009).

[52] For further details on the Taliban insurgency, see Seth Jones, 'Counterinsurgency in Afghanistan', *RAND* Counterinsurgency Study, Vol.4 (Arlington, 2008); Antonio Giustozzi, *Koran, Kalashnikov and Laptop: The Neo-Taliban Insurgency in Afghanistan* (New York: Columbia University Press, 2008); Ahmed Rashid, *Descent into Chaos: How the war against Islamic extremism is being lost in Pakistan, Afghanistan and Central Asia* (London: Penguin, 2008), pp.240-261; C. Christine Fair and Seth G. Jones, 'Securing Afghanistan: Getting on Track', *United States Institute of Peace Working Paper* (23 January 2009), http://library.usip.org/articles/1012068.1022/1.PDF. Accessed on 11 January 2011.

south is seen to be engaging the second generation Pushtun leaders like Nangarhar Governor Gul Agha Sherzai, and former Northern Alliance leaders like Marshal Fahim, Karim Khalili and Mohammed Mohaqiq.[53]

As the debate on reconciliation gathers momentum, India will have to respond to various gestures made by the Afghan Government, international community and insurgent factions. In contrast to those favouring talks with the Taliban, following the February 2010 attack on Indians in Kabul, thinkers in the Nehruvian tradition like the Indian Vice President Hamid Ansari, Pakistan-Afghanistan envoy Satinder Lambah and Chinmay Gharekhan have urged India to adopt a neutral position in Afghanistan. M.K. Rasgotra favours steering clear of this loose soil of reintegration. 'Wisdom demands that this task of reintegration be left to President Hamid Karzai,' he advises.[54] The Nehruvian school of thought advocates keeping out of internal Afghanistan politics but carrying on the development works in the war-torn republic.[55]

India, Af-Pak Strategy and Conditional Withdrawal/Drawdown of Forces

The Af-Pak strategy of the US heightened hopes and expectations among the Afghans of a renewed American commitment and resources to bring change in the war-ravaged country. The Obama administration's Af-Pak strategy, with its stated goal of 3D's-disrupt, dismantle and destroy of terrorist infrastructure, was seen as a win-win situation in the Indian strategic community. The Indian government has stressed that India and the US share the same goal in Afghanistan, that is, stability of the country.

While it is difficult to fault such admirable ambition, a more mature foreign policy position would require looking at the details of the 'stability' that continues to elude Afghanistan after a decade of a US-dominated policy. There is universal acknowledgement now that security in Afghanistan is at its worst since 2001 even as the western countries are moving towards a disengagement of troops. As a result, 'beyond a general commitment against terrorism, the US notion of "stability" would look very different from that envisaged by India.'[56]

While there seems to be a broad congruence of Indian and American interests in Afghanistan,[57] the US dependence on Pakistan continues to be a constant source of irritant in the relationship. For instance, Brahma Chellaney warns, 'The US can never win in

---

[53] Taliban spokesman Zabihullah Mujahid has also talked about reconciling with India. Also see, Shishir Gupta, 'India shifts Afghan policy, ready to talk to Taliban', *Indian Express* (29 March 2010).

[54] Maharajakrishna Rasgotra, 'Afghanistan: The March of Folly', *The Hindu* (11 June 2010).

[55] Shanthie Mariet D'Souza, 'India's Strategic Approach towards Afghanistan' (8-10 September 2010). Paper presented at the Oslo *IFS-IDSA Conference* on 'India's Grand Strategic Thought'.

[56] Aunohita Mojumdar, 'India's role in Afghanistan: Narrow vision returns meagre gains', *The Times of India* (17 April 2010).

[57] Sumit Ganguly & Nicholas Howenstein, 'India-Pakistan Rivalry in Afghanistan', *Journal of International Affairs,* Vol.63, No.1. (New York: Columbia University, Fall/Winter2009). http://jia.sipa.columbia.edu/files/jia/Ganguly_Howenstein.pdf. Accessed on 21 July 2010.

Afghanistan without first dismantling the Pakistani military's sanctuaries and sustenance infrastructure for the Taliban. The proposed surge could help the already-entrenched Taliban sharpen its claws while strengthening US logistics dependence on the Pakistani military, which fathered that Islamist militia and LeT.'[58] In a rather ominous note, Chellaney warns that 'Unless the US reverses course on Pakistan, it will begin losing the war in Afghanistan.'[59] He underlines the futility of the US effort in Afghanistan 'without a fundamental shift in US policy on Pakistan and recognition in Washington that the path to success in Afghanistan lies through Pakistan.'[60] Bharat Karnad, critiquing India's piggy backing on the US Af-Pak policy states, 'Free-riding offers relatively poor and weak countries or states, unwilling adequately to invest in their own defence, security without sweat, but it is something a would-be great power, such as India, should eschew.'[61]

Pakistan seeks reaffirmation of its crucial role in the war on terror, the Obama administration is grappling with how to balance India's role in Afghanistan. Washington is feeling pressure from Pakistan to limit India's role in Afghanistan.[62] There is recognition of India's positive contribution to the 'build and transfer component' of the present US counter-insurgency strategy of clear, hold, build and transfer. As of late, there have been calls for expanding India's developmental role in Afghanistan.[63] In the first Indo-US Strategic Dialogue in June 2010, Afghanistan topped the agenda. The need to work together in building an inclusive architecture and rebuilding Afghanistan was reiterated by American Secretary of State Hillary Clinton and Indian External Affairs Minister S.M. Krishna.[64]

During the visit of President Obama in November 2010, there was reaffirmation of the positive role played by India in Afghanistan. President Obama appreciated India's enormous contribution to Afghanistan's development and welcomed enhanced Indian assistance that will help Afghanistan achieve self-sufficiency. The two sides committed to intensify consultation, cooperation and coordination to promote a stable, democratic, prosperous and independent Afghanistan. In the joint statement, the two sides resolved to pursue joint development projects with the Afghan Government in capacity building, agriculture and women's empowerment.

---

58 Brahma Chellaney, 'An Afghanistan "Surge" is a Losing Battle: So why is Mr Obama betting on it?' *The Wall Street Journal* (9 January 2009).

59 Brahma Chellaney, 'Stop Pampering Pakistan's Military!', *The Christian Science Monitor* (12 December 2008).

60 Brahma Chellaney, 'Success in Afghanistan lies through Pakistan', *The Hindu* (31 January 2009).

61 Bharat Karnad, 'Habit of free-riding', *Seminar*, No.599 (July 2009).

62 Emily Wax, 'India's eager courtship of Afghanistan comes at a steep price', *The Washington Post* (3 April 2010), www.washingtonpost.com/wp-dyn/content/article/2010/04/02/AR2010040204313.html. Accessed on 2 September 2010.

63 Author's discussions with senior US government officials and diplomats in Washington D.C. (April 2010). Also see, Remarks by Assistant Secretary Robert O. Blake, Jr., 'The Obama Administration's Priorities in South and Central Asia' (Houston, TX : Rice University, 19 January 2011).

64 Secretary Clinton welcomed India's vital contribution to reconstruction, capacity building and development efforts in Afghanistan and its offer to enhance efforts in this direction. Both sides pledged to explore opportunities for coordination on civilian assistance projects that advance Afghan self-sufficiency and build civilian capacity. See 'U.S.-India Strategic Dialogue Joint Statement', (Washington D.C.: Office of the Spokesman, 3 June 2010), www.state.gov/r/pa/prs/ps/2010/06/142645.htm. Accessed on 21 August 2010.

However, this was with a caveat. While talking about India's positive role in Afghanistan, the dependence on Pakistan on the Afghan issue still exists. For instance, the US President underlined that all the countries of the region, including Pakistan, have to share the responsibility of bringing about stability in that nation. 'Pakistan has to be a partner in this process [of bringing about stability in Afghanistan]… We don't think that we can do this alone', he said, asserting 'a stable Afghanistan is achievable.'[65] The US dependence on Pakistan has remained a roadblock for deepening of India-US cooperation on Afghanistan.

The 'End Game' in Afghanistan

As the talks of exit gather momentum among the western nations, the search for an end game has intensified. In his 1 December 2009 speech at the US Naval Academy at West Point, President Barack Obama, in addition to renewing his commitment for the Afghan war by increasing the troop numbers, set a deadline of July 2011 for the conditional drawdown of forces. This arbitrary timetable, however, evoked regional scepticism and concern among the Afghans. In the event of withdrawal or drawdown of forces, in the face of declining support for the war among the domestic constituencies of western nations and the security situation further deteriorating in Afghanistan, there are serious concerns of conflict spillover into India.

In the Indian policymaking circles, debates on post-US exit strategies are gaining momentum. Concerns abound that the US$1.3 billion aid assistance, which has been the source of tremendous goodwill, may not be enough to sustain the reconstruction and development activities, in the case of premature international withdrawal. Moreover, New Delhi's bigger worries are that Pakistan's military might play a major role in the reconciliation moves in the post-US negotiated settlement.[66] Without a clear, integrated and Afghan-led reconciliation policy and adherence to the 'red lines,' the dangers of subversion of the presently weak Afghan Government by radical elements runs high and could undermine India's interest of maintaining a democratic regime.

The Realists caution against the return of the Taliban or civil war-like conditions of the early 1990s as clearly not in India's interest. According to former National Security Adviser Brajesh Mishra:

> 'India will be one of the biggest losers if Taliban-isation grips Afghanistan and extremism spreads through Pakistan. Therefore, it is imperative that India ramps up its defence preparedness, which has been hopelessly neglected since

[65] 'Obama appreciates India's role in Afghanistan', *The Hindu* (7 November 2010), www.thehindu.com/news/national/article872842.ece. Accessed on 9 November 2010.

[66] Pakistan has been positioning itself as a serious interlocutor in the power sharing arrangement in post US Afghanistan. Shanthie Mariet D'Souza, 'Great Game's Endgame?', *Business Standard* (New Delhi: 31 October 2010), www.business-standard.com/india/news/shanthie-mariet-d%5Csouza-great-game%5Cs-endgame/413240/. Accessed on 1 November 2010.

> the end of the Cold War. India should also expect more terror attacks from Pakistan-based groups if the Taliban finds a high enough space in Kabul. In the Afghanistan game, India stands to be the big loser and Pakistan the big gainer. India will need to think ahead to reverse that situation.'[67]

Similarly, K. Subrahmanyam indicates, 'The war in Afghanistan is crucial from the point of view of Indian national security. If the Americans withdraw and *jihadis* emerge with a sense of triumphalism, India will face increasing onslaughts of terrorism. The LeT Chief has already declared his goal is to break up India. A US withdrawal will make them feel that they have defeated two superpowers and therefore they can take on India.'[68] Indian diplomacy wants to avoid such a scenario by seeking a long-term international commitment in Afghanistan and strengthening the hands of the Afghan Government that would stonewall against any future return of the Taliban to the seats of power in Kabul.

The talk of US downsizing its troop presence its operations, however, has found resonance among certain sections of the Indian diplomatic circles who view it prudent to wind up India's development activities. There has been a scathing criticism of India's aid diplomacy and 'soft power' approach whenever India's mission or personnel are targeted. In times of such attacks, the talks of sending in the army, or 'putting boots on ground,' gain credence particularly in the military circles. Thinkers like Gurmeet Kanwal are not averse to putting boots on ground to retaliate and prevent such systematic targeting. Gurmeet Kanwal has written, 'I wouldn't use the expression, "flex its muscles". I would say the time has come to live up to our responsibility. If it involves military intervention, so be it.'[69]

In addition to sending troops there are increased calls for training troops to retain India's influence in the security sector. According to C. Raja Mohan:

> 'Instead of debating whether we should send troops to Afghanistan, Delhi should look at a range of other ways it can help Kabul and Washington make the Afghan National Army a credible and effective fighting force. The best contribution that India could make might be in the areas of combat training and creating capacities in logistics and communications. India could also perhaps help the Afghans in re-building their Air Force.'[70]

Of late, there are talks of training and rearming the Northern Alliance, who have been India's allies during the Taliban interregnum in Afghanistan. In a scenario of return to the civil war situation, it is not unlikely that India might use its 'northern card.'[71] In addition, there has

---

[67] 'Talibanization of Afghanistan will hit India hard: Brajesh', *The Times of India* (13 March 2010).
[68] K. Subrahmanyam, 'War in Afghanistan', *National Maritime Foundation* (6 September 2009), www.maritimeindia.org/pdfs/ksub6sep.pdf. Accessed on 21 August 2010.
[69] Somini Sengupta, 'Afghan Bombing Sends Stark Message to India', *The New York Times* (9 July 2008).
[70] C. Raja Mohan, 'Debating India's stand on military aid to Afghanistan', *Indian Express* (7 July 2009).
[71] Jayanth Jacob, 'India shuffles its Northern card', *Hindustan Times* (9 August 2010).

been increasing moves to revive the traditional and historical linkages among the Pushtuns as a counter-force and protectors to India's development projects in the south and east.

Surge of Pakistani Influence in Kabul: Talking to the Taliban

Critics in India have been quick to point out that fixing of an arbitrary timeframe to the summer of 2011 drawdown of forces, runs the danger of working to the advantage of the insurgent propaganda.[72] New Delhi is concerned about the ramifications of that possible US troop drawdown, which New Delhi feels is accelerating the Afghan Government's efforts to reconcile with the Taliban and America's hurry to hand over responsibility of running the country to the Hamid Karzai administration. India worries that Washington is moving too fast and leaving the door open for Pakistan military's manoeuvres in reinstalling a pliant regime.

The need to painstakingly stick to President Obama's promise of a 'conditions-based process' for leaving Afghanistan is compelling the US to take extraordinary steps to engage the Taliban. Former US Af-Pak envoy Ambassador, Richard Holbrooke, travelled to New York on 6 July 2010 specifically to negotiate the removal of select Taliban members from the UN anti-terror blacklist. Thinkers like Brajesh Mishra observe, 'The worry is caused by a feeling in the policy establishment that the US wants to get out [of Afghanistan] as soon as possible…Pakistan wants to broker a deal. The worry is that would lead us back to the 1990s.'[73]

The Pakistani military is clearly positioning itself as a serious interlocutor in the present reconciliation efforts. Media reports have indicated that in June 2010 secret talks took place between the Afghan President and Taliban affiliate Sirajuddin Haqqani.[74] The fact that Pakistan has successfully resisted attempts of individual Taliban leaders being based in Pakistan to open talks directly with the Afghan Government, since the arrest of Taliban commander Mullah Baradar in Karachi in February 2010, has not gone unnoticed in Kabul. Karzai, seemingly out of desperation, appears amenable to shake hands with Pakistan.[75]

While Nehruvians can still argue that the warmth between Afghanistan and Pakistan will not be at India's cost, it remains a fact that in recent times Karzai has tried to sideline the

72 In the Indian context, the COIN campaigns are carried out over a large timeframe under the liberal democratic constitutional framework where the state is ready to 'bleed' to let the insurgent groups engage the state through various dialogue mechanisms and in some cases even political representation. The successful end of the Mizo insurgency in India's northeast is a case in point. Shanthie Mariet D'Souza, 'Obama's Afghan Strategy: Regional Perspectives', *Atlantic Review* (10 December 2009).

73 Alistair Scrutton, 'In Afghan End-game, India Gets that Sinking Feeling', *Reuters* (29 March 2010), www.alertnet.org/thenews/newsdesk/SGE62B0F9.htm. Accessed on 30 March 2010.

74 'Karzai "holds talks" with Haqqani', *Al Jazeera* (28 June 2010), http://english.aljazeera.net/news/asia/2010/06/20106277582708497.html. Accessed on 6 September 2010.

75 Both countries have signed a series of pacts seeking political, strategic and trade cooperation. 'Afghanistan and Pakistan agree key trade agreement', *British Broadcasting Corporation* (BBC: 19 July 2010), www.bbc.co.uk/news/world-south-asia-10679464. Accessed on 12 August 2010.

Northern Alliance, a group that not only remains opposed to any form of peace with the Taliban, has not gone unnoticed in the Realist camp. Karzai's dismissal of Interior Minister Hanif Atmar, belonging to the People's Democratic Party of Afghanistan (PDPA), and National Security Chief Amrullah Saleh, belonging to the Northern Alliance, citing security lapses leading to an attack on the June 2010 peace *Jirga*[76] has been interpreted as an attempt to remove internal hurdles to the reconciliation plan.

The release of 90,000 classified US military documents related to the Afghan war by the whistleblower website WikiLeaks,[77] vindicated New Delhi's charge that Pakistan's intelligence agency, the ISI, has been playing a double-game in Afghanistan by providing both supplies and sanctuary to Taliban fighters. The documents, now in public domain, substantiated the charge that the ISI continued to maintain liaisons with and support for the Taliban despite claims by the Pakistani Government that ISI was swept clean of pro-Taliban officers years ago. The document revealed that General Hamid Gul, ISI's Director-General from 1987 to 1989, still operates in Pakistan informally serving the agency.[78]

However, it is highly unlikely that the revelations, known to the US policymakers all the while, would bring about dramatic changes in the dynamics of US-Pakistan counter-terrorism cooperation. While Pakistan remains a key ally for the US in the anti-Taliban operations in Afghanistan, the Pakistani military stands to benefit from the huge financial and military aid it accrues as a beneficiary of such cooperation. While US officials privately admit the deep complicity of the Pakistan army and the ISI on maintaining links with top levels of Afghan Taliban leadership, even as they jointly fight the war against terror, they are unwilling to publicly admit or delink from such self-defeating cooperation.

Reverting to the Traditional Alliance

The possibility of US and NATO withdrawal from Afghanistan and the accommodation of Taliban without strengthening the Afghan Government are could compel India to work towards a coalition with Iran and Russia. This 'self-interested coalition'[79] in the longer run could also include several Central Asian states that fear a Taliban return to Kabul. While the

[76] Ernesto Londoño, 'Karzai removes Afghan interior minister and spy chief', *The Washington Post* (7 June 2010). www.washingtonpost.com/wp-dyn/content/article/2010/06/06/AR2010060600714.html. Accessed on 12 August 2010.

[77] Robert Winnett and Andy Bloxham, 'Afghanistan war logs: 90,000 classified documents revealed by Wikileaks', *Telegraph* (26 July 2010), www.telegraph.co.uk/news/worldnews/asia/afghanistan/7909742/Afghanistan-war-logs-90000-classified-documents-revealed-by-Wikileaks.html. Accessed on 28 July 2010.

[78] 'WikiLeaks vindicates India's charge of ISI terror network', *Economic Times* (28 July 2010).

[79] Tim Sullivan, 'India, Pakistan face off in Afghanistan: Neighbours' heated rivalry will have a major impact on U.S. plans to deal with Taliban and get out', *Associated Press* (1 May 2010). www.statesman.com/opinion/insight/india-pakistan-face-off-in-afghanistan-657210.html. Accessed on 15 August 2010.

Taliban remain an anathema for Iran, Russia and India who believe that the extremists would pose significant risks to the region if allowed to come back to power, it was Russia's opposition that stalled US moves to remove Taliban from the UN blacklist. Moscow repeated its charges at the Kabul conference in 2010 that any such move to rehabilitate an unrepentant Taliban must be resisted.

After years of chill between India and Iran, since the days when India voted with the US against Iran's nuclear programme, a new warming between both countries was perceptible. In the first week of August 2010, Iranian Deputy Foreign Minister Mohammad Ali Fathollahi visited India on a three-day tour to discuss wide-ranging issues including efforts to stabilise Afghanistan. This was the second ministerial visit from Iran to India in less than a month; it followed the 9 July 2010 Joint Commission meeting at which both countries had discussed expediting the expansion of Chabahar Port in Iran, a move that could deepen India's reach in both Afghanistan and Central Asia, bypassing Pakistan. This came at a time when the rights of trade and transit through Pakistan's territory are yet again denied to India at the recently concluded Afghanistan-Pakistan Trade and Transit Agreement (APTTA).

India and Iran have also decided to hold structured and regular consultations with regards to closer cooperation in Afghanistan. Both have been seen as inching closer in their assessments of the unravelling Afghan quagmire and both have been seen to perceive a strategic advantage in coordinating efforts against the Taliban. In the days leading to the ouster of the Taliban regime in 2001, both India and Iran backed the Northern Alliance. However, with Iran blocking the transit of fuel into Afghanistan, the difficult US-Iran relations and India and Iran have a deadlocked relationship, most recently hit by an oil payments problem, the workings of this coalition seem mired in problems. Moreover, with India signing an agreement for the 680 km Turkmenistan-Afghanistan-Pakistan-India (TAPI) gas pipeline in Ashgabat in December 2010, the 2,300 km Iran-Pakistan-India gas (IPI) pipeline has been put on a backburner. The US backing for the TAPI project and attempts to wean India away from the IPI pipeline is seen as a move to further isolate Iran.

During the first week of August 2010, Ms Nirupama Rao, the Indian Foreign Secretary visited Russia, and held talks with her Russian counterpart, First Deputy Foreign Minister Andrei Denisov, and Deputy Foreign Minister Alexei Borodavkin who reiterated Moscow's continued emphasis on the red lines for the reconciliation of the Taliban, drawn at the London Conference on Afghanistan. The security situation in Afghanistan and the need to develop a coordinated strategy between both countries was discussed during foreign office consultations in Moscow. Russia which allowed the US to transport weapons across its territory to Afghanistan in 2009, has been wary of the Taliban insurgency's destabilising effect on Central Asian republics and the spilling over effect of instability into its Caucasus region. During Russian President Dmitry Medvedev's visit to New Delhi last year, both sides agreed to further step up their cooperation for peace and stability in Afghanistan.

Future Scenarios and India's Policy Options

Following President Obama's speech at West Point in December 2009, announcing troop surge with a tentative date for the drawdown of forces, coupled by talks of withdrawal among NATO countries, concerns abound among Afghans and regional countries of the international commitment in stabilising Afghanistan. Though there has been subsequent toning down of the 'withdrawal' talks since then, there has seemed to be a rush to bring the Afghan gamble to an end. However, consensus among the NATO allies and the US on the timeline of withdrawal has remained elusive as much as defining an 'end state', as witnessed during the NATO Lisbon Summit in November 2010. The lack of unified vision and effort among the international community has only contributed to dissipated efforts. Every actor is interested in imposing their own defined 'end state' on Afghanistan, as seen through their national agendas, with little understanding or interest in enabling the Afghans.

As the international community is 'muddling along', India will have to prepare for three scenarios in order to protect its core national security interests which might call for redefinition of its role in the evolving situation. More importantly, in the limited window of opportunity (2011-14), India will have to maximise its economic, socio-cultural and regional leverages for the long-term stabilisation of Afghanistan.

Scenario I: US Withdrawal: Return of the Taliban

In case of complete US withdrawal by the summer of 2011, the probability of the return of Taliban is not far-fetched, thereby relegating Afghanistan to what American analysts term as the 'worst case scenario'.[80] This would also lead to an emboldening of the Taliban-Al Qaeda combine and its affiliates, such as the LeT with instability spreading to Pakistan and Central Asia, reducing the region to becoming a base for Al Qaeda and its affiliates to carry out anti-Indian and anti-western operations.

Though there has been subsequent scaling down of talks by the Obama administration and the probability of withdrawal by the summer of 2011 seems less likely, what remains worrisome, however, is the hurry to bring the Afghan conflict to an end. As the Afghan quagmire deepens and US domestic support for the war in Afghanistan wanes, it is possible that the western coalition in its haste to find 'quick-fix' solutions will not be averse to continuing support for warlords and militias, and accommodating the Taliban, without efforts of instituting checks and balances to check the probability of subversion. In absence of a national reconciliation strategy and without attempts to build a politically inclusive order that calls for political sector reform, the strategy of passing on authority to a weak and discredited

[80] Andrew E. Axum, 'Afghanistan 2011: Three Scenarios' (Washington DC: Centre for New American Security, October 2009).

civilian government in Kabul seems in danger of failure. If the international forces were to begin withdrawal without ensuring a stable and credible government in Kabul, it is not unlikely that the Taliban would fill in the ensuing political vacuum.

Options for India

This scenario could compel India to downsize its operations in Afghanistan. To negate the possibility of this scenario, India might have to rely on its 'northern' card. This time around, India might have to revive its traditional and historical linkages with the Pushtuns as well. This strategy would be adopted by other regional powers that would arm and support their proxies. The Northern Alliance, compared to yester years, is much weaker today and would welcome any assistance in terms of arms and training. Such networks can be revived and can act as protectors of Indian aid projects but mostly in the north and west to which India's presence might be restricted.

Alternatively, India could support the current Afghan-led reintegration process. It can be more accommodating towards the idea of having those factions of the insurgency (those whom have indicated willingness to engage with India) included in Afghanistan's political process and power-sharing arrangement. This, however, would require a stable Afghan Government with constitutional guarantees and adherence to the 'red lines' set out at the London Conference in 2010.

Scenario II: US Limited Engagement- Intensification of the 'Proxy War'

The most probable scenario beyond the summer of 2011 is the reduced US presence in Afghanistan with troops limited to protecting key cities, a shift from overstretched counter-insurgency to a foreign internal defence (FID)[81] model and a greater reliance on special force operations. This could mean that the countryside would be open to the Taliban's influence – a mixed optimal case scenario for the Afghans and continuation of the present stalemate.

This would allow Pakistan military and intelligence agencies to continue its hedging strategy, whereby it continues supporting the Afghan Taliban and its proxy groups with the eventual goal of reinstating a pliant regime. In this scenario, the geopolitical competition would ensure the continuation of the present quagmire. In the case of intense regional competition and support for proxies continues, the balkanisation of Afghanistan into spheres of influence would not be a distant possibility.

---

[81] *Ibid.*

Options for India

In this scenario, India would be able to continue its aid policy with an objective of preventing Afghanistan's backwards slide into chaos, anarchy and destruction. Capacity building, community participation and local ownership would remain critical tools in sustaining the effectiveness of Indian aid. However, the current level and pattern of assistance programmes would have to be expanded and diversified to increase Afghan ownership by providing incentives. Low visibility projects with greater Afghan participation, both at the government and community levels would be the most feasible option. In the south and east, SDPs could be carried out by reviving support among traditional Pushtun groups and the second generation of Pushtun leaders, given that there is huge appreciation and demand for Indian projects in these areas.

However, much of the large scale aid and reconstruction activity would have to be limited to the north and west, given the insecurity that would continue to prevail in the south and east of the country. To ensure the safety and security of its interests and personnel, it might have to maintain its own security force, much larger than the current state of its paramilitary deployment. However, it cannot be a full-fledged military engagement. Such a measure will be counter-productive and will affect India's image in Afghanistan in the long term. India could alternately play a lead role in training the Afghan national security forces and in developing counter-insurgency capabilities as well as providing defence equipment.

On a diplomatic front, India needs to work towards the creation of a 'concert of powers' – a regional grouping which includes the US, Russia, the European Union (EU), India, Iran, the Central Asian republics and China.[82] India could play a lead role in carving out a greater role for the UN and the deployment of UN forces in Afghanistan symbolising the UN Security Council's endorsement[83] would not entirely be a misplaced policy option.

Scenario III: US Long-Term Commitment-Building on Afghan State Capacities

This would be a best case scenario for the Afghans, though such a state of affair seems unlikely given the downturn in the US economy and waning public support for the overstretched Afghan war in the US and its NATO allies. This would call for additional resources including troops to train and partner with the Afghan forces and the continuation of institution-building programmes for the next 10-15 years.

[82] Shanthie Mariet D'Souza, 'Securing India's interests in Afghanistan', *The Hindu* (22 October 2009).
[83] Maharajakrishna Rasgotra, 'Afghanistan: The way out; Give guarantees for its neutrality', *The Tribune* (31 December 2009), www.tribuneindia.com/2009/20091231/edit.htm#4. Accessed on 1 August 2010.

Options for India

India could play a lead role in institution and capacity building of the political, security, economic and justice sectors. However, given that such a scenario would not last indefinitely, in the near and medium term, India would need to pursue a reinvigorated policy in terms of protecting its projects and carving out a larger regional role in the stabilisation of Afghanistan. This has to be based on dynamic rethinking of its political, diplomatic and military options for the long term. Most certainly, India will have to make tough policy choices before the summer of 2011.

The Way Forward

As the international community seems to be in a rush to bring its ominous gamble in Afghanistan to an end, India has a limited window of opportunity to enable Afghans to play a lead role in their nation-building efforts. If the stated goal of transfer of authority, as set out by the Afghan President, were to be actualised by 2014, there are opportunities for India to deepen its levels of engagement at various levels in the near to medium term.[84]

1. <u>Security</u>: India can expand its role in training of the Afghan national security force (army and police) and air force. India could play an enabling role in training of the officer corps. As the process of reintegration gains momentum, India's experience of building a counter-insurgency grid in Jammu and Kashmir, and reintegration of the surrendered militants while providing employment opportunities could have some important lessons for Afghanistan. It could also help evolve civil-military relations.
2. <u>Political Reform</u>: India needs to work with the Afghan Government towards long-term political sector reform. The need for a parliamentary system with political parties system to build inclusive political orders is being increasingly felt both by the people and the politicians of other ethnic affiliations. The past presidential and parliamentary elections in Afghanistan have indicated the need for electoral and political reforms. The political impasse following the delay of the inauguration of the Afghan Parliament does not bode well for the long-term stability of the country. India could help in developing a federal polity based on its own experience of carving out and balancing the centre-state relations that represents and accommodates diverse and pluralistic ethnic, religious, cultural and linguistic identities.
3. <u>Reviving Traditional Networks</u>: India's policy of over-identifying with the 'Karzai' government in the past few years has alienated its traditional allies, the Northern Alliance groups. There is a need to revive the historical linkages with old networks not only in the north and west but also among the Pushtun networks in south and east. There are

[84] These views and perceptions were gathered from author's interactions and discussions with senior government officials, provincial governors, policymakers, key interlocutors, academia, media personnel, non-governmental organisations, security personnel and locals during a field visit to Afghanistan in October 2010.

alienated Pushtun communities in south and east Afghanistan are in need of Indian support in building local capacities in agriculture, rural development and alternate livelihoods.

4. Reconciliation and Reintegration: As some local commanders and insurgent faction leaders are sending feelers for reconciliation, India needs to widen its web of engagement. This is a requisite of counter-insurgency of separating the local commanders from the ideologically-hardened insurgent leadership based in Pakistan. However, the adherence to the 'red lines' stated at the London Conference including respect for the Afghan constitution, human and women rights would be crucial to prevent subversion of progress made thus far. Afghanistan's attempts at reconciliation need to be supported by larger political and constitutional reforms which would necessitate provisions for dialogue, autonomy and special representation of minorities, women and marginalised groups.
5. Governance: India could play a critical role in developing the decentralised structures of governance, based on its own Panchayati Raj system. Promoting grassroots democracy and local self-government institutions can emerge as an alternative to the top down approach adopted by the international community. India has worked at strengthening local institutions through the small development projects. These efforts need to be continued and intensified. One of the success stories of Afghanistan is the National Solidarity Program (NSP) that needs greater funding and support. While India has worked towards shoring up the Afghan Government's capacity in aid delivery, improving aid effectiveness would remain a critical goal. Towards this end, the participation of the local civilians in identifying and prioritising aid projects would remain crucial.
6. Economic: There is an immediate need for development of alternate livelihood programmes as well as reviving Afghanistan's traditional artisan and agricultural base. India's rich experience with Green Revolution could be usefully replicated in relatively stable northern parts of Afghanistan. Saffron cultivation in poppy-growing areas would be useful means of alternate livelihood project as part of an effective counter-narcotics strategy. Natural resource exploitation and industrial development in the relatively stable north and west provide opportunities of employment for the youth. Moreover, it would help Afghanistan graduate from being an externally dependent 'rentier state' to a self-sustaining economy. Indian business houses could be encouraged to invest in the mineral and energy sector in the relatively stable north and west.
7. Employment Generation and Industrial Base: There is also an urgent need for establishing an indigenous economic base to spur economic independence and generate employment, which would actively engage the youth of the country. Afghanistan, due to its very low tax regime, is swamped by foreign goods mainly from Pakistan, China and Iran. This inhibits the growth of local indigenous industrial base. India could contribute to establishing small-scale industries such as a carpet industry along with ornaments and handicrafts industry to help artisans, weavers and craftsmen. Follow-up studies on these projects, assessing their usefulness and linking with the development strategy of the Afghan Government, would be extremely critical. India's role being well received by the Afghans provides it with opportunity to invest actively in agriculture, rural development

and small-scale industries and mining which would provide employment generating opportunities.

8. Social and Cultural Capital: India needs to further capitalise on its traditional, historical, social and cultural capital in Afghanistan. As part of the counter-radicalisation campaign, messages of moderate Islam from the Deoband would be a good counter to neutralise the radical Wahabi messages. There is also a need to further expand the cultural, sports and educational exchanges between the two countries. Cricket is an important and popular sport that needs promotion within Afghanistan. The success of conducting Indo-Afghan musical concert in Jalalabad needs to be replicated in other regions as well. Music, art and poetry could be a binding chord for the peoples of the region. Setting up Pushtun centres in India and cultural centres in Afghanistan would be an important step.
9. Education: While there has been an appreciation of the educational scholarship programme, there is a need to ensure that deserving and meritorious students are selected. Setting up a board with Afghan and Indian observers for the process could be a step in ensuring that quality and transparency is maintained. Emphasis needs to be on vocational and 'hands on' technical training programmes that would help the Afghan youth find employment in their country.
10. Strategic Communications: Most of the international media puts out pessimistic stories from Afghanistan. It influences not only domestic public opinion but also works into the Taliban propaganda. It is crucial to build on the strategic communications to publicise positive stories through the radio, television and local print media, newsletters and leaflets. In places like Jalalabad, there have been requests for broadcast of programmes on history, culture, education and sports from India. There have also been requests for training of journalists and technicians to build the local media in Afghanistan.
11. Public Diplomacy: New Delhi needs to play an active role in public diplomacy campaign to highlight the rationale behind its developmental role. There is a need of active interface and exchange of ideas between the academia, non-governmental organisations, media, the youth, civil society and women groups as part of Track II initiatives.
12. Regional Cooperation: There is a demand for seamless information sharing, joint patrolling, border regimes and confidence building measures amongst the regional powers in addressing the challenge of terror in the region. On the economic front, India needs to work through SAARC to ensure better economic integration of Afghanistan with the region, which would accrue huge economic benefits and help build the 'peace constituencies' in the region.
13. Engaging Pakistan: India will need to explore the option of engaging with Pakistan's military directly in addressing the issue of sanctuary in that country and at the same time prevent its slide to instability. New Delhi will need to work on confidence building mechanisms and opening channels of communication not only with the civilian leadership but also with the Pakistan military, given the leverage the military has in dealing with the insurgency.

These goals, however, will have to be achieved within the limited window of opportunity of two to three years (2011-14). If New Delhi is unable to help the process of 'Afghan-isation' to enable Afghans take a lead role, and the western coalition quits without addressing the long-term stabilisation concerns in the region (Scenario I), the prospect of Indian downsizing its presence Afghanistan will not be entirely farfetched.

In the event of US limited engagement in Afghanistan beyond 2011 (Scenario II), India could continue with its assistance programme in Afghanistan. It would prevent Afghanistan's slide backwards into chaos, anarchy and destruction. The need would be to increase Afghan participation by raising the stakes and providing incentives. Low visibility projects with greater Afghan participation, both at the government and community level, would help in capacity building and ownership of the projects.

The complexity of the rapidly shifting dynamics in Afghanistan poses the greatest challenge for policymaking. The task of India, being outside the military operations, is even more difficult. It has to resist the temptations of military involvement and, at the same time, will have to protect its interest and personnel from systematic targeting. The expansion of Afghanistan's economic footprint is in India's long-term strategic interests. Thus, a lonesome policy of generating goodwill through aid diplomacy needs rethinking and possible expansion within the next two to three years. As developments in Afghanistan will directly impinge on India's security, and the search for the 'end game' quickens, New Delhi will have to position itself as a serious stakeholder in the long-term stabilisation of Afghanistan.

. . . . .

ISAS Working Paper

No. 125 – 19 April 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

The Future of Financial Liberalisation in South Asia

Ashima Goyal[1]

Abstract[2]

The paper defines financial liberalisation, distinguishing between liberalisation of domestic financial markets and capital account convertibility. It then examines the stages and the strategy of Indian financial reform. The Indian strategy followed a well thought out sequence whereby full capital account liberalisation was to come after deepening domestic markets, and improving government finances. One alone is dangerous without the others. The experience of the global crisis has validated the Indian strategy and also shown that foreign entry has benefits but cannot resolve all issues. Deepening domestic markets and better domestic and international regulation is a necessary prerequisite for full convertibility. The direction of future liberalisation should be such as meets Indian needs of financial inclusion, infrastructure finance, and domestic market deepening.

---

[1] Ashima Goyal is a Professor of Economics at the Indira Gandhi Institute of Development Research (IGIDR), Mumbai, India. She can be reached at ashima@igidr.ac.in. The views reflected in this paper are those of the author and not of the institute.

[2] Acknowledgement: An earlier version was presented at the International Council for Research on International Economic Relations/Japan Bank for International Cooperation and the Professor Kirit Shantilal Parikh IGIDR honour conference. The author thanks the participants, especially Ramgopal Agarwal, K.P.Krishnan, S. Narayan, Sanjaya Panth and S. Tendulkar for comments, Sanchit Arora for research and Reshma Aguiar for secretarial assistance. An earlier version of the paper appeared as IGIDR Working Paper 2010-022, (November 2010).

Introduction

Broadly liberalisation means, a greater role and more freedoms for markets but there are at least three components of financial liberalisation. It can refer to freeing domestic markets and institutions, to allowing foreign entry, and to the type of financial regulation.

Pre-reform South Asia had severe financial repression. Financial markets had little freedom, most interest rates were administered, and the aim of a plethora of controls was to make funds available for different types of government programmes. The Government fixed the exchange rates. There was scarcity and rationing of foreign exchange, so neither the current nor the capital account of the balance of payment was convertible.

Reforms have freed markets and developed underlying institutions, but it has been a gradual process with graded restrictions on foreign entry. More openness created more volatility, but on the whole, was beneficial. The sectors with the maximum foreign entry were not the most successful in achieving domestic development goals. These goals should define the future path of future reform as the strategic removal of controls, combined with development of domestic markets, continues. The paper draws out the implication for reform in different financial sectors.

The structure of the paper is as follows. After a discussion of financial liberalisation in section two the third section will discuss its consequences. Section four draws out lessons from the experience of global crises. Section five links the path of future liberalisation and to critical development imperatives. Section six gives a snapshot of domestic development issues in the financial sector. The seventh section brings out lessons for the structure and reform of regulation, before section eight concludes the paper.

Post-Reform: Liberalisation

The post-reform period beginning in the early 1990s, in India, and a little later in other South Asian countries, has seen considerable institutional and market development. More interest rates became market determined. In India, at the time of writing, only interest rates on savings accounts, government small savings and providence schemes were administered. Many private and foreign banks and mutual funds entered. Restructuring, computerisation and competition improved banking services and parameters such as non-performing assets. There was a rise in the share of retail credit.

India used new technology effectively to create electronic markets reaching and sometimes exceeding international benchmarks in disclosure norms, trading volume, settlement cycle, and low transaction costs. In the order driven screen-based trading system, each investor can access the same market and order book, at the same price and cost, irrespective of location. Dematerialisation of securities reduced bad paper risk. Exchanges were corporatised and demutualised, the National Stock Exchange (NSE) provided effective competition to the older Bombay Stock Exchange (BSE). A number of commodity exchanges entered. Settlement was now through clearing corporations. Derivatives were gradually introduced and soon achieved high trading volumes. Strict norms regarding disclosure of price sensitive information and conflicts of interest, contributed to reducing asymmetries of information in price discovery.

Changes in technology have had fundamental effects on the possibility of regulation, and on safe innovation. The Reserve Bank of India (RBI) continued as the regulator of banks. The new financial regulatory institutions set up were: the Securities and Exchange Board of India (SEBI), the insurance regulator; Insurance Regulatory and Development Authority (IRDA), the commodity futures trading regulator; Forward Market Commission (FMC), and the interim pension regulator: Pension Fund Regulatory and Development Authority (PFRDA). In general, controls gave way to market based regulation. A rule-based system, largely relying on self-certification, replaced cumbersome administrative procedure that required multiple discretionary approvals. Along with traditional oversight, advanced risk management systems promoted transparency, efficiency, safety, and market integrity. Practices included online monitoring and surveillance, positions limits, margin requirements, and circuit filters. A 2006 amendment to the RBI Act expanded its regulatory powers beyond banks to cover the financial system as a whole and to give directions to all agencies active in markets. However, procedural aspects of trade remained with SEBI, the capital market regulator.

There were rapid developments also in foreign exchange (FX) and money markets after 2000. A central counterparty, CCIL (Clearing Corporation of India) was set up to undertake guaranteed settlement for government securities (G Secs), repos in G Secs and FX market trades, following the International Organization of Securities Commissions (IOSCO) and Committee on Payment and Settlement Systems (CPSS) best practices. Infrastructure was created for electronic payments and real time gross settlement (RTGS), and steps were taken to encourage the migration from paper money.

After an initial double devaluation of the Indian exchange rate in June 1991, it became a managed float. The degree of flexibility and market determination increased with the deepening of FX markets. The 1990s saw steady depreciation, covering for India's relatively higher inflation, so there was no large deviation of the real effective exchange rate (REER) established after the initial devaluation. Two-way movement of the nominal rate began from 2003, as the dollar depreciated. The swings became wide after the global financial crisis were due to make substantial movement in portfolio capital.

Although the reforms established current account convertibility, with the Foreign Exchange Regulation Act (FERA) being changed to foreign exchange management (FEMA), convertibility of the capital account was more gradual. Liberalisation distinguished between types and direction of flows which was much greater for equity compared to debt flows including bank loans, and for foreign compared to domestic residents. Requirements for the latter's transactions were liberalised before portfolio outflows. Among debt inflows long-term debt was to be liberalised before short-term. The rationale was equity shares in, in contrast to debt, and therefore reducing liabilities in a crisis. Selective deregulation aimed to develop markets even while restricting foreign participation until they reached sufficient maturity to be able to handle volatility.

Both Bangladesh and Pakistan declared full current account convertibility in 1994, a few years after India did. While convertibility remained partial on the capital account for both, Bangladesh retained more controls compared to Pakistan.

In Pakistan, reforms gained momentum after 1997. Foreign banks were allowed to bring in and take capital out, remit profits, dividends and fees without any prior approval. Corporate sector could acquire equity abroad. Resident Pakistanis could open foreign currency accounts with banks in Pakistan, freely transferable abroad, exempted from income and wealth tax, with no questions about the source of foreign exchange. Foreign investors could purchase up to 100 per cent of equity in industrial companies on repatriable basis. Shares could be exported and remittance of dividend and disinvestment was permissible without prior approval of the State Bank of Pakistan (SBP). Income tax treatment of foreign private investment was at par with similar investments made by local citizens. There were no restrictions on foreign banks.

After 1998, reforms included privatisation of and free foreign investment in state-owned enterprises except for a few specified industries. Foreign investors were given permission to retain 100 per cent equity in a company with no obligation to go public. They had permission to bring in any amount of foreign currency and to take it out freely.

In contrast, in Bangladesh, resident owned capital is not freely transferable abroad. It is subject to prior Bangladesh Bank (BB) approval, which is given only sparingly. So even current settlements, beyond certain indicative limits, are subject to bonafide checks. Direct and portfolio investments of non-residents, capital gains and profits/dividends are repatriable abroad.

Reform also freed the domestic financial sector from controls. In Pakistan, the statutory liquidity ratio (SLR) has been brought down to around 20 per cent of total demand and time liabilities from its highest of 45 per cent at one point of time. Caps on maximum lending rates of banks and non-bank financial institutes (NBFIs) for most trade and project related modes of financing were removed in 1995. Caps and floors on minimum lending rates were abolished in July 1997. Banks and NBFIs were able to set their lending rates in relation to the demand and supply conditions in the market. Monetary policy uses indirect tools such as open market operations, discount rates etc. Domestic interest rates on lending dropped to five per cent from 20 per cent. The creation of the Security and Exchange Commission of Pakistan (SECP) is aimed at establishing a professional agency that would improve the regulation and supervision of the securities market

Although Bangladesh's financial sector has strengthened, government interventions in the form of ceilings, moral suasion, and directed credit still exist. Accounting and reporting is non-transparent. Banks are free to fix rates of interest on their deposits of different types after withdrawal of restriction on the floor rate of interest in 1997. Banks are also free to fix their rates of interest on lending except for export sector, which was fixed at seven per cent per annum with effect from 10 January 2004. The SLR has been changed in the past decade, but on an average has been around 20 per cent.

In both countries, the debt market remains underdeveloped. No benchmark rate or yield curve exists because of absence of long-term debt instruments and administered interest rates on popular government instruments. It also suffers from lack or regulation, infrastructure, expertise and innovation. Other problems are absence of institutional investors because of various impediments and passive capital market.

Pakistan adopted a market-based unified exchange rate system on 19 May 1999. Since 2001, despite its preference for a floating rate, the SBP has attempted to maintain the real effective exchange rate at a competitive level. It intervenes from time to time to keep stability in the market and smooth excessive fluctuations. Bangladesh has also adopted a floating exchange rate regime beginning on 31 May 2003. Under the regime, BB does not interfere in the determination of exchange rate but operates monetary policy to minimize extreme swings in the exchange rate that could have adverse repercussions. In the forex market, banks are free to buy and sale foreign currency in the spot and also in the forward markets.

In sum, these countries have been proceeding on the same liberalisation path as India, with some lags. Pakistan has the most open capital account.

Consequences of Financial Liberalisation

Trend growth rose in the post reform period, but so did volatility. Opening out had coincided with a period of major international financial crises. But conservative regulation and the gradual approach meant the financial sector did not undergo a crisis.

A distinction was made between different types of private foreign investments[3] (FIs).

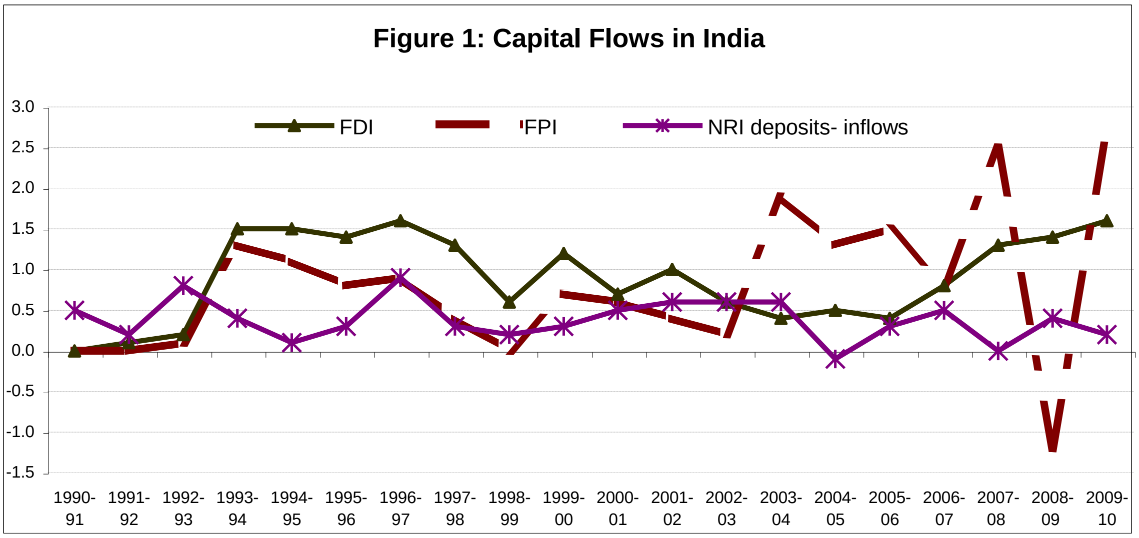
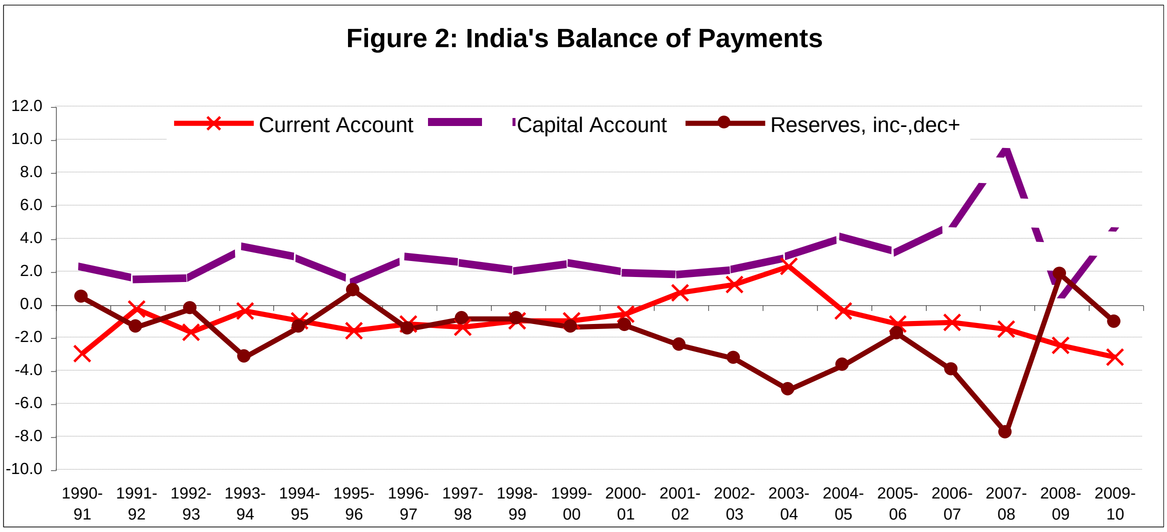


Figure 1 shows some of the categories of inflows as a percentage of gross domestic product (GDP). There was steady acceleration in foreign direct investment (FDI), which is an equity type flow, and higher levels continued despite the global crisis. Figure 1 also shows how the absorptive capacity of the economy increased. US$3 billion in the beginning of reform came to about 1.5 per cent of GDP and US$29 billion in 2007-08 came to a similar ratio as GDP had increased. Gross inflows were even higher, since Indian firms began investing abroad. Foreign portfolio investment (FPI) shows fluctuations, turning briefly negative both during the East Asian and the global financial crisis. NRI flows did not have the same amplification. They respond to opportunities for interest rate arbitrage, but NRI deposit rates were capped in the later years. So non-resident Indian (NRI) inflows were quite low when other types of inflows were booming.



3 These include Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI) and other long- and short-term investment flows. The analysis builds upon earlier work, in particular Goyal (2010). All references are not given but are available at www.igidr.ac.in/~ashima. Figures quoted, unless otherwise mentioned, are from IMF, RBI, Ministry of Finance, SPB and BB websites.

Figure 2 shows that reserve accumulation was the mirror image of the capital account. It was volatile capital flows that were absorbed as reserves[4], while the current account deficit (CAD) was about 1-2 per cent of the GDP. Reserves provided self-insurance and damped volatility of the exchange rate, but had a cost. Given India's higher interest rates, the sterilisation of reserve accumulation, to maintain targeted rates of money supply growth imposed large interest costs borne by the Government, RBI and banks. The RBI has to pay more on government bonds it sells in India compared to what it earns on assets held abroad.

Global Depository Receipts (GDRs) allowed firms to raise equity abroad and relaxation of External Commercial Borrowing (ECB) norms in 2006 allowed them access to cheaper loans. Domestic interest rates exceeding foreign and an exchange rate expected to appreciate created incentives to borrow abroad. Restrictions such as eligibility criteria, caps, minimum maturity period and end use criteria have prevented excessive borrowing in response to domestic distortions, even while selective relaxation for longer-term debt made credit available for large corporates and for infrastructure funding.

Partial capital convertibility gave flexibility along the line of control, making selective tightening feasible if necessary. Additional instruments were available to tackle the policy trilemma, giving some monetary autonomy even under volatile capital inflows. Fine-tuning was possible. For example, stricter end use criteria were imposed for firms bringing funds in during periods of excessive inflows. Inflows have to be allowed to go out if they were to come in, but continuing restrictions on domestic capital outflows reduce the reserve cover required. But, as reserves accumulated, selective easing of outflows by domestic residents and further trade liberalisation were used as another way of absorbing inflows. Stricter controls, such as limits on bank open positions, continued for intermediaries, whose mutual interconnections are a source of risk.

The CAD is also the excess of domestic savings over investment. A small CAD implied the contribution of foreign savings to financing the resource gap remained small, although they contributed to relieving sectoral financing constraints. Macroeconomic policy affects the investment savings gap and therefore the extent of inflow absorption, which also depends on a general rise in absorptive capacity. Reducing the gap between domestic and foreign interest rates would support the domestic investment environment. More appreciation would increase net imports and the CAD. But persistent CADs imply there are limits to appreciation. Temporary capital inflows do not always reflect fundamentals and cannot determine the equilibrium exchange rate.

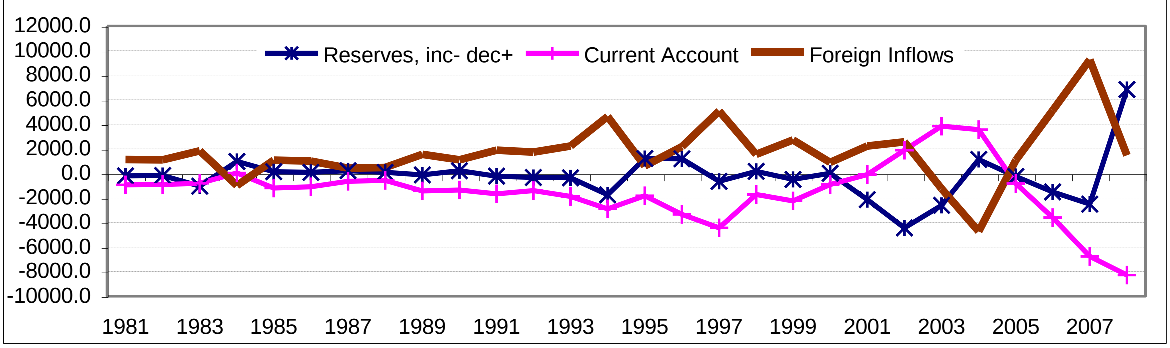
India's policy strategy of 'middling through' followed a well thought out sequence, whereby full capital account liberalisation, was to come after deepening domestic markets and better

---

4 India's foreign currency reserves peaked at US$ 315.66 billion in June 2008 and had fallen to 262 billion in end March 2009, when they exceeded India's foreign debt by just US$ 22 billion. Although outflows were only US$20 billion, much of the fall was due to valuation effects.

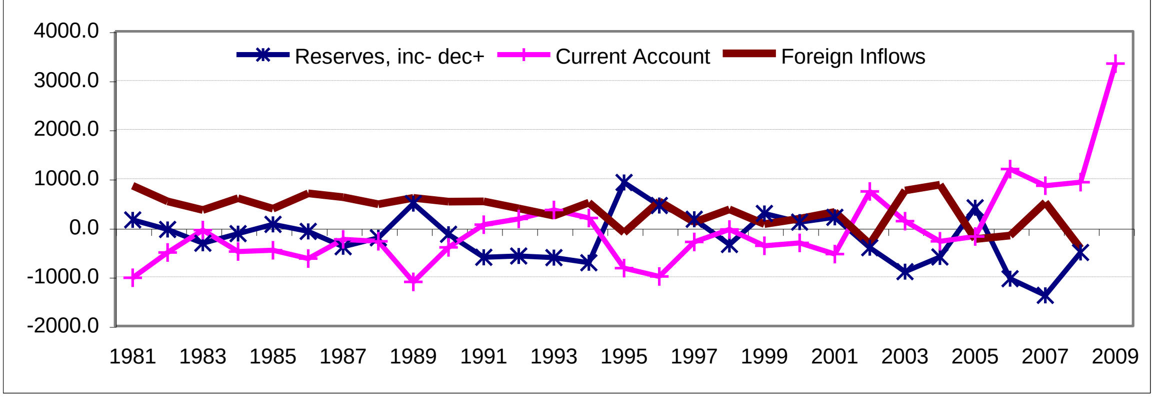
government finances. Liberalising, deepening markets and improving institutions and policy all form a package. One alone is dangerous without the others. Research and empirical estimation has found that only countries with strong domestic institutions, markets and government finances benefit from foreign inflows. These features determine absorptive capacity that reduce volatility and give countries the ability to withstand it. The crisis showed that stronger international financial architecture and regulation are also preconditions for full capital account liberalisation. Countries with more controls have a lower probability of crisis.[5]

Figure 3: Pakistan's Balance of Payments



In Pakistan and Bangladesh (Figure 3 and 4, in US$ billions) the change in reserves is not the mirror image of capital inflows.[6] First, the current account was much more volatile and reserves had to be frequently used to finance it. Second, inflows were not so substantial and – at least for Pakistan – were often the result of IMF loans. Bangladesh saw a sharp improvement in its current account after 2005, while for Pakistan it was the reverse.

Figure 4: Bangladesh's Balance of Payments



5 Jonathan D. Ostry , Atish R. Ghosh, Karl Habermeier, Marcos Chamon, Mahvash S. Qureshi, and Dennis B.S. Reinhardt, 'Capital Inflows: The Role of Controls", *IMF Staff Position Note*, Vol.5, No.1 (19 February 2010).

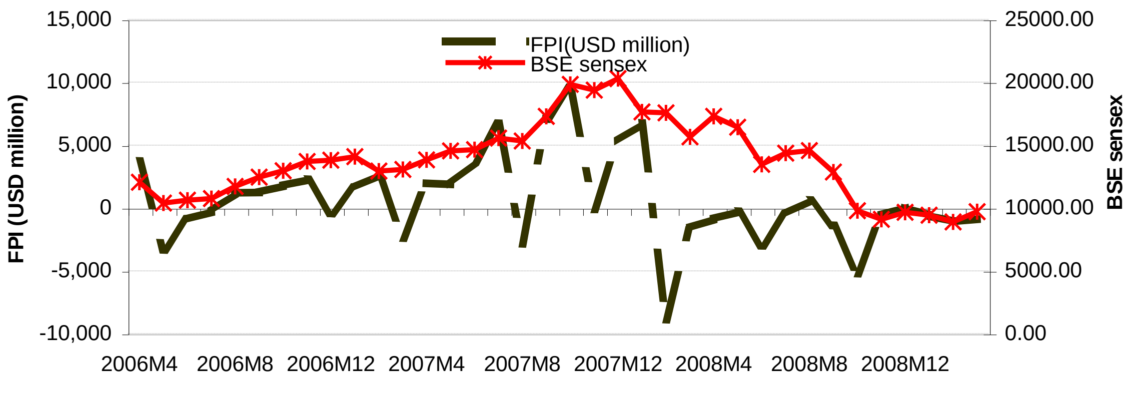
6 Due to lack of data on capital flows they are derived as change in reserves plus current account deficit for Pakistan and Bangladesh.

Crisis Lessons

Foreign inflows do make more resources available, demonstrate better organisation and technology, offer a stimulus to local investment, give an opportunity for better allocation of world savings and for better price discovery in markets. But inflows to emerging markets (EMs) are subject to sudden stops or reversals due to infectious panics unrelated to domestic fundamentals. The global financial crisis demonstrated this again.

FDI was relatively stable, suggesting it is worth reducing hurdles to entry. FPI was volatile. Figure 5 shows how FPI affected the stock market index. But it resumed soon with Indian growth prospects and demonstrated the risk sharing effect. Inflows were three times larger than outflows for an equivalent variation in market indices. As markets fell during outflows, the value remitted was lower. In the two years prior to October 2007, the BSE stock index rose from 8,000 to 20,000 and FPI inflows were US$47 billion. But over the next year, as stock markets fell back to 8000, outflows were only US$15 billion,

Figure 5: India: FPI and BSE sensex



Despite higher volatility in narrow markets, the FPI inflows did benefit firms. Loans became easier to get and more venture capital entered, in the high growth period of 2003-08, as the ratio of gross investment to GDP rose from 25.2 to 39.1, and again as investment demonstrated, there was a sharp recovery in 2010.

But households did not benefit. Retail participation shrank. Reforms raised entry costs for the retail investor. The share of household financial savings in shares and debentures post-reform were at a low of 5.1 per cent in 2005-06, compared to 23.3 per cent in pre-reform 1991-92. Pre-Lehman Brothers (2007-08) they had increased to 12.5 per cent but post (2007-08) collapsed again to 2.6 per cent. Free foreign entry was allowed in mutual funds, but they focused on high-end customers and firms. Despite entry of new private banks, 60 per cent of the population remained unbanked.

Firms who were dependent on foreign trade and other short-term credit suffered severely as international credit markets froze. Even for long-term loans, reset clauses raised firms' costs as the spreads widened. Understanding currency risk and lowering the interest differential is a precondition for more wholesale liberalisation of external borrowing.

Thus, foreign entry is not a panacea. Foreign entry helps but it alone cannot deepen markets. Other conditions also have to be in place. Eventual internationalisation of Indian financial services is required as Indian companies go global. But the sequencing has to be correct. Considerable deepening of equity markets and improvements in regulation have taken place but more broad-basing is required. Given the high domestic savings ratios, a larger percentage of household savings going to markets would make them more stable, as well as meeting investment needs without too large and risky an expansion in current account deficits.

The sharp rise in inflows after 2003 was partly an aberration due to regulatory weakness in developed countries, so self-insurance was the correct policy response. It was not arbitrage driven by low developed country interest rates since the federal fund rate peaked at 5.25 per cent in 2007. Rather high leverage, given regulatory capture by investment banks, enhanced flows in response to profit opportunities. When Lehman Brothers failed its leverage was 30:1 compared to 15:1 for a commercial bank.

During the exit in 2010 the West and emerging markets (EMs) were in different phases of their macroeconomic cycle. Higher growth in EMs and the near zero interest rates at home led to portfolio rebalancing towards EMs. The promised tightening of global regulations was relegated to the future and large Western financial institutions were encouraged to improve their impaired profits through trading. The hype about emerging Asia pushed them there, just as the hype about the 'miracle economies' pushed herds of investors into East Asia, building up bubbles, which eventually burst. Controls and prudential requirements are an essential line of defence. They can be designed to be market friendly. India has become a member of the financial action task force (FATF) against global terrorism and money laundering. Detailed electronic trails, linked information and Know Your Client (KYC) norms makes it possible to discriminate between origins and types of flows together with central registration that reduces transaction costs. Pure controls involve restrictives on cross border flows by residence. Market-based controls include un-remunerated reserve requirements and taxes. For debt, pure controls must continue, but for portfolio flows the latter set may be considered if necessary, ideally as part of a global agreement on handling capital account distortions.

Capital resists taxes by arguing that it would increase costs for the country that imposes them. But just as prudential regulations are considered necessary for market stability, if cross-border taxes contribute to crisis proofing they too will lower costs over the long-run. Costs are also minimal if one country is not doing it alone.

Pakistan had a much freer capital account than Bangladesh. Taking 1995 as the reform date for the two countries, in the post-reform period Pakistan needed help from the International Monetary Fund (IMF) seven times.[7] In contrast, Bangladesh had only one arrangement with the IMF in 2003. India, which also retained capital controls and had more capital market deepening compared to Bangladesh[8], did not have to go to the IMF at all. India's good growth performance led to large inflows of private capital. So while strategic controls are protective, so is domestic market deepening.

There is a perspective that regards any departure from full liberalisation as a failure of reforms. But experience shows a carefully sequenced path predicated on domestic reforms is a better strategy for liberalisation. Distinction between types of flows is useful and must be retained. In South Korea, the security of reserves led to high short-term debt. So the latter, has to be discouraged regardless of other buffers. Free foreign entry without the other harder preconditions would put the country in unnecessary risk.

Transparent sequenced capital account convertibility should follow domestic financial deepening and rise in absorptive capacity with the real sector as priority. Improvements in international financial regulation or regional arrangements would allow faster liberalisation including more integration for financial intermediaries.

Asian Integration

The 1990s crisis activated regional financial forums, even though there was no history of coordination in Asia. After the East Asian crisis, Asian countries reformed their financial systems. But a reform of the International Financial System (IFS), which could have prevented the global crisis, was not carried out, since lender countries and interests dominated international financial institutions.[9] Aid was arranged much faster for Mexico in 1995 than it was for Asia in 1997. So Asia was pushed to adopt self-insurance and cooperation measures that improved its bargaining position and helped it survive the global crisis.

South Asia is inadequately involved in these cooperatives, although things are starting to begin, which need to be pursued vigorously. Given the continuing dollar weakness, there are many advantages from coordination, resistance to and slow pace of reform in the international financial architecture. The large intra-regional Asian trade could benefit from

---

7 There were two arrangements with the IMF in 1997 one in each of 1993, 1995, 2000, 2001, and 2008.

8 A review of the outcomes of the financial sector adjustment credit (FSAC), which Bangladesh contracted with the World Bank, done under the *Structural Adjustment Participatory Review Initiative* (SAPRI) in 2000 indicated that although reform implementation was satisfactorily, desired outcome were not achieved.

9 Ashima Goyal, 'Global Financial Architecture: Past and Present Arguments, Advice, Action' *Margin-The Journal of Applied Economic Research*, Vol.4, No.2 (24 May 2010) pp.233-247.

financing within the region.[10] High Asian growth and trade expansion provide incentives for such moves. Stable Asian savings would become available to finance large Asian infrastructure needs. Credit markets freeze due to problems in Western banks partly caused the crash in Asian exports in 2008.

Alternatives to Western markets, currencies and institutions would make the globe more stable. Regionalism is not incompatible with globalisation. It can even raise the probability of optimal globalisation by improving the balance of global power and stability. A consensus may more easily be hammered out at the regional level and then taken to the international forums.

Leaders of the ten ASEAN member countries, along with the Peoples' Republic of China, Japan and Korea, initiated the ASEAN+3 process in 1997, with initial focus on macroeconomic and financial issues. Results included setting up regional liquidity support arrangements through the Chiang Mai Initiative (CMI), establishment of the Asian Bond Fund (ABF), and progress on the Asian Bond Market Initiative (ABMI). Medium-term aims included the establishment of a regional financing facility, a mechanism for closer coordination on exchange rates, and establishment of regional surveillance. The Economic Review and Policy Dialogue (ERPD) was the first step working through information exchange, policy discussions, and peer reviews. There was some progress but the absence of a secretariat and the low involvement of Central Bank governors limited its efficacy.[11]

Among these bodies, South Asian countries are involved only in the Asia-Europe Meeting (ASEM). ASEM has financial market development and strengthening economic cooperation between Asia and Europe as part of its limited agenda, and SEANZA (Southeast Asia, New Zealand and Australia), which is concerned with capacity building among central banks. India is part of the East Asia Summit (EAS) – comprising the ASEAN + 3, Australia, India and New Zealand – concerned with strengthening regional economic cooperation among members. Many of these bodies are handicapped by the absence of secretariats, poor focus and coordination and conflicts of interests among members, so progress is slow. For example, the EAS uses the ASEAN Secretariat.

[10] Asian intraregional trade accounts for about 50 percent of total trade, but its intraregional financial integration is limited. In 2004 intraregional cross-border portfolio liabilities were 2.25 per cent of Asian GDP, its liabilities to either North America or the European Union were more than three times as much.

[11] This section is based on: Ashima Goyal, 'Global Financial Architecture: Past and Present Arguments, Advice, Action' *Margin-The Journal of Applied Economic Research*, Vol.4, No.2 (24 May 2010) pp.233-247; Ashima Goyal, 'Asian Clearing Union: Current Status and the Way Forward' *ADB Project Report* (2010); Ashima Goyal, 'Regulatory Structure for Financial Stability and Development', *Economic and Political Weekly*, Vol.XLV, No.39 (25 September 2010); Masahiro Kawai, 'From the Chiang Mai Initiative to an Asian Monetary Fund' Paper prepared for the conference on the 'Future Global Reserve System' organised by Columbia University in partnership with ADB and ADBI in Tokyo on 17-18 March 2010; Masahiro Kawai, 'Reform of the International Financial Architecture: An Asian Perspective', *ADBI Working Paper Series,* No.167 (24 November 2009); Jee-young Jung. (2008) 'Regional financial cooperation in Asia: challenges and path to development', *BIS Paper* No.42 (October 2008), pp.120-135.

The global financial crisis gave another push to efforts to promote regional financial stability, including multilateralisation of the CMI. A crisis-affected member could immediately obtain liquidity support for the first 20 per cent of US$90 billion bilateral swap agreements (BSAs) in the CMI, but the remaining 80 per cent was linked to an IMF programme and its conditionality. Potential creditors, including Japan and the PRC, were concerned to avoid creating moral hazard. Demands for assistance could be due to poor policy fundamentals, requiring effective adjustment. The main ASEAN swap arrangement, which allowed member banks to swap their local currencies with major international currencies, was only US$2 billion on April 2009.

When hit hard by currency speculation and capital flow reversals in 2008, Korea found the CMI inadequate. Instead, it went to the United States (US) Federal Reserve for precautionary liquidity support. The solution was to make the EPRD effective and move to multilateralisation of the CMI. The Chaing Mai Initiative Multilateralization (CMIM), signed on 24 December 2009, will have a more institutionalised structure, with an independent surveillance unit under the guidance of an advisory panel of experts, based in Singapore. The quantum of support has increased and an active EPRD will enable it to be made available in a more flexible manner, comparable to the IMF’s Flexible Credit Line, but delinked from the IMF. The CMIM includes all the low-income ASEAN members, which were excluded from the CMI BSAs. This more inclusive arrangement opens up the possibility of the participation of other countries.

Studies are also taking place on medium- to long-term currency coordination to avoid competitive devaluations. Since the CMIM weights have been agreed to, they can form the basis for individual currency weights in a proposed regional monetary unit which could act as a benchmark for individual currencies, limiting their relative movements.

The ABF, a fund comprising foreign exchange reserves of regional member CBs, has the aim of investing in regional bonds to contribute to the development of regional bond markets, and reduce dependence on dollar denominated assets. ASEAN + 3 is also seeking to strengthen regional markets through the ABMI, and building a common market structure: securitisation, a credit guarantee, credit rating and settlement system, essential for developing regional market interaction.

A well functioning Asian Bond Market (ABM) would make the Asian financial system more balanced by encouraging markets as well as banks to provide alternative avenues for savings and encouraging sources for infrastructure investment and recycle the region’s large savings for regional long-term investment, thus reducing maturity and currency mismatches and global imbalances, as dependence on US capital markets would fall.

Future Liberalisation and Critical Development Imperatives

Future domestic and external liberalisation is likely to progress fastest in the directions that satisfy critical development needs. Since India leads other South Asian countries in market and institutional development the focus will now be on India. The needs are:

Inclusion

Although financial inclusion is a major aim, the reforms have not been so successful in this. The idea of inclusion has to expand beyond just availability of credit to expansion of banking, insurance and other financial services.

Financial markets have been unable to leverage the shampoo sachet effect, to evolve a low denomination strategy to tap the huge potential numbers that make low margin-high volume a viable business model in India. In order to do so, systemic features that discourage small investors have to be removed, their confidence built up and positive incentives offered. Possible measures include:

1. Education of investors, increasing financial literacy
2. Making one point disinterested information available
3. Reducing transaction costs in using technology for ease of entry, exit
4. Registering and rating of agents
5. Promoting simple transparent low cost instruments – index funds, exchange traded funds (ETFs)

The sub-brokers that households trusted had disappeared from the market, in favour of technology enabled distribution. But given the large job requirement in India, a technology plus people strategy may be more viable. Trusted technology enabled sub-brokers with local knowledge should be reestablished. Some big broking houses are setting up large national chains.

Infrastructure Financing

Poor Indian infrastructure is both a bottleneck and an opportunity. Spending on infrastructure is currently 6 per cent of GDP and is expected to reach 9-12 per cent to finance US$1 trillion over the 12th Plan for 2013-2017. Long-term finance is required and developing bond markets has some urgency in this context. More retail, pension funds participation, and limited investment by such foreign investors in long-term rupee denominated bonds could contribute. Limits are necessary since structures can be created to index local currency denominated bonds to or make them payable in foreign currency, thus creating currency risk.

Currently the maximum tenor of financing available is 15-20 years that is also in limited quantities. New instruments, such as take out financing, are beginning to be used to rollover short-term financing and allow exit of risk capital. After a project begins earning, other more risk-averse types of capital are willing to participate. Such instruments can enable its entry. Experience has been gained in public-private partnership (PPP) contracts with good incentive features. They allow allocation of tasks according to comparative advantage and of risk to parties best able to bear it.

Risk: Derivative Markets

Laying-off risk requires not only development of instruments and markets but also random movements in asset prices, so agents are not able to speculate on expected one-way movements. In thin markets, regulators sometimes have to create such movements, even while restraining excess volatility. Since firms cannot sell insurance to those who need it in imperfect markets, they may underinsure reversals of capital inflow. A well functioning bond market, for example, also allows firms needing external resources to share their revenues with those with access to foreign funds.[12]

Complex derivatives can be misused to create positions where the risk is non-transparent even to the holder. In 2007, many Indian firms entered into so called hedging deals, which were actually complex bets on the value of the Swiss Franc. With the steep rupee depreciation in 2008 many firms lost money.

Although one leg of every over-the-counter (OTC) trade is regulated in India, so information is available to the regulator, it is not available to the market as a whole. Standardised exchange traded instruments have the advantage of simplicity and more transparency. So risks are known. The crisis has demonstrated the robustness of exchanges compared to other financial institutions. Worldwide no exchange failed since they have multiple risk management systems and the Standard Portfolio Analysis of Risk (SPAN) to cover tail risks. Post crisis worldwide there is a move to more exchange traded instruments. But currently day trading dominates in many instruments since physical delivery is limited. It is necessary to increase contrarian positions, open positions and hedging.

[12] Ricardo Caballero and Arvind Krishnamurthy, ‘Smoothing sudden stops’, *Journal of Economic Theory,* Vol.119 (1 November 2004), pp.104-127

Inclusion and Domestic Development

Banks

Indian banks, especially private banks, provide better services to large corporates and HNIs. For example average loan rates for blue chips was 5-7 per cent but for medium and small scale enterprises (MSEs) it varied over 9.0-11.25 per cent. As established firms began raising credit abroad at cheaper rates, banks turned to retail credit, consumer durable and housing finance expanded. The Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002 and fledgling credit bureaus making credit histories available have contributed to the expansion of credit. Banks also participate in infrastructure finance but do not have the scale and size to meet large financing needs. Indian credit deposit ratios remain one of the lowest in the world. There is considerable scope for expansion.

Banking penetration was poor, partly because technology was not available. But technology has improved. Although banks have been slow in making optimum use of technology, RBI wants to give banks the opportunity to leverage new technology and a widespread agent network.

The very rapid growth in mobile usage, their wide penetration, competition and dynamism in designing new products, suggests permitting mobile financial services would enable rapid strides in financial inclusion. Delays and transaction costs would fall for users. A mobile-based product would make customers independent of agents. Business correspondents (BCs) (the RBI's favoured mode of inclusion) would only be required for enrollment, cash deposit and cash withdrawal. Whereas, in a smart card based technology, an agent is required for initiation of all transactions. Account details and the transaction data are stored on the smart card.

The provision of additional banking services, increasing access to credit, and raising the level of savings, for those currently excluded from the formal financial sector is the additional advantage of bank involvement even in mobile financial services. India has about 100 million migrant workers from Central India who need to send remittances home. Their security would increase since they would no longer have to carry cash.

Because the overarching goal is to expand financial services to unbanked population, specific policies have included expanding permitted points of service for small value transactions, for example by allowing managed service providers (MSPs) to function as BCs, regularising pilot projects, reducing the reporting requirements to set up no-frills bank accounts, and subsidising inclusion for non-banked population.

But after more than a year of the approval for mobile banking transaction volumes remained low in 2010. Banks found end-to-end encryption costly, and wanted to avoid it for low value transactions. They found entering into partnerships with MSPs difficult. There are conflicts on the value creation by each party. But regulators have to increase competition between alternative service providers. If banks take too long, alternatives must be explored to ensure inclusion. Unbundling allows competition in one component. The RBI in 2008-09 did do away with encryption for amounts less than ₹ 5000. It also lowered reporting requirements on the reasoning that small cards cannot be used for terrorist financing. Limits can be revised upwards to permit transactions like air-ticket purchases.

It also permitted non-bank entities to issue mobile-based prepaid payment instruments, based on representation from MSPs. But the response was poor. MSPs value added services have to improve. They are interested in the financial float, but RBI regards this as equivalent to deposit taking, which it is not willing to allow non-banks. There is a problem in extending deposit insurance to non-banks.

Markets

The new stock exchange established, NSE, was supposed to compete with the older, BSE, but it soon became dominant with 85 per cent market share. In electronic markets, physical distance does not matter, so the regional stock exchanges also died. Electronic markets work like a network, costs fall in the one that is able to attract more customers, so others also find it in their interest to migrate and the equilibrium tips over. In the days of floor trading the greatest geographical clustering of financial intermediaries had the advantage but with information and communication technology geographically dispersed intermediaries can provide liquidity. The exchange with the best technology attracts the most customers. The governance structure of exchanges also changes to a for profit corporations from a no-profit club of intermediaries distributing the rent among heterogeneous members. The latter does not work with dispersed membership. Profits help in improving technology, which is now the main avenue of competition. BSE also demutualised but was unable to compete with NSE's more modern processes. Aware of the possibilities of tipping in networks, market managements try to lock in customers in various ways. Therefore, regulators have to be proactive to maintain competition. For example, the judiciary had to intervene in the famous Microsoft case. Competition alone was inadequate given the possibility of tying software.

America's Security and Exchange Commission (SEC) has a 'best price' stock-handling rule to maintain competition across exchanges. But when the New York Stock Exchange (NYSE) was using favourable network effects to lock-in users, resist automation, and reward insiders, the SEC levelled the playing field by allowing 'fast' automated markets that execute trades automatically to bypass a better price on a 'slow' exchange.

Therefore regulators have to be pro-active to maintain competition. This SEBI has not been able to do. NSE makes large profits and rewards management while transaction costs remain high for users. BSE had acquired a bad name because of the dominance of insiders, but that governance structure was a function of the floor trading system and changed with its passing. NSE had a clean image. But without regulation, corporations will try to lock in customers and create entry barriers to increase profits and without competition transaction charges will not come down for consumers.

The Forward Market Commission that regulates commodity market exchanges has allowed a number of new exchanges to enter on the philosophy that competition will benefits users, but SEBI has not allowed even one. Regulators have to maintain a system that creates the best outcomes for users, and with for profit corporations in a network industry competition is important, even while high standards are enforced on exchanges as self-regulating organisations.

Equity

Trading in Indian markets is dominated by a few stocks, products, cities, and is largely short-term and cash settled. Only 1.5 per cent of the population is invested in markets, only 100 large cap stocks are liquid, 90 per cent trading volume in top 10 cities and in equity and commodities. AMFs, ETFs, MSEs and single stock options, are all underperforming.[13] (FOFM, 2010). FPI inflows have been able to dominate equity markets. More competition in exchanges may induce strategies for greater domestic inclusion.

There is an attempt to use mobile trading to help the spread of equity culture since India had about 47 crore mobile connections in July 2010, while demat accounts, which indicate the number of investors, are only 1.6 crore. In 2010, SEBI allowed stock trading, already available through internet banking, on a mobile phone platform. Brokers will have to ensure that they provide secure access and encryption for internet-based securities trading using wireless technology, and also take adequate measures for user identification, authentication and access control using means such as user-ID, passwords, smart cards and biometric maps. The unique identification number used for internet based trading will be applicable for securities trading using wireless technology.

[13] 'Indian Financial Markets Reforms Report 2010' *FOFM Future of Financial Markets Research,* www .fofm.in/ifmr. Accessed 13 April 2011.

Fixed Income Markets

The Indian debt market is underdeveloped, and India has a high government debt of 80 percent of GDP. The G-secs market is deep but retail holding is negligible. Banks are forced to hold this through a still high statutory liquidity requirement (SLR) of 25 percent NDTL. This must be brought down and more government debt held by households in a domestic retail market before freer entry of foreign rupee debt funds. The Greece sovereign debt crisis and the post-crisis explosion in government debts suggest that risks associated with external holding of sovereign debt can be large. Risks include high interest rate volatility that Indian households are not yet ready to face. Even after removing the captive held-to-maturity part, which is not marked to market, G-secs available for trade in 2010 were a large 10.5 lakh crores.

The corporate bond market is underdeveloped. Suggestions on domestic reforms required include rationalising stamp duty, incentivising development of market maker, permitting pension type funds to invest in such instruments, support mechanism reducing cost of issuing, for example by simplifying disclosure documents for debt investments, and creating credit enhancement mechanisms.

Interest Rate Futures

Globally exchange traded derivatives, comprise 81 per cent, and IRFs dominate in these. But in Indian markets the share was only one per cent in 2009. Attempts were made in 2003 and in 2009 to start interest rate futures in Indian markets but they did not succeed. There was correction of some design flaws, such as a shift from the synthetic zero coupon yield curve to a yield to maturity, but problems remained such as insistence on physical settlement. Initially there was lack of liquidity in the underlying since only two long-term G secs were deliverable. The fundamental reason for the failure of IRFs is players take positions to benefit from expected interest rate movements rather than hedge risks. This is the advice brokers give to clients. To change this short-term interest rate surprises are required. Wider holding and more active trade in G-secs and start of the corporate repo would provide more users. Development of one segment encourages another.

FX Markets

As elsewhere OTC conducted by banks dominates, with swaps being most widely used. Exchange traded futures were permitted only in 2009 and saw rapid growth. But limitations continue such as they cannot be settled in hard currency, the low contract size of USD 1000 makes OTC the preferred option for large corporate deals. So day traders dominate and open interest is low. Even so, there is continuous development with futures in multiple currencies and options being allowed. The RBI has been expanding permissions from the earlier focus on underlying exposures to also allow indirect hedging. BIS reported that Indian FX markets had the fastest growth rate among world markets although this slowed down after the global crisis. Even so, FX markets are still thin; large spikes can occur without CB intervention, especially given large capital movements in a currency that is not fully convertible.

These brief snapshots show the steady market developments and the sequence of development on the long path still remaining.

Structure of Regulation

The crisis also gives lessons for the regulatory structure India should follow.[14] The reasons for the regulatory failure it illustrated in advanced countries were partly ideology – the belief in market efficiency and self-regulation, but also the US comparative advantage in finance. This generated political support for finance driven growth. Tighter regulation was thought to have a cost in terms of compliance, innovation foregone, and higher cost of funds.

Both regulators and markets bought into the dominant paradigm of efficient and rational markets where failures do not occur. But markets as well as regulators failed, implying better incentives are required for markets and less discretion for regulators. Financial regulation must ensure the integrity of financial markets and that finance meets the needs of the real economy. In addition to supervision or enforcement the four basic market failures require regulatory intervention: failures of information and inclusion, behaviour that creates procyclicality, and the 'too big to fail' syndrome.

The crisis may help discover the right combination of regulation and markets. Regulatory discretion invites excessive restraints, corruption and regulatory capture. But rules need to incentivise better behaviour, moderating the basic market failures identified. A complex enough rule can be closer to a principle-based approach, yet reduce delays and regulatory forbearance. A combination of micro and macro prudential regulation can usefully moderate the failures. If regulation induces better outcomes through creating correct incentives for market participants it would enhance safety without crippling the energies and initiatives of markets.

There are many good reform suggestions that can be classified as principle-based rules. Prudential regulations all have this character. Principle-based rules retain operational flexibility. For example, a rise in capital adequacy, linked to the stage of the cycle[15] (a sharp

---

[14] This section is based on Ashima Goyal, 'Regulatory Structure for Financial Stability and Development', *Economic and Political Weekly*, Vol.XLV, No.39 (25 September 2010).

[15] Markus K. Brunnermeier, Andrew Crockett, Charles A. Goodhart, Avinash Persaud and Hyun Song Shin, 'The Fundamental Principles of Financial Regulation', *Centre for Economic Policy Research* (2 July 2009), www.cepr.org/pubs/books/P197.asp. Accessed on 5 August 2009.

rise in credit is normally a good indicator) would have to be implemented by the domestic systemic regulator. Implementing micro-prudential standards in financial markets such as prompt corrective action linked to banking parameters is a task for a local sectoral regulator. Principle-based rules avoid regulatory intervention in operational decisions of firms

Global coordination of basic prudential standards is also necessary. Such coordination can push financial firms to choose safe over risky strategies, by removing the moral hazard from bailouts, and assuring that the competitor is not adopting risky strategies either. Competition can force the choice of risky strategies. That is why external regulatory standards are so powerful. If a bank is assured its competitor will not choose risky strategies that may allow it to make more money, it will not choose those strategies either. Universal application of basic standards prevents regulatory arbitrage. Such regulatory improvement and harmonisation across countries will allow faster liberalisation.

Macro- and micro-prudential regulations each require different skills and information. The best alignment of information and incentives occurs if Central Banks (CBs) are responsible for macro-prudential regulation, sectoral regulators for micro-prudential regulation, and there is good coordination between the two. Formal oversight authority over banks and markets generates information for CBs. This is useful for monetary policy, and policy analysis is useful for macro-prudential tasks. For example, FX and interest rate derivatives markets affect macro variables. CBs have become crucial for the financial sector in their role as lenders of the last resort. The crisis forced them to expand this function beyond banks, as the financial sector diversified, its interlinkages thickened, and ability to inflate balance sheets procyclically and create risk increased. More responsibility for the systemic risk regulator must come with more power to check such inflation.

Micro-prudential supervisors also have an essential role since they have detailed knowledge of financial markets and institutions and will have critical information to assess stability risks. The macro-micro regulatory split has a functional basis. An apex body must not be a financial market regulator like the Financial Services Authority (FSA) in the United Kingdom, which would tend to support financial sector competitiveness and profitability, but a body for coordinating and sharing information led by the systemic risk regulator. The FSA has now been terminated as an experiment that failed, with responsibility for banks reverting to the Bank of England.

Indian Regulatory Structure

Regulators used a combination of restrictions, supervision, and incentives with a wary eye on market failure. Controls had been reduced with steady market development. But restrictions continued for complex financial products. One of the parties entering into an OTC contract had to be regulated by the RBI. Guidelines on securitisation imposed conservative capital adequacy requirements on exposures. Innovation in products and markets was slow.

The experience of scams in the securities market, and involving a non-bank financial company (NBFC), a cooperative bank, and a commercial bank, after the 1990s reform, led to a strengthening and extension of supervision and prudential norms to cover NBFCs. Given large capital flows there was a regulatory focus on systematically important non-deposit taking NBFCs and financial conglomerates. Thus the scams pushed the regulators towards universal regulation, and towards closing the regulatory loopholes that plagued mature financial markets. Cross border flows across several regulatory jurisdictions led to initiatives for regulatory coordination across borders.

But most prescient were the macro-prudential regulations implemented much before their worldwide post-crises recommendation. Countercyclical provisioning and differentiated risk weights for bank lending to bubble-prone sectors, such as real estate and equity markets, created incentives to moderate risky behaviour. A system of Prompt Corrective Action for banks based on capital adequacy, non-performing assets, and return on assets parameters gives an example of principle-based rules. All these reduced pro-cyclical incentives. There was an emphasis on stress tests to compensate for weakness in risk models.

This conservative yet forward looking regulation implies Indian banks are in such good health that the cost of Basel III compliance will be low. Banks tier I capital to risk weighted assets is 9.3 already compared to the 8 percent required. Some issues for India are the credit to GDP ratio is very low and must be allowed to rise structurally; the cost of OTC derivatives will rise; and the SLR is not accepted as a liquidity buffer, since it is compulsory.

The High Level Coordination Committee for Financial Markets (HLCCFM) was formed in 1992 in response to scams and regulatory arbitrage to monitor systematically important institutions with informal coordination across regulators, with the RBI governor as chair. In 2010, a Financial Stability and Development Council (FSDC), with the Finance Minister as chair, and the RBI governor as chair of the stability sub-committee is to replace the HLCCFM. The proposal is a diluted response a series of reports from committees that sought to shift power away from the RBI to favour market development. But these reports were all influenced by the pre-crisis free market regulatory philosophy. Worldwide the CB is being given more responsibility for financial stability. India was unique in moving towards reducing the role of the CB, despite the current regulatory structure having done well in the crisis. The RBI's broader regulatory responsibilities provided information and contributed to designing preventive macro prudential measures. There was synergy between monetary policy and regulatory responsibilities over many market instruments.

Apart from crisis lessons, giving more power to politicians, who had distorted India's financial sector to force it to fund the Government, ignores lessons from India's history. It is better to encourage independent, professional regulatory institutions with good interaction and peer review.

The Indian regulatory structure, is however, overweight on stability. Development is slow. Since coordination is poor among government agencies, the FSDC should function as a strengthened HLCC. The latter was set up in a crisis, without a well thought-out structure and function. Better norms of functioning can be devised. Legislation can mandate the objectives of systemic stability and market development.[16] It can plug regulatory gaps and assign responsibility with clear time lines to fulfill the objectives.

Better coordination is essential to deliver both stability and development. Modern financial products do not respect regulatory boundaries. Consider the introduction of currency options in 2010: participating members must be registered with SEBI and follow its guidelines for position limits, margins, surveillance and disclosures. But RBI retains the power to modify eligibility, limits, margins or take any actions required for stability and orderly development of FX markets.

Sectoral regulation is best organised on a functional basis, but inevitable overlaps require a more complex definition of functions. Overlap may even create more regulatory ownership. A narrow regulatory jurisdiction can lead to neglect of the big picture. With its stability concerns addressed, RBI would favour deep liquid markets that could improve the transmission of monetary policy. Overlaps have been blamed for many delays but it is the unclear allocation of responsibility that creates problems such as passing responsibility to the other, gaps in covering systemic risks, or high costs for industry in fuzzy dealings with many regulators.

Regulators will coordinate better if each regulator is vulnerable to the other. For example, while trading is the primary responsibility of SEBI, where it impinges on monetary policy or systemic risk the RBI must continue to be involved, but with a mandate for market development. A clear allocation of responsibility even with interlocking regulation, could resolve delays such as in establishing corporate repos. The government has since clarified that SEBI will be responsible for the primary and secondary market in corporate bonds and RBI for corporate repos. With the systemic risk regulator coordinating the FSDC with a clear mandate for development, markets can be given more freedom to design products. The finance minister should come in only as a last and rare resort.

---

[16] The Economic and Political Weekly Research Foundation in 2009 suggested creating a Financial Market Development Agency reporting to the Government as in New Zealand.

Concluding Remarks

In an emerging market it is natural to regard mature markets as an ideal, so that domestic systems are seen as lacking. But the crisis has exposed flaws in the finance dominated markets and regulation of the West. Countries such as China and India that followed non-standard paths have done the best; it is worthwhile to study those paths to see what worked. It is possible the goal itself may have to be modified to some extent. Finance is a good tool but a bad master; the real sector must have priority.

But even taking the goal as given, it is not correct to ignore the path and insist that the goal be reached instantly. The path may have to be long, with domestic institutions and markets strengthened before full capital account liberalisation. Domestic market liberalisation includes regulation that creates the correct incentives. Future liberalisation must follow the principles, which have succeeded in the past, as well as further India's critical developmental needs, such as inclusion and infrastructure. Improved domestic markets will benefit foreign participants as well.

It is necessary to ask why India and China, with some controls, had the highest post crisis world growth rates. The experience of India's neighbours also demonstrates that a middling through path does best. Pakistan with a more open capital account suffered several shocks and had to turn often to the IMF for aid. Bangladesh that retained more controls needed help only once. India continued with strategic controls and had more successful domestic institutional and market deepening. It did not need the IMF at all, and was able to build up substantial reserves. Thus, moderate and sequenced external and domestic liberalisation is the way to go.

. . . . .

ISAS Working Paper

No. 126 – 21 April 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Shaping the Coordinates of India's Trade Policy Architecture: Domestic versus International Drivers

Amit Shovon Ray[1]

Asia has experienced an explosion of regional trade agreements (RTAs) in recent years particularly in East and Southeast Asia. Production and institutions across these regions have become further integrated due to these RTAs. The domain of integration now extends to South Asia with India and other South Asian economies getting connected to East and Southeast Asia through formal trade arrangements. Proliferation of RTAs has revived the debate on multilateralism and regionalism. While most regional economies figure in the multilateral framework of the World Trade Organization (WTO), their pursuit of RTAs has raised questions over whether they repose greater faith in regional trade networks. The Economics and Trade Policy research cluster at ISAS organised a workshop at Singapore on 20 October 2010 on 'Trade Policies in South Asia and Southeast Asia: Encouraging Regionalism?' that examined different aspects of the theme including comparative dimensions of trade frameworks, bilateral trade relations and country perspectives on regional trade. The papers are being brought out by ISAS as a working paper series. This paper is the third in this series.

Abstract

India's trade policy architecture has undergone a phenomenal metamorphosis over the last six decades. The objective of this paper is to understand the 'factors' that have shaped India's trade policy architecture at various junctures in its development path. In particular, the paper will identify whether domestic economic compulsions or international economic environment have played the key role in determining the coordinates of India's trade policy architecture over time. The paper broadly concludes that India's trade policy architecture

---

[1] Amit Shovan Ray is Professor of Economics at the Centre for International Trade and Development, School of International Studies, Jawaharlal Nehru University, New Delhi. The views reflected in this paper are those of the author and not of the institute.

has remained by and large homegrown, dictated by domestic imperatives, both economic and political, rather than by the forces of the international economic order. Even at the WTO, India's stance has been shifting rather dramatically, but much of it may be linked to India's 'self interest' as opposed to international compulsions.

Introduction

India's trade policy has been a matter of intense academic discussion and debate among economists, cutting across different schools of thought. There is now a rich body of economic literature on this topic, but much of it pertains to critical appraisals of India's trade policy regimes as they evolved over time.[2] Economists have analysed the consequences of India's trade policy as it changed gears at various points in time over the past six decades. Indeed, some of this research and analyses have perhaps acted as important academic inputs in shaping the changing coordinates of India's trade policy architecture over time.

The present paper has a somewhat different flavour. Rather than focussing on the consequences and impact of India's trade policy on development trajectory, the objective of this paper is to understand the 'factors' that have shaped India's trade policy architecture at various junctures in its development path. In particular, the paper will identify whether domestic economic compulsions or international economic environment have played the key role in determining the coordinates of India's trade policy architecture.

Trade Policy in the Post-Independence Planning Era – until the Mid-1980s

Post-independence, India adopted a policy of inward-looking, import-substituting industrialisation that was significantly inspired by the Soviet model of development. Centralised economic planning, accompanied by widespread public sector dominance, regulatory controls over private sector activity, restriction on foreign investment and export pessimism, characterised independent India's development policy for the first four decades of India's growth experience.

---

[2] Some of the notable among them are; J.N. Bhagwati and P. Desai, *INDIA: Planning for Industrialisation* (London: Oxford University Press, 1970); J.N. Bhagwati and T.N. Srinivasan, *Foreign Trade Regimes and Economic Development: INDIA*, (New York: National Bureau of Economic Research, 1975); V. Joshi and I.M.D. Little, *INDIA: Macroeconomics and Political Economy 1964-1991* (Delhi: Oxford University Press, 1994); and A. Panagariya, *India: The Emerging Giant*, (New York: Oxford University Press, 2008).

India remained a virtually closed economy for nearly four decades after its independence in 1947. Trade received very little attention in the foundation of India's post-colonial development strategy. The notion of 'self-reliance' played a major role in defining the 'norm' of development in India. The aspiration was perhaps to mimic the development trajectories of the 'advanced' West, although very much within the framework of import substitution and self-reliance. It was perhaps important to the Indian policymakers to signal to the rest of the world that India could do whatever the advanced nations can. Accordingly, a diversified industrial production base was meticulously planned out for India, ranging from simple consumer items to sophisticated capital goods and heavy machinery. This drive towards self reliance also prompted India to engage in highly complex and resource intensive activities such as space research or nuclear technology. The notion of natural comparative advantage took a back seat in this planning process.

The adoption of an inward-looking trade policy by the Indian development planners may be linked to several considerations. First and foremost, the overriding goal of Indian development planners was to achieve economic 'self reliance'. Apart from the long history of colonial rule that made the country vulnerable to global economic powers, Indian planners were also influenced by the Latin American 'structuralist' school of thought highlighting elasticity pessimism and inequalising trade between the centre and the periphery. They were somewhat cynical about the international trade and exchange, and hence wanted to reduce India's dependence on the world economy for its immediate needs and the associated vulnerability of India's exposure to the world economy. Pursuit of 'self reliance' was perhaps just an expression of this long-term objective. 'Self reliance' was also a reflection of the norms of development defined by the India's development planners after independence. It was important for them to show that India could also produce what the rest of the world could, ranging from high end capital goods to mass produced consumer items. To this end, the conventional infant industry argument perhaps further buttressed India's protectionist trade policy during the immediate post-independence planning era that remained in place for nearly four decades. Although the overall trade policy framework remained consistently inward-looking during this period, there were considerable modifications and fine tuning made by the policymakers at different points in time. The paper will divide the discussion of trade policy changes in this period into three sub-periods – firstly, pre-1966, secondly, 1966 devaluation and lastly post-devaluation.

Pre-1966

Import and exchange control policy in India relied primarily on quantitative restrictions (QR), based on detailed estimates of foreign exchange availability made by the Government. After pre-empting for the essential requirements for embassy expenses, and import of food fertilisers, petroleum, oil and lubricants, the available foreign exchange was allocated to competing users through an elaborate administrative mechanism of import licenses. The allocation of these licenses was based on two principal criteria – essentiality and indigenous non-availability. Each applicant had to obtain a clearance certificate to this effect from designated government agencies, on the basis of which import licenses were issued specifying the quantity and composition of imports. Unfortunately, however, there was a lack of a well defined set of objective principles to determine the twin criteria of essentiality and indigenous non-availability in order to allocate scarce foreign exchange among 'eligible' competing users. Among the long list of priority industries, foreign exchange was to be distributed on a 'fair' and 'equitable' basis. Among rival claimants within each industry, small scale units were given preference over large scale and public sector over private.

From 1962 onwards, the QR regime of import and exchange control was supplemented by increasing use of tariffs. The period 1962-66 was characterised by a steady attempt at unifying import duties which had been steadily increasing to mop up the import premia on the QR-based allocations of foreign exchange. Although, the average import duty rose steadily until 1966, but a vast majority of these increases were selective and differential.

On the export policy front, India's attitude in the 1950s had been one of indifference and 'pessimistic neglect'. Export control on several commodities originated during the Second World War and was carried over to much of the 1950s and even later for some items. Export duties prevailed on several items at varying rates. Export controls combined with the growing strength of domestic demand resulted in a stagnation of India's exports during the first two plan periods.

Deliberate policies of direct export promotion were adopted after the launching of the third five-year plan in 1961-62. Export incentives were provided in the form of export subsidies through fiscal measures or through import entitlement schemes. Fiscal measures included drawback and exemption from various duties and taxes, non-discriminatory direct tax concessions to exporters, outright cash subsidies, and freight concessions. In addition, there were indirect measures like trade promotion fairs and export promotion councils set up by the Government. The import entitlement schemes, which eventually became the principal instrument of export promotion, entitled exporters to import licenses fetching high import-premia, pro-rata to the value of exports effected (not exceeding 75 per cent of the export value or twice the value of the import content). There were, of course, restrictions on the type of imports permissible under this scheme, mainly intermediate and capital goods. The import entitlements were transferrable at a market clearing premium (subject to a ceiling).

1966 Devaluation

The 1965-66 was a grim era for the Indian economy, witnessing a severe drought and the second Indo-Pakistan War. The war apart from draining resources also led to suspension of major financial aid flows. Aid-India Consortium offered to resume aid flows after the war, but only under the condition that India devalued its highly overvalued currency. On 6 June 1966, the Indian rupee had been devalued by 57.5 per cent. This was accompanied by other policy measures including elimination of some export subsidies, reduction in import duties and imposition of countervailing export duties. The idea was to liberalise India's protectionist trade regime to some extent. However, the liberalisation attempt was largely unsuccessful. The policy changes that took place after 1966 led to a quick reversal of exchange control regime to the pre-devaluation state.

Post-Devaluation

The most striking development in the post-devaluation period was an early revival and expansion of export subsidies. Large scale cash subsidies were introduced on an explicit basis which was extended to a number of items, by as early as 1967. The subsidies were selective, varying between 10 to 25 per cent ad valorem and remained concentrated on a few items. The objective was to overcome short-run bottlenecks to exports by offsetting the difference between the short-run marginal cost and the realised export price, as well as, the domestic taxes not covered by the duty drawback scheme. The subsidies were announced quarterly making it rather unpredictable to make long-run investment plans for exporting.

The earlier import entitlement schemes were replaced by a similar scheme of import replenishment, under which exporters were granted premium-carrying import licenses of a value equal to the import content of their exports. Other subsidisation schemes like duty drawback, direct tax benefits, freight subsidies, and subsidised export credit continued to exist in full form.

With respect to import policy, the intention was to liberalise. But the ultimate outcome of the liberalisation episode was a relapse into the pre-devaluation import control regime. The QR regime of import control continued with high premia on several items. With some improvement in the balance of payment situation in the early 1970s, some attempts were made to partially 'liberalise' import policy especially for general exporters. But there was no significant fundamental change in the attitude towards import of final goods, and for that matter, the overall trade policy regime. The shopping list of replenishment licenses for exporters was expanded and then scrapped altogether in 1977-78. In the same year, the general import licensing itself was de-licensed and thus the special incentives to exporters disappeared. All import licenses were to be given in free foreign exchange. But this did not last for long. In 1979, the policy stepped back from liberalisation and by 1980-81 it was back to its pre-1975 form of restrictive import licensing with special incentives to exporters.

Meanwhile, tariffs continued to remain unusually high by international standards – it was more than 140 per cent for about 70 per cent of tariff categories, 100 per cent or more for 88 per cent of categories and 80 per cent or more for 99 per cent of items.

To summarise, India's trade policy has remained consistently inward looking. The strategy of import substitution has generated an anti-export bias by sharply titling relative profitability in favour of the domestic (import competing) sectors against the exportable sectors. Some of these policy distortions against exports were sought to be countered with direct and indirect export incentives in a somewhat indiscriminate manner. However, except for a few isolated items, import duty remained well above the export incentive rates. Even within this overall framework, the Government's intention to boost exports and ensure adequate profitability (in the short run, perhaps) was made clear especially from the mid-1970s. Export incentives have been more and more generous over time and the bureaucratic procedures have been sought to be simplified for exporters. But by no means, there was any indication during the first four decades of India's independence, of a movement away from the basic ideology of import substitution towards a more export oriented outward looking trade regime. Bhagwati and Desai aptly summarises India's trade strategy during this period as follows, 'India should produce whatever it can and should export whatever it produces.'[3]

Consequences of the Protectionist Policy Regime

The objective of India's inward-looking trade strategy of import substitution was to set up domestic industrial capacity for whichever goods (consumer and producer) could be produced domestically and protect them from international competition. In 1975, Pioneering estimates by Bhagwati and Srinivasan of Effective Rate of Protection (ERP) enjoyed by 77 manufactured items in 1968 indicate excessively highly degree of protection enjoyed by some of the industries in India during this policy regime.[4] As one expects, in line with the Heckscher-Ohlin-Samuelson framework, labour abundant India will tend to grant more protection to the capital intensive industries. Khanna's (1984) econometric results confirm this presumption.[5] This implies that protection in India would have distorted resource allocation towards capital intensive industries that would otherwise be unprofitable domestically under an 'efficient' market determined allocation of resources in line with its

---

[3] J.N. Bhagwati and P. Desai, *INDIA: Planning for Industrialisation* (London: Oxford University Press, 1970).

[4] J.N. Bhagwati and T.N. Srinivasan, *Foreign Trade Regimes and Economic Development: INDIA*, (New York: National Bureau of Economic Research, 1975).

[5] A. Khanna, 'Market Distortions and Export Performance: India's Export of Manufactures in the 1970s', *Weltwirtschaftliches Archiv*, Vol.120 (1984), pp.348-360.

natural comparative advantage. Moreover, indiscriminate and automatic protection to whichever industry sets up indigenous capacity, irrespective of costs and quality considerations, led to the development of a high cost (and perhaps low quality) industrial structure. Indeed, the high order of protection granted especially to intermediate and capital goods industries had the effect of raising the industrial cost structure across the board, which in turn could operate only in a sheltered market. This created the need for further protection to all industries, making Indian manufactures uncompetitive by international standards of costs and quality.

Economic Reforms in India

Genesis of the Reforms Process

Limitations of the earlier approach was, however, becoming all too apparent over the years, forcing serious rethinking on India's economic policy design from the middle of the decade of 1980s. The flipside of this protectionist trade policy regime soon revealed itself in the form of inefficiencies of various kinds. For one thing, there was no incentive to keep pace with the fast changing global technology frontier in many of the manufacturing sectors, which resulted in Indian industry becoming technologically backward and inefficient with respect to global standards of costs and quality. From the mid 1980s, a technological view of development started gaining momentum in India's development policy. It was increasingly realised that being able to produce everything could not be the end-all goal. It is very important to be able to do things 'efficiently' as well. That may require opening up the doors to latest technological development on the global frontier, quite a departure from its earlier protectionist policy regime. This, in a sense, marked the beginning of India's policy of liberalisation.[6]

But initially the policy response, beginning in the mid-1980s, had been quite feeble and was mostly limited to liberalising particular aspects of the control system, both in the spheres of manufacturing and trade, without any major change affecting the system itself in any fundamental way. These attempts of liberalisation have, however, been arguably piecemeal and somewhat ad-hoc without a comprehensive programme of reforms that some of the other inward-looking economies had already adopted (including China from 1978).

It was the year 1991 that marked a radical departure from the past when, faced with an exceptionally severe balance of payments crisis, India launched a massive economic reforms

---

[6] A.S. Ray, 'India's Economic Reforms: Opportunities, Challenges and Political Economy Perspectives', in Lyal White (ed) *Is there an Economic Orthodoxy? Growth and Reform in Africa, Asia and Latin America*, (Johannesburg: SAIIA, 2006).

package consisting of short-term stabilisation measures along with a longer-term program of comprehensive structural reforms. These reforms were much wider and deeper than earlier piecemeal attempts, and which ushered in a complete paradigmatic shift in policymaking that now emphasised not only liberalisation of government controls, a larger role for the private sector as the engine of growth, freer operation of market and competitive forces in order to boost efficiency, but greater integration with the world economy through free and unrestricted trade flows.

Interestingly, the balance of payments (BoP) crisis of 1991, that precipitated India's massive economic reforms package coincided with the Uruguay Round of negotiations that culminated in the establishment of the WTO, heralding the beginning of a new world order of globalisation as discussed in the previous section. Hence, a better perspective on the Indian reforms process is gained by viewing it against the backdrop of the evolution of the WTO-driven new world order, instead of regarding it merely as an isolated occurrence.

India's economic reforms process, launched in 1991, may be classified into the 'first phase of reforms' that lasted from 1991 to 1995-96, which focused on broad-based reforms in key sectors of the economy and the 'second phase of reforms' that began in 1997, which essentially involved further deepening of reform measures already in place, as well as, initiation of newer ones. The section below highlights some of the key trade policy reforms during these two phases.

The First Phase of Reforms

One of the most comprehensive and path-breaking set of reforms was initiated in the external sector. Pervasive quantitative restrictions in imports and steep custom duties of the earlier import-substitution policy gave way to a liberalised trade regime, characterised by rationalisation of tariffs and duties and placing of the bulk of imports under the Open General License (OGL) list. Exchange rate reforms comprised a gradual move towards a market determined exchange rate regime through the initial devaluation of the rupee in July 1991 by 24 per cent and adoption of a flexible exchange rate in 1993 with the rupee becoming fully convertible in the current account of the BoP. Over time the Indian rupee has become by and large market determined and takes its value in response to movements vis-à-vis a basket of major global currencies like the United States (US) dollar, United Kingdom (UK) pound, Euro and Japanese Yen. The Reserve Bank of India (RBI) intervenes only in the event of excessive volatility in the foreign exchange market.

Post 1991, an investor friendly and enabling 'foreign investment policy' was also put in place and foreign direct investment (FDI) was actively sought in various sectors. Foreign investment was largely permitted through the automatic route, though in some sectors, e.g.

automobiles, there were conditions relating to local content use as well as export obligations in the early years of reforms. Those proposals that were not eligible for the automatic route were considered for approval from the Foreign Investment Promotion Board (FIPB). Sectoral caps to foreign equity participation were also significantly enhanced. Individual states also became increasingly interested in attracting investment, both foreign and domestic. As a result, foreign direct and institutional investment depicted a steadily increasing trend in the post-reforms period, although it has also been claimed that approvals for FDI often exceeded actual flows.

The Second Phase of Reforms

Although the first phase of reforms marked a successful and radical transition in India's trade industrial and financial policy regime, progress on fiscal consolidation and reforming agriculture and infrastructure was significantly limited. In fact some of these were much difficult to implement, and hence India adopted a slow and cautious path with respect to these dimensions. During mid-1990s, the reforms process showed some signs of deceleration/ slowing down, mainly owing to exogenous factors like the East Asian crisis and domestic emergencies like Orissa cyclone, Kargil War, etc. Besides, frequent changes in government during 1996-1999 also undermined the executive's capability to carry forward the process of reforms. However, from the late 1990s, economic reforms once again picked up again momentum with India entering the second phase of reforms.

In the second phase there was not only deepening of reforms in the external and industrial sectors, but also more progressive and radical (but somewhat difficult) reforms being initiated in areas like fiscal consolidation, streamlining the legal framework, revamping of public sector enterprises, strengthening physical and social infrastructure, vitalising India's capital markets and financial institutions, and boosting India's dynamic comparative advantage in information technology and other knowledge-based industries.

The existing reforms have undergone considerable deepening and widening in the external sector with a WTO compliant trade regime now in place. The Foreign Exchange Management Act (FEMA) in 1999, replacing the erstwhile the Foreign Exchange Regulation Act (FERA), has made provisions in conformity with the demands of a liberalised foreign exchange regime. The Indian rupee, too, is now being managed according to market principles, with the RBI intervening only occasionally to curb excessive volatility whenever such circumstances arise. Restrictions on capital account convertibility have been substantially removed, although India is yet to reach full capital account convertibility.

The reforms have put in place a liberal, transparent and investor friendly foreign direct investment (FDI) policy, wherein FDI up to 100 per cent is allowed under automatic route for most of the sectors, with special thrust on 100 per cent export-oriented units, export processing zones, software and hardware technology parks and industrial parks. Moreover, the sectoral cap for FDI in telecommunications and civil aviation has been raised from 40 per cent to 49 per cent. FDI is now permitted in real estate, as well as, integrated township development, ports, telecommunication, defence and insurance. The Foreign Investment Implementation Authority (FIIA), established in 1999, acts as the single point interface between investors and the administrative set-up.

Likewise, the Foreign Institutional Investment (FII) ceiling in the paid-up capital of Indian companies has been hiked considerably over the last three years and several procedural simplifications have been put in place.

Policies governing external commercial borrowings (ECB) have also been significantly liberalised with Indian companies now being able to raise resources from the overseas market through the automatic route up to a ceiling of US$500 million. At the same time, India has been successful in attracting large volumes of non-resident deposits. Though initially, interest rates offered to non-resident Indians (NRI) were significantly high, leading to arbitrage opportunities, such differentials have been progressively eliminated with the rates now being linked to London Interbank Offered Rates (LIBORs).

All quantitative restrictions on trade have been lifted with effect from 1 April 2001. The latest Union Budget for 2005-06 expresses its intention to further liberalise trade policy building on the growing external strength of the economy. In line with the earlier stated policy of gradually reducing tariffs in India to the Association of Southeast Asian Nations (ASEAN) levels, peak rate of customs duty (for non-agricultural products) have been reduced from 20 per cent to 15 per cent in the Budget.

The National Foreign Trade Policy for 2004-09 was announced with the explicit target of doubling India’s share of world trade by 2009. Export-oriented sectors like jewellery, software, pharmaceuticals etc. have been given particular policy attention. The initiatives announced include, inter alia, the setting up of a Board of Trade and the Service Export Promotion Council (SEPC), exemption of export oriented units from service tax, extension of duty free entitlement to more sectors and special focus on agriculture.

India and the WTO[7]

Any discussion of India trade policy architecture remains incomplete without a look at India's stance at the WTO.

Notwithstanding India's closed economy policy stance, India has been one of the initial signatories to the 1947 General Agreement on Tariffs and Trade (GATT), which was formed post World War II. GATT was as an effort on the part of the developed world faced with mixed fortunes at the end of the war, to discipline themselves in trade in goods and to limit the spread of proactive protectionist policies by individual national governments. India in-principle was supposed to have accepted the mandate, but it remained firm on its trade and development policies aimed at self-reliance and import substitution.

Interestingly, the Uruguay Round of the GATT negotiations began in 1986, precisely when India's development policy making process was at a watershed. By the time India launched its massive economic reforms package in 1991, marking a paradigm shift in its policy, the Uruguay Round negotiations were well under way, paving the path towards Marrakesh in 1994 and the establishment of the WTO. India's attitude towards the WTO may be best understood against this perspective of the changing mental frame of the Indian policymakers from the mid-1980s onwards, both reinforcing each other.

It is hardly surprising that India remained a 'cautious' and somewhat 'passive' player during the initial years of the Uruguay Round negotiations, given its long legacy of inward looking development strategy and protectionist trade policy regime. With the liberalisation of its trade regime from 1991, India could perhaps slowly perceive an alignment of its policy interests with the core philosophy of the WTO. Free trade and greater engagement with the world economy was therefore no more a taboo among Indian policymakers. However, this is not to suggest that the 1991-reforms made India euphoric about the prospects of WTO and its consequences for India. It is natural that the Indian intelligentsia remained rather sceptical about potential vulnerabilities of the nation from the sudden exposure to the world economy. It was only in the area of manufacturing that India's unilateral trade liberalisation was carried out during the early 1990s. Therefore during the Uruguay Round, India was clearly reluctant to move beyond trade in manufactured goods at the WTO.

The post-Marrakesh (beginning in 1994) period is primarily identified with negotiations at three Ministerial Meetings, namely Singapore (1996), Geneva (1998) and Seattle (1999). This phase saw multiple instances of loss of mutual confidence among negotiating partners, in

[7] This section draws upon an earlier paper by the author. A.S. Ray and S. Saha, 'Shifting Coordinates of India's Stance at the WTO: Understanding the Domestics and International Economic Drivers', in Amrita Narlikar and Brendan Vickers (eds), *Leadership and Change in the Multilateral Trading System*, (Dordrecht: Republic of Letters Publishing/ Martinus Nijhoff Publishers, 2009).

spite of the Marrakesh agreement signed by all members that led to the establishment of the WTO with sector specific commitments to liberalise trade regimes. Developed countries tried to use the Singapore (1996) platform to broaden the agenda of WTO to areas popularly known as the 'Singapore Issues', namely; investment, competition policy, transparency in government procurement and trade facilitation. They also wanted to introduce core labour issues in the negotiations. Developing countries including India objected to such designs, arguing that the 'Singapore Issues' were essentially non-trade issues and for negotiating labour standards, the International Labour Organization (ILO) should be the right platform and not the WTO. Geneva (1998) was an intermediate phase where members were keener on facilitating the process of negotiations by working on issues pertaining to agriculture and services, already mandated. Instead of whipping up the Singapore Issues, the Geneva Ministerial only endorsed the earlier mandate of continuing the work programmes on these issues. But Seattle (1999) proved to be yet another failed attempt by the developed world to promote an expansionary agenda within the WTO, incorporating labour standards and issues of coherence in global economic architecture (the Singapore Issues). For the present analysis, it is worth noting that even towards the end of the Uruguay Round (Seattle in 1999), the US, the European Commission (EC) and Japan remained stubborn on anti-dumping and agricultural subsidies.

All this prompted India to take a hard line on not endorsing a new round at Doha in 2001, arguing that commitments of the Uruguay Round has not been fulfilled (especially on the part of the developed countries as mandated by Article 20 of the Agreement of Agriculture [AoA]) and hence it is pointless to initiate a new round of negotiating agendas. Perhaps India had also been wary of the various dispute settlement cases arising out of the Marrakesh commitments, throughout the latter half of the 1990s.[8] This is hardly surprising, given India's lack of capacity to tackle these cases, especially against developed nations that were much better equipped with legal manpower and expertise in these matters.

However, finally India reluctantly signed the Doha Agreement in 2001. At the end, India was quite happy with the Doha outcome, because of its success on three issues; several concessions on implementation issues, weakening of the trade-related aspects of intellectual property rights (TRIPS) to accommodate access to medicine and public health concerns of developing countries, and most significantly keeping the Singapore Issues at bay.[9] In fact, it was post-Doha that India emerged as a leading and key negotiating partner at the WTO and assumed the role of a pro-active player in the whole process. There was a clear shift from its earlier position of cautious or at best passive participation. But this shift must be understood in the changing global economic context of the present decade with the slow but steady emergence of India as a major player in the world economy. In this changing economic

8 A. Panagariya, 'Developing Countries at Doha: A Political Economy Analysis', *World Economy*, Vol.25, No.9, (September 2002), pp.1205-33.

9 A. Panagariya , 'India at Doha: Retrospect and Prospect', *Economic and Political Weekly* (26 January 2002).

scenario, India began to look at the WTO as a global institutional framework that could fetch enormous economic gains for India by bringing down the prevailing distortions in trade, not only in manufacturing but also in services. Its immediate 'success' in Doha and its growing urge for expanding the market for its producers beyond domestic boundaries for the sustained growth of its economy, it was now in India's interest to take forward the WTO agenda beyond trade in goods.

At the same time, India's emergence as a major economic player in the world has contributed to a heightened profile of the country at the WTO. India's increasing attention from the world on WTO negotiations can perhaps be traced back to Singapore (1996), where India posed a stiff opposition to the inclusion of the so-called 'Singapore Issues'. Again in Seattle (1999), India played an active role in scuttling the issue of labour standards, championing the cause of developing countries. Later in Doha (2001), India received a lot of criticism and negative publicity, especially from the western media for its stand on resisting a new round.[10] While India was being branded as having a negative attitude towards negotiations in the sense of adopting a position of what 'should not' be included rather than a positive stand on what 'could' conceivably be included for its own interests. The publicity brought India to the limelight and conveyed a signal that India could potentially block the progress of multilateral negotiations and India's withdrawal from the negotiating table might prove costly. Indeed, India's claimed victory on counts of developmental concerns being acceded to in Doha, gave it a renewed confidence to adopt a more pro-active and enthusiastic posture at the WTO negotiations. Later in the run up to Cancun, the formation of G20 to resist the US-EU agenda on agriculture, India again played a leading role along with its allies Brazil, South Africa and China and this further contributed to India's importance at the WTO.

Finally, when the Doha Round was suspended at Geneva in 2006, India was considered to be among the select key members, which could salvage the round. Along with the US, the EU and Brazil, India became a part of the high profile G4 to take forward the round and break the stalemate. There could, of course, be several interpretations of India's inclusion in this group. But, there is a strong perception that the US and the EU, which enjoyed the maximum bargaining power and could easily drive the WTO agenda/negotiations in the early days, were now losing ground. Especially post-Doha, with developmental concerns being explicitly recognised, the US-EU coalition found it increasingly difficult to ignore the developing countries' voices, that were vehemently put forward by countries like India (among others) with global support from civil society lobbies. Under these circumstances, the only sensible step was to co-opt some of these countries into a closed group to seek out solutions. India, being a large emerging economy with a large poor population (giving it legitimacy to fight for developmental concerns) and already acknowledged as an important negotiator at the WTO, was a natural choice.

[10] *Ibid.*

However, at the present juncture, the entire institutional framework of the WTO is facing a major crisis. Due to repeated collapse of the negotiating process, the WTO has become a lame duck in carrying forward its mandate to promote a free and fair world trade regime. It now remains to be seen how India responds to this crisis of the WTO.

Domestic verse International Drivers

The pre-reform trade policy regime in India was, by and large, dictated by domestic imperatives, both political and economic, rather than by the international policy environment. As seen earlier, 'self reliance' was the buzz word for the post-independence policy planners of India. The overriding objective was to reduce India's dependence on the world economy for its immediate needs, after a long legacy of the colonial rule that made the country extremely vulnerable to global economic powers for two centuries. Although, contemporary international scholarship in development theory did play a role in shaping India's development strategy and norms in the 1950s and 1960s, India's strive towards economic self reliance acted as the key driver. Indeed, looking at the nitty-gritty of some of the operational details of this import substituting industrialisation strategy, the pre-dominance of domestic economic drivers becomes all the more apparent. For instance, the scarce foreign exchange resources under this regime was sought to be allocated as per the twin criteria of essentiality and indigenous non-availability – both reinforcing the domestic needs and compulsions. Likewise, the initial pessimistic neglect of exports was soon replaced by an active (but ad-hoc) export incentive scheme introduced in the 1960s to counter the anti-export bias of the regime and augment the profitability of the exportable sector. As the foreign exchange requirement grew with the rising requirements of essential imports, commensurate with the country's steadily (but slowly) growing economy, the export incentives were made more elaborate and generous. This was again a reflection of how the trade policy details were essentially driven by domestic needs and priorities.

One could, of course, argue that 1966 devaluation episode was partly dictated by the international economic environment. It was at the behest of the Aid India Consortia that the devaluation and associated trade liberalisation package was put in place. Given India, severe exchange crisis, there was no other alternative. However, the 1966 devaluation turned out to be only a one-shot phenomenon rather than any fundamental long term change in India's trade policy architecture. Post-devaluation policy changes immediate led to reversal to its earlier exchange control policy of a protectionist trade regime. Moreover, as the import-substitution strategy was carried out deeper and deeper, it created the need for further protection. By then, there was a strong domestic capitalist lobby that also had a vested interest in keeping the protectionist policies in place and perhaps to get it reinforced and extended as much as possible. Indeed, the decade of the 1970s witnessed the passage of a few other policy acts (Monopolies and Restrictive Trade Policies [MRTP] Act of 1969, Patent Act of 1970 and FERA of 1973) that reinforced India's protectionist trade policy regime aimed at achieving 'self reliance'. Overall, it is, therefore, pertinent to conclude that domestic imperatives rather than international economic reasons acted as the key driving force behind India's inward looking trade policy regime till the mid-1980s.

There is considerable debate on whether India's transition to a more open and liberalised trade regime, beginning in the mid-1980s in a somewhat feeble and ad-hoc manner and then culminating in the comprehensive 1991-reforms package, was dictated by the prevailing international economic order with the International Monetary Fund (IMF)-World Bank and the GATT (later the WTO) as the prime architects. However, this discussion on the genesis of this reforms process in India clearly shows that there was a perceived change in the approach towards defining the norms of development by a section of the Indian policymakers since the mid-1980s. Needless to say that international scholarship on development, with extensive analyses of the consequences of prolonged protection, must have influenced this new policy thinking. However, there were major debates and differences of opinion on this among Indian policymakers and scholars, and hence the initial liberalisation attempts of the 1980s remained arguably piecemeal and somewhat ad-hoc, lacking a comprehensive reforms package that some of the other inward-looking economies had already put in place (e.g., China since 1978). The 1991 reforms package adopted by India was a direct fallout of the acute BoP crisis faced by India in 1990. This marked a paradigm shift in its trade and development policy approach in a fundamental way. The need for this change of policy gear was already being felt for some time and the crisis only acted as a trigger. As noted earlier, India's trade reforms coincided with the established of WTO driven world order, but was not dictated by it. Therefore, it can be broadly concluded that India's trade policy architecture has remained by and large homegrown, dictated by domestic imperatives, both economic and political, rather than by the forces of the international economic order. Even at the WTO, India's stance has been shifting rather dramatically, but much of it may be linked to India's 'self interest' as opposed to international compulsions.

The immediate question that comes to our mind is which way should India's trade policy be directed towards? Given that WTO has come to an effective standstill, should India now start vigorously pursuing a bilateral and or a regional trade agenda? Although, this is not a simple question to answer, having examined the broad coordinates of India's trade policy, one tends to believe that it is in India's best interest at this juncture to take forward a multilateral trade agenda through the institution of the WTO. India must try to capitalise on its heightened profile and leadership stature at the WTO to see revitalise the institution. While bilateral trade agreements may serve some immediate short-term gains for India, it can never be an effective substitute for a free and fair global trade regime in a multilateral framework that is in India's best interest in the long run.

. . . . .

ISAS Working Paper

No. 127 – 9 May 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

South Asia: Policy Responses to the Global Crisis

S. Narayan[1]

Abstract

The impact of the economic crisis of 2008-09 was felt significantly in the economies of South Asia. Demand for exports and foreign investments fell in the real economy as well as in the financial markets. This led to a softening of domestic demand in the consumption sectors, leading to a slowdown in the growth of these economies. The economies in South Asia have now recovered and the problems of 2009 and 2010 have been left behind. Policy interventions that were adopted in the different countries varied not just due to differing macroeconomic considerations, but also because of the political economy considerations in these countries. This paper attempts to examine these interventions, their causes and effects.

Introduction

Both advanced and emerging economies initiated various fiscal and monetary measures in the form of bailouts and stimulus packages during the economic meltdown in 2007-08. The objectives of such initiatives appear to be: to restore confidence in the financial system and revamp and stabilise the financial markets; to stimulate domestic demand; to create new job opportunities; to support domestic industries; and to safeguard export interests.

---

[1] Dr S. Narayan is Head of Research and Visiting Senior Research Fellow at the Institute of South Asian Studies, an autonomous research institute at the National University of Singapore. He was the economic adviser to the former Prime Minister of India, Mr Atal Bihari Vajpayee. He can be contacted at snarayan43@gmail.com. The views reflected in this paper are those of the author and not of the institute.

A review of stimulus packages by countries mentioned above reveals some common policy stances: boosting domestic demand through additional investment in infrastructure and productive sectors; fiscal stimuli by way of reduced duties and taxes; aggressive monetary policy through rate cuts and reduced interest rates; readiness to go for higher deficits to stimulate the economy; fiscal/financial incentives in the form of cash compensation schemes, income tax rebates, credit at reduced interest rates in support of export-oriented sectors.

The impact of the economic crisis in 2008-09 was felt significantly in the economies of South Asia. Demand for exports and foreign investments fell in the real economy, as well as, in the financial markets. This led to a softening of domestic demand in the consumption sectors, leading to a slow down in the growth of these economies. However, most of the South Asian economies had recovered remarkably in 2009-10 and have regained much of the momentum that they had lost in 2007-08. This was a consequence of a combination of prudent fiscal and monetary policy measures, as well as a consistent focus on growth, even at the risk of some inflationary pressures. The monetary and fiscal policies pursued by these countries did not quite address all the features outlined above, but these were due to peculiar political and economic constraints that each country was facing. In some of the South Asian countries – notably Pakistan, Sri Lanka and Nepal – factors such as political stability and changes in regime have had their impact on the recovery process. This paper attempts to trace the features of these economies during this period (2007-10) and to outline the steps taken to deal with the consequences of the global economic crisis.

India

In India, the impact of the crisis was first felt in the financial markets, as institutional investors withdrew close to US$16 billion in the months following the Lehman Brothers' collapse. The market capitalisation of the National Stock Exchange listed that equities fell by over 40 per cent and the Sensex fell from 20,800 in January 2008 to 8,600 by December 2008. In the real economy, exports fell every month from October 2008, with a 16 per cent drop in January 2009 alone. The decline in orders from the European Union (EU) – among India's most important trading partners – played a significant role in driving this overall fall of exports. As a result there was a considerable increase in unemployment in the export sector, with the Government of India estimating a loss of 1.5 million jobs from September 2008 to March 2009 alone. While no export sector was immune from the downturn, the effect was particularly severe in the labour intensive industries such as textiles, leather goods, automobiles and gems and jewellery.

The subsequent recovery has been remarkably swift. Exports recovered in 2010, with a growth averaging 26.5 per cent year-on-year (YoY) to US$18.8 billion in November 2010.[2]

[2] 'Nov exports rise 27%, may exceed $200-bn target', *BS Reporter* (4 January 2011).

Exports continue to be buoyant. Real estate prices that fell in 2008, recovered in the urban centres, though there is some sluggishness in the recovery of commercial and retail space.

In short, India has been quick to recover from the effects of the financial meltdown in the developed countries and appears well on its path to recovery. The gross domestic product (GDP) growth that fell to 6.0 per cent in 2008-09 is set to reach 8.5 per cent in 2010-11[3] and the estimates for fiscal year (FY) 2011-12 appear to be in the same order.

This recovery has been in part due to policy responses of the Government and in part due to the inherent strengths in the Indian economy.

Policy Response

At the beginning of 2008, the Government of India took the step of waiving recovery of debt to agriculture and this combined with substantial increases in the material requirement planning (MRP) for wheat and rice, resulted in increasing the fiscal deficit 6.1 per cent of the GDP against the 2.7 per cent a year earlier.[4] The combined fiscal deficit of the centre and the states rose to around 11 per cent, thus impacting state revenues.[5]

During the year, confronted with the slowdown, the Government decided to make a virtue out of necessity. They deepened the fiscal giveaways that were targeted to the poorer sections, increased subsidies on food and petroleum, and took the risk of inflationary pressures as a measure to counter the slowdown. The norms of the Fiscal Responsibility and Budget Management (FRBM) Act were given a go ahead as the budget opted for greater deficit financing. The initial fiscal stimulus was provided in the budget for FY 2008-09, announced in February 2008. Electoral considerations made this into an expansionary exercise that included massive increases in public outlays in support of employment guarantee schemes, farm loan waivers, paid commission rewards, and increases in food and fertiliser subsidies. This fiscal expansion resulted in the revenue deficit increasing from 1.4 per cent of the GDP in FY 2007–08 to 4.3 per cent in FY 2008–09.[6] At the same time the fiscal deficit of the central government increased from 2.7 per cent in FY 2007-08 to 6.1 per cent in FY 2008-09. The expansionary public outlays included some measures that implied a hefty transfer of purchasing power to farmers and to the rural sector in general. These included farm loan waivers, funds allocated to the National Rural Employment Guarantee Programme (NREGP), Bharat Nirman (targeted for improving rural infrastructure), the Prime Minister's Rural Road

---

[3] 'Economic Outlook for 2010/11', *Economic Advisory Council to the Prime Minister* (July 2010), http://pmindia.nic.in/Economic_Outlook_2010-11.pdf. Accessed on 9 May 2011.
[4] 'India budget expected to cut deficit; borrowing a worry', *Reuters* (25 February 2010).
[5] 'Fiscal deficit, the biggest challenge', *The Hindu* (20 July 2009).
[6] 'ADB-INDIA Economic Bulletin April-June 2009', *Asian Development Bank/India Resident Mission* (July 2009), www.adb.org/Documents/Economic_Updates/IND/2009/eco-bulletin-ind01.pdf. Accessed on 9 May 2011.

Programme, and a large increase in subsidies for fertilisers and electricity supplied to the farmers. There was the comment that these measures were taken because of political considerations and not in response to the global crisis. Nevertheless, they helped to shore up rural demand for both consumer durables and non-durables.

In effect the higher than expected GDP growth rate in both the third and fourth quarters of FY 2008-09 could be attributed to the budgetary splurge announced in February 2008.[7] However, while this has succeeded in shoring up GDP growth, by raising rural demand, it did not leave much fiscal space for the Government of India.

Three fiscal stimulus packages – one each in the months of December, January, and March – were announced in 2008.[8] These in aggregate amounted to ₹106,050 crore or US$21 billion, which is approximately two per cent of the GDP. This can be compared to the four per cent of the GDP that was provided as stimulus in the FY 2008-09 Budget, discussed in the paragraph above. The three post-December 2008 stimulus packages included increased government spending on infrastructure, reduction in indirect taxes, and some assistance for export-oriented industries. In an attempt to boost the infrastructure spending that has been acknowledged as the most effective tool to counter the economic downturn, the Government increased its planned spending by US$4 billion and also allowed the state governments to borrow an additional amount of US$6 billion from the market.[9] Apart from this, the India Infrastructure Finance Company Limited (IIFCL), a special purpose vehicle, established in 2007, was allowed to issue interest free bonds worth US$6 billion for refinancing the long-term loans for various infrastructure projects.[10]

The budgets of 2009-10 and 2010-11 outlined a bold policy towards ensuring that growth was not impaired by the global crisis. First, there was a focus on the poor – the *aam aadmi* – through direct grants and subsidies. The ambit of the National Employment Guarantee Programme was extended to cover all districts – this would enable the rural unemployed to seek and be assured of a minimum of 100 days of unskilled labour. Several states extended the availability of cereals through the Public Distribution System at subsidised prices. Subsidies continued for fertilisers, cooking gas and kerosene, and the prices of all petroleum products continued to be controlled. These measures provided a substantial amount of liquidity that was targeted at the poor and disadvantaged.

---

[7] Rajiv Kumar and Pankaj Vashisht, 'The Global Economic Crisis: Impact on India and Policy Responses', *Asian Development Bank Institute* (November 2009), www.adbi.org/working-paper/2009/11/12/3367.global.economic.crisis.india/. Accessed on 9 May 2011.

[8] D. Subbarao, 'Annual Policy Statement for the Year 2009-10', *Reserve Bank of India* (21 April 2009), www.rbi.org.in/scripts/Notification User.aspx?Id=4936&Mode=0. Accessed on 9 May 2011.

[9] 'G20 Statistical Update, India', *International Labour Office* (July 2010).

[10] Rajiv Kumar and Pankaj Vashisht, 'The Global Economic Crisis: Impact on India and Policy Responses', *Asian Development Bank Institute* (November 2009), www.adbi.org/working-paper/2009/11/12/3367.global.economic.crisis.india/. Accessed on 9 May 2011.

Second, there was a focus on public spending in infrastructure, education and health with increased budgetary allocations during the two years. In the budget of FY 2010-11, the Government announced a policy of being a facilitator in economic development rather than a prime actor and enjoined the private sector to play an even more active role in economic development through public and private partnerships.

Third, in order to encourage capital formation and investments, there was some further opening up of the financial markets, including derivatives trading and currency futures. This created room for new products and activities in the primary and secondary markets, with considerable interest from foreign institutional investors driving up the market capitalisation of equities. Market related buoyancy enabled several corporates to raise funds through public offerings, thus providing the capital for growth. Simultaneously, monetary policy was cautious and interest rates reasonable, to enable access to debt financing. The financial markets recovered smartly in 2009 and 2010, and market capitalisation was at levels close to the peak seen in the end of 2007. Foreign institutional investors continue to see secondary markets in India as an opportunity, and there is significant flow into the equity and commodity markets. There are new instruments including derivatives that are attracting investor attention: it is possible to say that financial markets would continue to be healthy and investor friendly, though somewhat volatile, in 2011.

The Central Bank of India responded by letting the exchange rate depreciate to stem the outflow on the current accounts, by providing extra liquidity to the financial sector and by raising the limit on private foreign borrowing. Prudential monetary management ensured that foreign debt and debt service remained low and reserve cover (US$274 billion) substantial. The high domestic saving rate (34 per cent of the GDP) provided added cushion.[11]

Fourth, the Government decided to tackle the consequent inflationary pressures of these fiscal expansion measures head on. With food and commodity price inflation in the double digits, the Government resolved to bite the bullet and go for growth. There were two advantages to this strategy. First, with fiscal deficits mounting, a higher rate of inflation would enable the Government to balance its books better – an approach of inflating one's way out of the deficit. Further, the buoyant financial markets enabled the Government to go in for sales of shares in its public sector undertakings, the resultant revenues coming as a relief to the revenue flows in the budget.

These measures have not been without attendant risks. First, the growing inflationary pressures have caused serious concerns for the poor. After remaining in the negative territory for over three months, the Wholesale Price Index (WPI) based inflation rate gradually inched up to positive territory during 2009. There was some respite in the early months of 2010, but

[11] 'Global Financial Crisis: Implications for South Asia', *South Asia Region, The World Bank* (21 October 2008), http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1171488994713/3455847-1212859608658/5080465-1224618094138/SARGlobalFinancialCrisis.pdf. Accessed on 9 May 2011.

subsequent months have aggravated the problem, with food inflation crossing 14 per cent by the end of 2010.[12] The recent monetary tightening measures announced by the Reserve Bank of India (RBI) have given little relief to the increases in prices.

Going into 2011, the Government has realised the dangers of inflationary pressures that have been caused by the easy liquidity. The RBI has progressively tightened liquidity but supply side bottlenecks, an inability to progress with reforms, and growing demand continue to be causes for concern. The inflation versus growth debate is strident in India, and there are fears that the inflationary pressures due to global commodity price increases, would funnel down into price increases for the consumer.

In short, the response was timely, swift and effective. It kept the economy growing, but the attendant risks of a lax fiscal and monetary policy need to be tackled during this year. The 2011 budget has unveiled cuts in expenditure, as well as fiscal tightening, and it remains to be seen whether these measures, when implemented, would hold the balance between increases in prices and growth.

Pakistan

The second largest economy, Pakistan, is much more fragile and faces the most vulnerability in the region. High fiscal and current account deficits, rapid inflation, low reserves, a weak currency, and a declining economy have placed Pakistan in a very difficult situation to face the global financial crisis. Efforts are now underway to arrest the decline of the macro-economy through appropriate demand management including tightening of monetary and fiscal policies. Pakistan's ability to borrow externally is already heavily constrained and bond spreads are very high. The global financial crisis has meant that non-official foreign capital flows would be even more expensive than in early 2011. Pakistan’s economy has been under strain due to excess demand pressures that have been building since 2004. The combined effects of global food, fuel and financial crises took quite a toll on the economy as the current account balance and fiscal deficits increased, inflation surged and growth slowed. Economic growth has taken a hit, with growth slowing down from 7.3 per cent during 2004-07 to 5.8 per cent in 2008 and down to around 4.0 per cent in 2009.[13] The scope for counter cyclical fiscal policy is limited at this time, but Pakistan is taking measures to protect social spending to help reduce the adverse effects of the crisis on the poor.

[12] ‘Food inflation at 10-week high of 14.44 pc’. *Press Trust of India,* (30 December 2010).
[13] ‘Impact of Global Financial Crisis on South Asia’, *South Asia Region, The World Bank* (17 February 2009), http://siteresources.worldbank.org/SOUTHASIAEXT/Resources/223546-1171488994713/3455847-1232124140958/gfcsouthasiafeb172009.pdf. Accessed on 9 May 2011.

Fiscal Policy

One of the main objectives of the fiscal policy was to reduce the fiscal deficit to a sustainable level of 4.2 per cent of GDP from 7.4 per cent in 2007-08.[14] In 2008-09, the Pakistan government announced a programme that would enable this to be achieved.[15]

1. To achieve this goal, the Government planned to reduce its expenditure and increase revenues. In this regard, the tax revenue was to be increased by 0.6 percentage points of GDP and non-interest current expenditure reduced by about 1.5 percentage points of GDP. This reduction was to be achieved mainly through the elimination of both oil and electricity subsidies by June 2009.

2. The Government also announced to cut the domestically financed development spending by about one percentage point of the GDP through better project prioritisation during the 2010-11 fiscal year. A number of steps were implemented consistent with the planned fiscal adjustments. More specifically:

3.
    a. The subsidy on petroleum has already been completely eliminated by adjusting the petroleum prices three times since June 2008.
    b. At the same time, electricity tariffs were adjusted by an average of 18 per cent effective 5 September 2008.
    c. In addition, steps were taken to slow the pace of development spending.
    d. The research and development subsidy for the textile industry were fully eliminated.
    e. Wheat procurement prices have been raised to international levels, and
    f. The general sales tax (GST) rate has been raised by one percentage point to 16 per cent.

4. The targeted reduction in the fiscal deficit in 2008-09 was to prevent the State Bank of Pakistan (SBP) from financing of the budget. The Government planned to reduce borrowing from SBP to zero to finance its spending from 1 October 2008 to 30 June 2009. During this period, the fiscal deficit was to be fully financed by available external disbursements, the acceleration of the privatisation process, the issuance of treasury bills, and other domestic financing instruments (including Pakistan Investment Bonds) and the National Savings Scheme (NSS).

[14] ‘Pakistan Gets $7.6 Billion Loan from IMF’, *IMF Survey* (24 November 2008).
[15] Zafar Mueen Nasir, ‘National Policy Responses to the Financial and Economic Crisis: The Case of Pakistan’, *International Labour Organization*, (5 February 2009), www.ilo.org/public/libdoc/jobcrisis/download/rapid_assessment_pakistan.pdf. Accessed on 9 May 2011.

5. A further reduction in the fiscal deficit to 3.3 per cent of the GDP was envisaged for 2009-10.

6. The Government's fiscal consolidation efforts will continue over the medium-term. The Government's fiscal framework assumes a further reduction in the fiscal deficit to 2.0-2.5 per cent of the GDP by 2012-13. Fiscal consolidation will be supported by a strong tax effort, which will allow for higher spending in infrastructure and the social sectors. Specifically, the Government is committed to increasing tax revenue by at least 3.5 percentage points of the GDP over the medium-term as a result of measures to broaden the GST base, significantly reduce income tax exemptions and further improve tax enforcement.

Interestingly, the approach in Pakistan, post 2008-09, was a measure of fiscal tightening and control, rather than the approach of fiscal easing that was followed by India. The result was that Pakistan's economy went into a steady decline in 2008. After several years of strong and comparatively stable growth, Pakistan quickly slid into a severe economic crisis in 2008. Growth in real GDP declined sharply from about eight per cent to three-four per cent;[16] inflation rose to nearly 24 per cent; and Pakistan's Rupee depreciated by over 23 per cent against the US dollar. Pakistan's unemployment rate rose and the United Nations (UN) reported that ten million Pakistanis were undernourished.[17]

Rising trade and current account deficits generated a 'capital crisis' in the autumn of 2008. Pakistan's foreign reserves slid from US$14.2 billion in October 2007 to US$4.1 billion by the end of October 2008. Pakistan needed US$4 to 5 billion by the end of November 2008 to avoid defaulting on maturing sovereign debt obligations. In addition, even after securing this assistance, the Government stated that Pakistan required US$10 to 15 billion in assistance over the next two to three years to continue to service its account deficits and outstanding debt.[18]

Several factors, in addition to the current global financial crisis, contributed to the downturn in Pakistan's economy. Pakistan's continuing struggle against Islamist militancy in its tribal areas along the border with Afghanistan had led to high federal deficits and uncertainty about the stability of the Pakistan government. A recent escalation of bombings and violence in Pakistan has raised the risk for many foreign investors and businesses. This has worsened the nation's capital shortage. In addition, the flight from risk that has followed the US financial

[16] 'Economic Survey 2008-09', *Ministry of Finance, Government of Pakistan*, http://finance.gov.pk /survey _0809.html. Accessed on 20 April 2011.

[17] Dick K. Nanto, 'The Global Financial Crisis: Analysis and Policy Implications', *Congressional Research Service* (2 October 2009).

[18] Simon Cameron-Moore, 'Pakistan Needs $10-15 Bln Fast, Says PM's Adviser', *Reuters* (21 October 2008).

crisis has apparently contributed to some capital flight from Pakistan, especially among overseas Pakistanis and investors from the Middle East.[19]

Pakistan sought the required assistance from several countries (including China, Saudi Arabia, and the US), international financial institutions (including the Asian Development Bank (ADB), the International Monetary Fund (IMF), the Islamic Development Bank (IDB), the World Bank and an informal group of nations called the 'Friends of Pakistan'. Although the ADB, the World Bank and others did offer some support, the total amount was insufficient to avoid the default risk. As a consequence, Pakistan reluctantly began negotiating a loan with the IMF (International Monetary Fund).[20] Finally, Pakistan had reached a tentative agreement with the IMF to borrow US$7.6 billion in 2009 and 2010, to be repaid by 2016.[21]

This US$7.6 billion loan is well short of the estimated US$10 billion to US$15 billion Pakistan says it needs over the next two years, to avoid a financial crisis. Some observers speculate that the IMF agreement will spur help from other potential donors, such as China, Saudi Arabia, and the US. However, given the continuing economic problems of the potential donor nations, Pakistan may not be able to secure the full amount of assistance it says it needs. As a result, the IMF loan may end up being only a short-term patch to a long-term economic problem.

There were reforms in the taxation policy that were also announced, including measures to reduce tax evasion. These measures, though unpopular are likely to have been part of the IMF mandate. The elimination of food, electricity and fuel subsidies impacted the poor in the country. In short, Pakistan's approach was to tighten its belt, and go for fiscal prudence rather than growth.

In 2009-10, the economy started to recover. Real GDP growth was close to four per cent and inflation came down from 25 per cent in October 2008 to 12–13 per cent by late 2009. To contain inflation, in July, the State Bank increased its policy interest rate by 50 basis points to 13 per cent. Gross reserves reached US$13 billion in June 2010, and the exchange rate has been stable around 85–86 Pakistan rupees per dollar. The pickup in reserves resulted from a steady narrowing of the current account deficit to US$3.5 billion (2 per cent of GDP) in 2009-10.[22] Consequently, the 2009-10 fiscal deficit reached 6.3 per cent of the GDP, compared with an unadjusted programme target of 5.1 per cent and an adjusted target of 4.6 per cent of the GDP.

[19] Dick K. Nanto, 'The Global Financial Crisis: Analysis and Policy Implications', *Congressional Research Service* (2 October 2009).

[20] 'IMF Okays $7.6 Bln Package for Pakistan: Tareen', *Associated Press of Pakistan* (15 November 2008).

[21] Jamie Anderson, 'Pakistan Turns to IMF for Financial Aid', *Money Times* (16 November 2008).

[22] 'Pakistan: Letter of Intent', *Government of Pakistan and the IMF* (10 September 2010). www.imf.org/external/np/loi/2010/pak/091010.pdf. Accessed on 9 May 2011.

The Budget for fiscal year 2010-11, set before the floods, targets a deficit of four per cent of the GDP – a federal fiscal deficit of five per cent of the GDP, combined with a provincial surplus of one per cent of GDP. To achieve this target, the General Sales Tax (GST) rate was raised by one per cent and increases effected in some excise and direct taxes.

The economic outlook has deteriorated sharply as a result of the floods. The agriculture sector – which accounts for 21 per cent of GDP and 45 per cent of employment – has been hit particularly hard. An estimated eight per cent of total cropped area has been flooded, with very significant damage to industrial crops (i.e., cotton and sugarcane), wheat, vegetables, fruits and livestock. Lower agricultural output will reduce domestic demand. Manufacturing output and exports have also been affected. Real GDP growth is unlikely to exceed 2.75 per cent in 2010-11, mainly because of sharply lower agricultural output growth. GDP growth could be even lower if damage to crops exceeds preliminary assessments or if the floods recede at a slower pace than expected. Disruption of supply chains and the agricultural damage has already started to push up prices, especially for food items, while additional demands for building material, medicine, and social services will also contribute to price pressures. Annual inflation projections are of 13.5 per cent in 2010-11 compared to 11.7 per cent in 2009-10. Inflation jumped in August 2010, due to a sharp increase in the prices of perishable foods. Headline month-on-month inflation increased by 2.5 per cent and YoY inflation was 13.2 per cent, while core inflation declined to 9.8 per cent.[23]

Table 1: Macro economic Indicators: 2009-10 to 2010-11

	2009-10	**2010-11**	
		Pre-flood	**Post-flood**
Real GDP growth at factor cost	4.1	4.3	2.8
CPI inflation (period average)	11.7	11.5	13.5
Current account deficit/GDP	-2.0	-2.5	-3.1
Memorandum items			
External debt/GDP	31.6	30.7	31.8
Official reserves/months of imports	3.7	4.6	4.6

Source: Collated from Pakistan Ministry of Finance data for IMF review

[23] 'Pakistan: Use of Fund Resources – Request for Emergency Assistance – Staff Report; Press Release on the Executive Board Discussion; and Statement by the Executive Director for Pakistan', *IMF Country Report*, No.10/295 (September 2010). For Bangladesh see, *IMF Country Report* No.10/38 (February 2010); Mustafizur Rahman and Debapriya Bhattacharya, 'Paper 1: Bangladesh Discussion Series, Global Financial Crisis', *Overseas Development Institute* (May 2009); Ahmed Taneem Muzaffar, 'Experiences from the Past and Lessons for Bangladesh: Global Financial Crisis and Recession', *Global Business and Management Forum* (22 December 2009). For Nepal and Sri Lanka see, ADB Regional Forum, 'Report-5', *Asian Development Bank* (14 January 2010); 'Country Case Studies, Early Impact Assessment of the Global, Financial Crisis on Education Financing' *UNESCO Institute for Statistics* (2009).

The outlook for this economy remains uncertain. On the one hand, the continuing problems of internal strife and the war in Afghanistan are diverting resources and policy away fro addressing economic issues. On the other, the structure of manufacturing and the goods and services sector has been affected by the continued conflict and lack of confidence among investors. Poor governance and severe shortage of capital is affecting public expenditure while the economy continues to rely on remittances and aid to tide it through the current crisis.

Bangladesh

For Bangladesh, cross-country evidence has relevance in two ways: first, it provides an insight into the thinking of policymakers of neighbouring countries in the area of macroeconomic management against the backdrop of the ongoing crisis; second, it provides an idea about how export-competing sectors of these countries are being supported, with consequent impacts on Bangladesh's own relative competitiveness situation in the global market.

Bangladesh Bank took a number of steps when the financial sector crisis first kicked off in October 2008. Central bank reserves were safeguarded through withdrawal from risky investments and transfer to reliable central bank accounts, and private sector financial institutions were immediately advised by the bank to protect their respective deposits. The capital market was only exposed to foreign portfolio investment to a limited scale (2.4 per cent of market capitalisation) and exotic but toxic derivatives were not traded on the country's capital market. This enabled Bangladesh to avoid the consequences of the first wave of the adverse impact. However, as the analysis indicates, Bangladesh has not been immune to the second wave of impact, when financial crisis hit the real economy. The adverse impacts were to be transmitted through various channels into the domestic economy.

Bangladesh has maintained generally prudent macroeconomic policies**.** Balance of payments has been in surplus owing to rapidly rising remittances and prudent demand management. Fiscal deficit has increased five to six per cent, but remains manageable in view of falling global oil and food prices from their global peaks during 2009-10. The financial sector is showing signs of improved health from past reforms and is mostly insulated from foreign markets because of very low private capital inflows. External debt is low and reserves are comfortable.

The Government of Bangladesh announced, on 19 April 2009, an interim package of fiscal and policy supports for the country's agriculture, power and export sectors to help combat the immediate effects of the ongoing global recession. To finance the package an additional allocation of Tk34.24 billion were allocated in the revised budget for the next fiscal year. Under the fiscal support part of the package for the April-June period of the FY 2008-09, the rates of export subsidy were increased for some sectors. Cash support rates for other export items remained unchanged. Because of the increase in export subsidy the total amount of export subsidy was Tk15 billion in the revised budget for the FY 2008-09 as opposed to the earlier allocation of Tk10.50 billion.

The initiatives taken by the Government also suggests that to weaken the effects of global recession, the Government reviewed public spending and strengthening social safety nets to help come through the storm of the global crisis. The subsequent year's budget is likely to be an expansionist one, to take care of social safety nets and subsidies. There is however, concern about the implementation capabilities of several of the programmes.

The budget for FY 2008-09 (presented in June 2008) was relatively large, prepared against the backdrop of high inflation, commodity prices, import burden and subsidies. A large deficit projection of Tk30,623 crore, equivalent to 5.0 per cent of the GDP, made the task of balancing the budget challenging. This higher deficit was to be met by higher revenue generation and higher financing by development partners, to be replenished by increased government borrowing from domestic sources, both banking and non-banking.

Subsequent developments had repercussions for the budget in FY 2008-09 – some bringing comfort and some adding to the challenges. With the onslaught of the financial crisis and the consequent decline in global demand, global commodity prices experienced a significant fall. This was particularly for petroleum products, which were the single largest contributor to demand for subsidy in the budget. The rate of duty on capital machinery imports and spare parts was reduced from five per cent to three per cent in the FY 2008-09 budget. In this regard, the Central Planning Department (2008) observed at the time, given the depressed investment scenario, that imports of capital machinery and spare parts may be made duty free to stimulate industrial investment.

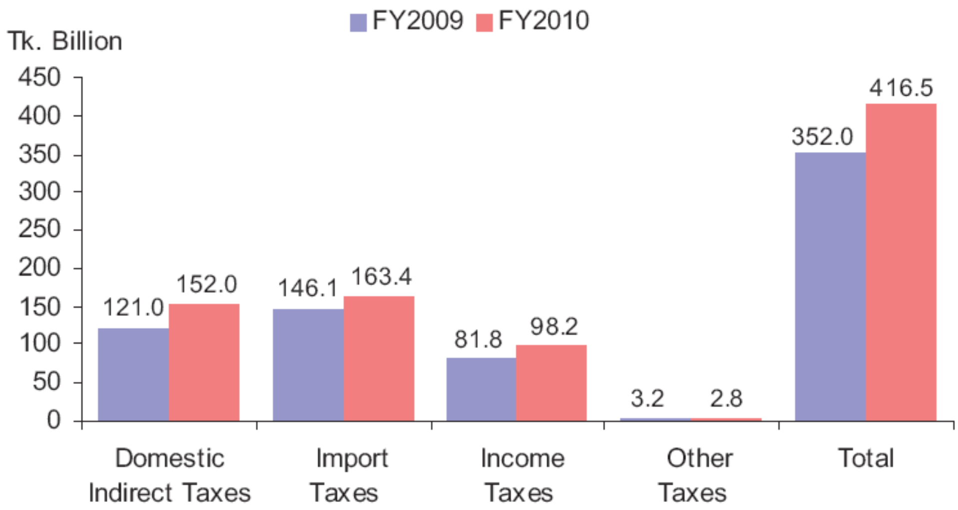
In July 2008, the Government relaxed import conditions to enable producers to take advantage of low-cost Indian yarn. To protect the interests of the local spinning sector, the Bangladesh government tightened rules on yarn imports, particularly from India. However, additionally, local spin millers are demanding a rescheduling of the loan payback time. In view of this, extension of loan settlement could be considered.

A number of fiscal measures were proposed in the budget for FY 2008-09 in support of SMEs. For example, the SME sector was given income tax relief by defining SMEs as entities with an annual turnover below Tk2.4 million. The upper limit of investment in capital machinery, in order to enjoy the cottage industry benefit (i.e. no value added tax (VAT)), was increased from Tk700,000 to Tk1.5 million and the turnover limit was raised from Tk2 million to Tk2.4 million. A tax holiday was given to agro-processing industries.

As noted earlier, in the US and the EU apparels markets, China, India and Vietnam are some of Bangladesh's major competitors. Stimulus packages of these countries have significantly enhanced their competitive edge vis-à-vis Bangladesh. Until now, Bangladesh's performance record has been maintained, thanks mainly to readiness of exporters to accept lower cuts, make charges and profit margins. Yet, another example relates to the adverse impact on backward linkage sectors, such as yarn spinning, which have now lost a large part of their competitiveness as a consequence of stimulus-induced lower import prices of Indian yarns. It may also be recalled in this connection that, in the recent past, a number of large-scale buyers, particularly from Japan, have shown interest in sourcing apparels from Bangladesh in view of higher prices in China. The stimulus packages put in place by China have now limited Bangladesh's opportunity to avail itself of these new opportunities.

The Government's medium-term macroeconomic framework (MTMF) envisages a fiscal policy that will help attain pro-poor growth along with maintaining macroeconomic balance and debt sustainability.

Figure 1: Revenue collection by National Board of Revenue (July-March)



Source: National Board of Revenue, Bangladesh

During July–March of FY 2010, total tax revenue, collected by the National Board of Revenue, which accounts for more than 95 per cent of total revenue, rose by 18.3 per cent over the same period of the previous year. This commendable performance, especially during the economic recession is mainly due to implementation of ongoing tax reform measures. The Government seeks to improve tax collection by implementing reform measures including widening the tax base; decreasing tax evasion and leakages; enhancing transparency, accountability, efficiency in the revenue administration and tax collection system; simplifying tax rules; curbing discretionary power in tax laws; and implementing reforms and capacity building of the National Board of Revenue.

Tax collection from import-based taxes started to improve with the recovery of imports after a lull during the first half (July-December) of the FY 2010. Collections rose by 11.8 per cent during July-March FY 2010 over the same period of FY 2009. During July–March FY 2010, customs duty grew by 4.3 per cent, import stage value-added tax by 13.4 per cent and supplementary duty by 36.1 per cent. Revenue from domestic indirect taxes rose by 25.7 per cent, with value added tax growing by 27.1 per cent, supplementary duty by 22.4 per cent and excise duty by 41.9 per cent. Turnover tax experienced a decline of 6.4 per cent. Income tax, which constitutes slightly more than one-fourth of total tax revenue, grew by 20.1 per cent.

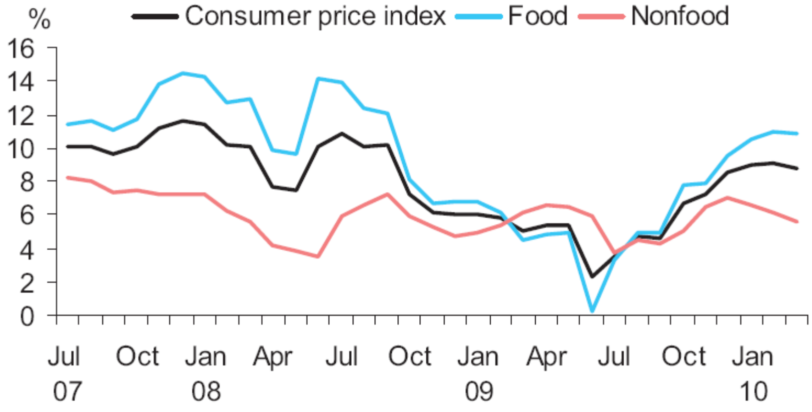
Through the revised Second National Strategy for Accelerated Poverty Reduction, the Government announced a fast-track poverty reduction strategy, requiring a sustained increase in public expenditure. The FY 2010 budget targets an increase in total expenditure from 15.3 per cent of the GDP in FY 2009 to 16.5 per cent in FY 2010. Higher expenditures include a fiscal stimulus package to address the global economic crisis; support agriculture, finance infrastructure (particularly power and gas), achieve greater regional balance and support comprehensive social safety net programmes. In parallel, the Government emphasises mobilising external grants and concessional loans to finance development activities and to offset the impacts of the global economic recession. During July–January 2010, 33.9 per cent of total current expenditure allocated for the FY 2010 budget was spent. The utilisation rate was four per cent less than the corresponding period of FY 2009. The sector utilisation pattern shows that education (21.5 per cent) has the largest share followed by interest payment (21.1 per cent), public order and safety (10.0 per cent), and defence (9.8 per cent).[24]

Poor implementation of the Annual Development Programme (ADP) is a major problem. Despite isolated reforms, utilisation of the ADP is still low because of institutional weaknesses, especially the weak implementation capacity of the line ministries. During July-April FY 2010, the ADP utilisation rate was 59.0 per cent compared with 52.0 per cent during the same time of FY 2009, the fiscal deficit remains within limits. During July–February FY 2010, the total deficit financing was Tk52.8 billion, down from Tk143.5 billion during the same period of FY 2009. Foreign financing was higher at Tk64.8 billion compared with Tk50.4 billion in the corresponding period of the previous year. The Government repaid Tk12 billion net to domestic lenders compared with net borrowing of Tk93.1 billion in the same period of FY 2009.

[24] ‘Bangladesh: Financial System Stability Assessment’, *IMF Country Report* No.10/38, (12 February 2010).

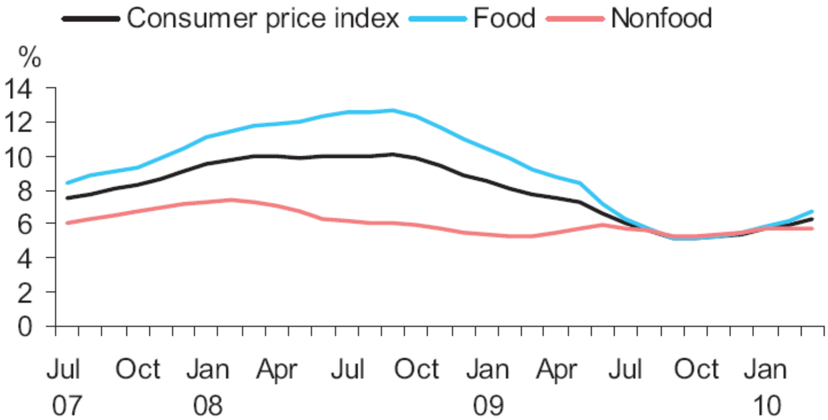
Inflation

Figure 2: Inflation, point-to-point



Source: IMF Country Report, February 2010

Figure 3: Inflation 12 Month Moving Average

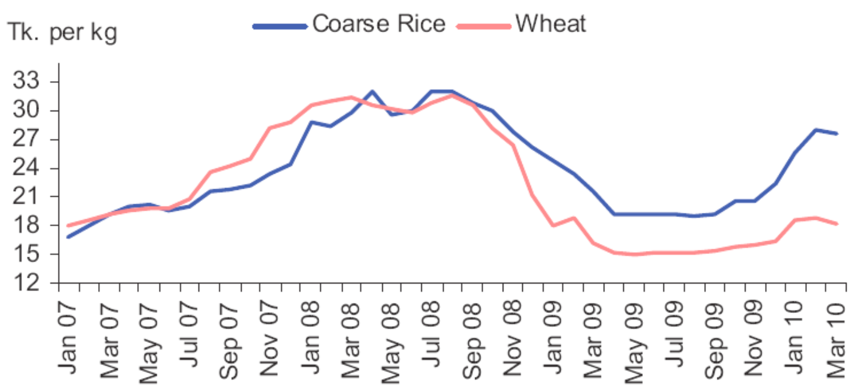


Source: IMF Country Report, February 2010

Inflation has been steadily rising in FY 2010, reaching 8.8 per cent YoY in March 2010 up from 3.5 per cent in July 2009, largely due to an increase in domestic food prices. The price of the main staple food, rice (coarse), reached Tk28.0 per kg in February 2010, a 16-month high, from Tk19.2 per kg in July 2009. Domestic production was affected by unfavourable weather. The price of wheat reached Tk18.7 per kg from Tk15.2 per kg during the same period. The continued rise in international commodity prices, including oil, along with higher-than-targeted money supply growth contributed to the recent price escalation. While food inflation surged to 10.8 per cent in March 2010 from 3.3 per cent in July 2009, non-food inflation marginally rose to 5.6 per cent from 3.7 per cent.

The Government and the Bangladesh Bank continue to take measures to contain inflation. The Government imposed a ban on rice exports in early December 2009; issued 'krishi cards' (agricultural cards) to 18.2 million farmers for fertilisers, agricultural loans, and subsidies for diesel and other inputs; started open market sales of rice in Dhaka, the capital city, and adjoining districts in January 2010; and introduced fair price cards in February for 2.5 million ultra poor families across the country.

Figure 4: Domestic open market retail prices of food grains



Source: IMF Country Report, February 2010

Figure 5: Average spot-crude oil price

Source: IMF Country Report, February 2010

Bangladesh Bank raised the interest rates on government securities, particularly bonds, and resumed the auction of 30-day Bangladesh Bank bills as a step to reduce the excess liquidity. To curb inflationary pressure, it raised the rates on the cash reserve ratio and the statutory liquidity ratio by 0.5 percentage points. Also, as a precautionary step, Bangladesh Bank directed all commercial banks to cap interest rates at 12.0 per cent on import finance for essential items (edible oil, gram, lentils, pulse, onions, spices, dates, fruits, and sugar) to ensure an adequate supply of these items and to keep prices under control during the ensuing Ramadan.

The management of the economy and the markets has not been without hiccups. In the second half of 2010, there have been allegations about manipulations in the secondary markets for equity through price fixing and insider trading that has left traces of suspicion against the regulators as well as some market operators. A report by regulators alleging wrong doing by some market operators has not found favour with the Government. In short, market volatility, as well as lack of transparency is affecting secondary markets. It is also alleged that the lax monetary policy of keeping interest rates low has been a ploy to lure unwary investors into secondary markets. These signals indicate that policy making on the macro-economy has yet to reach levels of stability and transparency.

Nepal[25]

Nepal has been experiencing serious economic challenges caused by internal political crisis as well as global phenomena. Economic growth has been low in Nepal compared to other South Asian countries, and increases in commodity prices have increased inflationary pressures. Nepal is thus emerging from a conflict situation with low growth and the adverse effects of a global food and fuel crisis**.** Its domestic financial sector is weak in terms of financial indicators with non-performing loans and low capital adequacy even though the financial sector is insulated from global finances due to the negligible amount of foreign private capital flows.

Table 2: GDP and Sectoral Growth Rates (in percent)

GDP					
Per cent YoY	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09**
GDP	3.5	3.4	3.3	5.4	4.7
Agriculture	3.5	1.7	0.9	4.7	2.2
Mining	6.8	8.3	1.5	2.8	2.5
Manufacturing	2.6	2.0	2.6	0.2	-0.5
Utilities	4.0	4.0	13.0	3.7	-1.1
Construction	2.9	7.7	2.5	3.1	5.7
Wholesale and retail trade	-6.2	3.7	-4.5	7.0	4.7
Hotels and restaurants	-5.4	6.0	3.5	8.5	5.1
Transport and Communication	2.0	7.0	4.6	7.1	7.9
Financial service	24.3	24.4	11.4	13.8	3.3

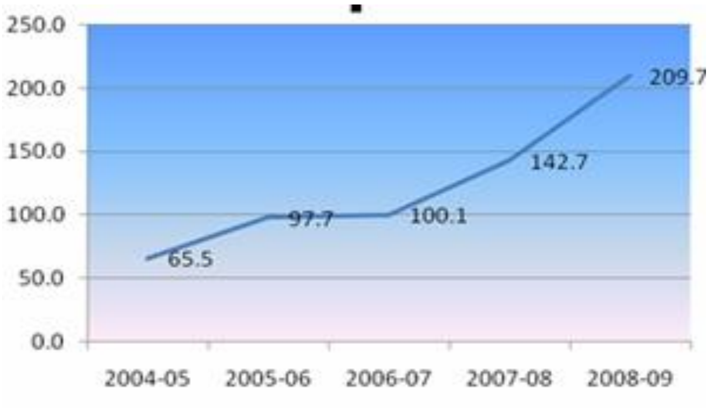
Source: Collated by Centennial Group using report from the Nepal Ministry of Finance.
Note: (1) Fiscal year in Nepal ends on 15th July; (2) Numbers for 2008-09 are preliminary estimates by the Central Bureau of Statistics, calculated by producer prices.

The economy of Nepal has several unique features, as it is one of the highly liberalised countries in South Asia. Trade is completely deregulated and no trade and non-trade barriers including the complete lack of support measures in exports. Subsidies are also small, and except for transportation and fertiliser subsidy in remote areas, there is no other subsidy. In large and medium industries up to 100 per cent of foreign equity participation is allowed with repatriation facilities. Foreign equity participation is allowed for up to 75 per cent in banking

[25] All references of Rs. in this section refer to the Nepalese rupee.

and 100 per cent in the insurance sector, even if on a selected basis. The actual average tariff rate has reduced to 5.13 per cent in 2007 from 6.1 per cent in 2003. Likewise, the imports tariff rate has gone down to 6.23 per cent from 7.72 per cent during the same period. Remittances are the major source of external inflow exceeding more than Rs.140 billion. These remittance flows have led to the growth of banking and financial institutions.

Figure 7: Annual Remittance for the Last Five Years (Amount in PKR Billion)



Source: Nepal Investment Bank Limited, Research and Development Department, Durbar Marg, Kathmandu

Though there is no formal research on the uses of remittance inflows in Nepal, anecdotal evidence shows that most of the remittance income has been used up for consumption purposes. Even if the remittance incomes are used predominantly in consumption they can be productive provided that higher consumption, through multiplier effects, leads to expansion of production. However, the manufacturing sector has not been able to pick up in Nepal (in FY 2008-09, the manufacturing sector witnessed a decline of 0.5 per cent). Given the above background of elevating remittance inflows and shrinking and stagnant production sector, one can argue that remittance has also been instrumental in driving up the price levels.

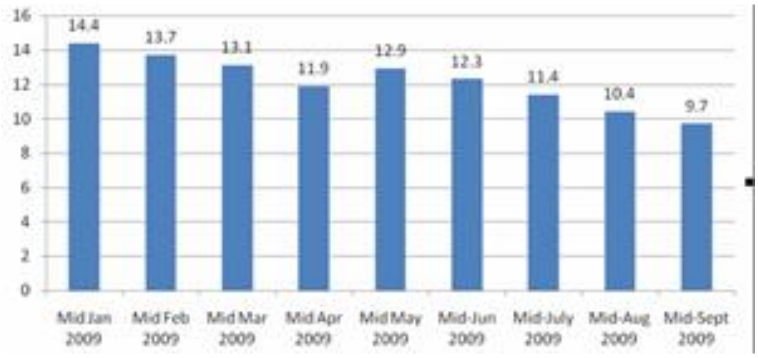
Foreign aid is an important contributor to the development budget, and Nepal has always adhered to aid conditionality. Aid flow has therefore been consistent, supporting the budget and development projects. The economy remains vulnerable to external shocks due to high dependences on aid and remittances.

Given the vulnerabilities, the global financial crisis resulted in a decreasing trend of export growth, slowdown in overseas employment and hence decreases in remittances, and increasing unemployment. Tourism industry revenues were affected, and the foreign direct investment (FDI) in industry decreased. There was a tightening of credit, and interest rate spreads increased for banking transactions.

However, these developments were as much due to the political uncertainties in Nepal, as they were to the global crisis. There has been no diminution of foreign aid for development programmes. The balance of payments and the fiscal situation are not stressed, and there is no evidence of a liquidity constraint on domestic demand.

Nepal has also been affected by inflationary pressures especially the rise in prices of food and beverages. Officials at the Nepal Rastra Bank (NRB) and the Ministry of Finance (MOF) have attributed higher inflation to supply constraints emanating from energy crisis, constant strikes and *bandhs* and carteling among businessmen.

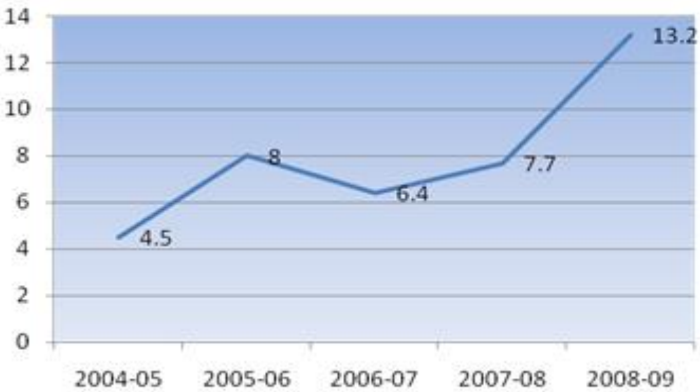
<u>Figure 8</u>: YoY Inflation Figures (2009)



<u>Source</u>: NRB (Nepal Rastra Bank)

These supply-side factors have played a major role in pushing the prices up, however, going forward if the NRB is not able to soak up the excess liquidity in the market then inflation might further creep up especially with a larger government expenditure programmes. On the monetary side, the NRB, with the view of containing inflation, has put a lower projection on the growth of M2 – broad money- of 17 per cent in 2009-10 compared to 21 per cent in 2008-09.

<u>Figure 9</u>: 5 year Annual Average CPI Based Inflation



<u>Source</u>: Nepal Investment Bank Limited, Research and Development Department, Durbar Marg, Kathmandu, Nepal

Investments of the state and the private sector have been shrinking because of several reasons. Therefore, expected improvements have not been attained in economic growth, poverty, unemployment, etc. The major challenge has been the lack of favourable investment climate in the country, due to inflation and the concerns over the peace and security situation.

The year 2010 did not witness any major improvements on the fiscal and monetary front. The country remained caught up in political uncertainty that made economic decision making difficult. GDP growth remained at 3.5 per cent in 2010, much lower than the neighbouring countries. The Government expects agriculture to grow by 1.1 per cent, against the earlier projection of 3.3 per cent. Non-agricultural growth is expected to nearly halve to 3.6 per cent from the 6.6 per cent projected earlier.

Prolonged drought and unseasonal rains adversely affected Nepal's agriculture, which contributes to 33 per cent of the GDP. A grain deficit of 400,000 tons is expected in FY 2010, and there has been little or no new investment to mitigate the effects of weather. Investment in agriculture and irrigation remained at a low average of 0.55 per cent of the GDP in FY 2009

Improved foreign aid has helped to finance rising spending. Foreign aid rose from 3.6 per cent of the GDP in FY 2007 to 4.7 per cent of the GDP in FY 2009. Official remittances rose from about 13.8 per cent of GDP in FY 2007 to 22 per cent of the GDP in FY 2009. This is less than the total amount as it does not account for inflows from India and informal channels. Fuelled by high remittances, monetary growth has been high in the last two years.

Imports have risen fast from US$1.6 billion (26 per cent of the GDP) in FY 2001 to US$3.6 billion (30 per cent of the GDP) in FY 2009 – largely due to thriving consumption made possible by remittances. Exports have remained under US$1 billion, and as a share of the GDP, have continuously declined from 13 per cent to 7.0 per cent. Exports of readymade garments, carpets and Pashmina – erstwhile main exports have declined.

Since 2007, fiscal and monetary policy interventions in Nepal have been characterised by ad hoc responses to events rather than a conscious strategy to react to the events in the global arena. One of the reasons could be that, as a small emerging economy with little exposure to the sophisticated markets of the west, it was somewhat protected from the fluctuations in the developed markets. It could also be that this period witnessed considerable political turmoil within the country and that these political developments prevented the Government from acting in a decisive and a far sighted manner. Even at present, the economy remains fragile and unless there is a strong government in place the economy of the country will continue to be vulnerable.

Sri Lanka

Sri Lanka was one of the hardest-hit countries by the crisis. Economic growth dropped from 7.7 per cent in 2006 to 2.5 per cent in 2009 due to slowing economic activities, especially in international trade. While the Sri Lankan banking sector was relatively free of toxic assets, the global financial crunch resulted in a sudden withdrawal of foreign funds. This resulted in a quick deterioration of the current account balance and, moreover, hit the fiscal sector hard which relied heavily on international borrowing. In mid-2009, the country received a US$2.6 billion stand-by arrangement from the IMF, leading to a recovery in the industrial sentiment. In 2009, the long internal strife with the Tamil separatists was finally over, and the law and order situation improved. The subsequent national elections saw the Government returned with a strong majority, following this there has been a significant pickup in economic activity in the country.

The Central Bank of Sri Lanka (CBSL) has been vigilant in maintaining stable interest rates and exchange rate to protect the domestic economy and strengthen it. CBSL has been concerned about the adverse implications that would arise due to any undisciplined lending by banks. Because of this reason, directed all the banks to make a general provision of one per cent on performing loans and advances, in November 2006, also increased the risk weight applicable for housing loans from 50 per cent to 55 per cent in November 2006. It placed a limit on commercial banks' borrowing from abroad to 15 per cent of their capital. The Central Bank took measures to formalise and strengthen the banking supervision activities and to educate the banks on the management of risks, issued new far reaching directions on corporate governance, limits on shareholdings, maximum accommodation and single borrower limits, and enforced these new directions stringently. Internationally, CBSL invested its external reserves with highly rated international banks, basically with other foreign central banks, and thereby ensured the security and safety of its own reserves.

Sri Lanka has taken actions to reduce monetary growth and contain the fiscal deficit. This, along with lower commodity prices, has helped reduce inflation, which has come down sharply from a peak of 28 per cent in June 2008 to 11 per cent in January 2009. But Sri Lanka's balance of payments is under stress, as current account deficit surged to about 7.5 per cent of the GDP in 2008 and reserves fell to less than two months of imports. Access to foreign commercial credit was sharply curtailed by the rapid rise in the cost of borrowing. Economic growth came down from seven per cent during 2006-07 to six per cent in 2008 and to decline to four per cent in 2009.[26] The problems were exacerbated by the commitments to accommodate public investments relating to continuation of the infrastructure development, maintaining government support to agriculture, SMEs, education, health, there was resort to additional public expenditure in 2009. Fiscal stimulus provided by way of subsidised credit for agriculture and SMEs, tax moratorium, concessionary electricity and fuel prices for

[26] 'Fiscal Management Report - 2010', *Government of Sri Lanka* (29 June 2010), www.treasury.gov.lk/FPPFM /fpd/pdfdocs/fmr2010/fmr2010-eng.pdf. Accessed on 9 May 2011.

industry etc helped private sector to manage challenges in global economic situation. These developments together with high interest rates on public debt and falling government revenues due to depressed global trade, caused the Government's fiscal deficit to deteriorate to 9.9 per cent of the GDP. The high interest rates also had an adverse effect on the Budget. Interest expenditure increased from 4.8 per cent in 2008 to 6.4 per cent in 2009. As a consequence, the Government missed out on the fiscal management targets.

In view of the parliamentary elections, the cabinet approved an interim, pre-election (vote-on-account) budget in early 2010. This interim budget limited expenditure in the first four months of 2010 to one-third of the budgeted Sri Lanka rupee expenditure for 2009, thus helping to deflect pre-election spending pressures. In particular, the interim budget made ambitious cuts in non-interest recurrent expenditure of 1.75 per cent of GDP (on an annualised basis) relative to the first four months of 2009.

Soon after the elections, the Government unveiled a fiscal management report in June 2010, outlining a medium-term fiscal strategy, in which it said:

‘Given the prevailing uncertainty in the speed of recovery of international trade and hence on Government revenues, a modest improvement in revenue to the GDP ratio of 14.8 per cent is expected in 2010. While maintaining the public investment at 6.5 per cent of GDP, total expenditure will be 23.2 per cent of GDP, which is a reduction of around two per cent of the GDP compared to 2009. The budget deficit in 2010 is expected to be contained at eight per cent of GDP and further improvements are required to bring it below seven per cent in 2011 and around five per cent in 2012.’

This deficit reduction path is expected to be realised with the economy accelerating its growth rate from six per cent to eight per cent in the medium-term which requires sustained public investments at current level and facilitating to augment private investment well in excess of 28 per cent of GDP through continuous improvements in infrastructure, tax system, regulatory arrangements and quality improvement in public services

As part of this strategy, the Government has planned revenue enhancement through a broadening of both the indirect and direct tax bases, removal of concessions and tax holidays, and simplification of the VAT and indirect tax regimes. The fiscal management programme is being closely supervised by the IMF and multilateral lending agencies that are focusing on tightening the fiscal gap through raising revenues as well as expenditure control measures. The ADB has agreed to fund a fiscal efficiency management project.

Table 3: Medium Term Macro Financial Framework 2010-2013 (as a percentage of GDP)

Medium Term Macro Fiscal Framework 2010-2013

(as a percentage of GDP)

Indicator	2009	Projections			
		2010	2011	2012	2013
Revenue	**14.5**	**14.8**	**15.5**	**16.6**	**17.0**
Tax Revenue	12.8	13.1	13.8	14.8	15.2
Income Tax	2.9	2.9	3.0	3.4	3.5
VAT	3.6	3.8	4.4	5.1	5.5
Excise Tax	2.0	2.1	2.0	2.0	2.0
Tax on External Trade	3.4	3.4	3.5	3.5	3.5
Other	0.9	1.0	0.9	0.8	0.7
Non Tax Revenue	1.7	1.6	1.7	1.8	1.8
Grants	**0.5**	**0.4**	**0.4**	**0.3**	**0.1**
Expenditure	**24.9**	**23.2**	**22.7**	**22.0**	**21.9**
Current Expenditure	18.2	16.9	16.5	15.8	15.6
Salaries and Wages	5.6	5.4	5.3	5.1	5.1
Interest payments	6.4	6.1	6.0	5.8	5.7
Subsidies and Transfers	3.9	3.8	3.7	3.5	3.5
Other goods and services	2.2	1.6	1.5	1.4	1.3
Public Investment	6.8	6.5	6.5	6.5	6.3
O/W :					
Highways	1.7	1.5	1.7	1.4	1.3
Ports and Aviation	0.6	0.6	0.3	0.3	0.2
Electricity	0.6	0.3	0.3	0.3	0.2
Water and Irrigation	0.8	0.7	1.0	1.5	1.3
Education and Health	0.6	0.7	0.9	0.8	0.8
Rural Sector	0.3	0.3	0.3	0.3	0.2
Revenue Deficit (-)/Surplus (+)	(3.7)	(2.1)	(1.0)	0.8	1.4
Budget Deficit (-)/Surplus (+)	(9.9)	(8.0)	(6.8)	(5.2)	(4.8)
Government Debt (% of GDP)	86.2	83.1	78.0	72.0	70.0

Source : Department of Fiscal Policy

Source: Department of Fiscal Policy, Sri Lanka

The year 2010 has also seen considerable activity in the inflows of the FDI, primarily into infrastructure projects, funded by China. There is considerable capital formation happening through road and port projects, as well as development of hospitality services. The resultant economic activity has, to some extent, cushioned the economy from the consequences of the sharp tightening mandated by the IMF managers. Among the measures to stem the deteriorating macro-balances, Sri Lanka has started tightening monetary policy and is also trying to contain the fiscal deficit by passing on the energy price increases to consumers. The performance of the financial sector has improved over time, although there is a slight upward trend in non-performing loans (NPL) in recent years. The role of foreign capital in Sri Lanka's domestic financial sector is limited. The main downside risk on the financial sector is a reduction in capital flows from outside, including for the Government. There is already evidence of a rise in spreads for Sri Lanka bonds. Switching of demand to domestic financing in an environment of inflation and further tightening of monetary policy would raise interest rates and slowdown economic activity. Financial difficulties in domestic firms could also adversely affect NPLs. Though, overall, there is little risk of a financial collapse.

Conclusion

The patterns of policy interventions in the major South Asian economies in response to the challenges of the global financial crisis of 2008 have been varied. These variations have arisen from the nature of the economies at the beginning of the crisis, their openness to the global economy, and in no small measure to the internal political economy. It is not wrong to conclude that the reactions have been primarily with the domestic constituency and conditions in mind, rather than a technical response to an economic problem. For example, in India, the largest of the South Asian economies, responded with the traditional medicine of fiscal expansion and public expenditure, while keeping monetary policy as a tool for controlling inflationary pressures. However, the fiscal expansion was targeted towards providing social support to the weaker sections, rather than towards capital formation – a policy dictated by the structure of the economy and by internal politics of ‘inclusive growth’ rather than by economic theory. The consequences of inflation now have to be dealt with.

In Bangladesh, with a more limited exposure to the external markets, and with a steady growth in the economy, the responses were less in terms of fiscal expansion, and rather more in terms of liberalisation of trade and remittance flows – the economy benefited, during the global crisis, by an increase in global demand for the low-end textiles it was exporting. There were also measures to keep the currency stable and to provide support for the weaker sections – the caution that was exercised, quite rightly, was to keep the currency stable and inflation in check. With the advantage of a capital surplus and not enough public investment, the country weathered the crisis well and ended up with higher than before reserves. Again, this was more due to the lethargy in public expenditure and public expenditure rather than lack of need for utilisation of these scarce resources.

During this period, both Sri Lanka and Nepal had to contend with internal political strife. Of the two, Sri Lanka has emerged stronger, with a decisive government victory over the Liberation Tigers of Tamil Eelam, and an election that has established a strong government. This government has now focused on infrastructure development and economic reforms, and appears well on the way to regaining its economic strength as a major producer and exporter in the region. On the other hand, solutions for political turmoil have been difficult to find in Nepal, and the governance of finance has taken a back seat. Nepal has been affected by falling aid and falling remittances, but as its integration with the global economy has been small, the effects have been limited. It is to be hoped that the establishment of a new government will enable the policy makers to address pressing problems of the economy.

Of all the countries, the situation in Pakistan is most difficult to predict. The country has managed to keep its head above water, due to a good aid package and IMF support, and is trying hard to control fiscal deficit and to increase tariff compliance. Long term reform measures in the real economy as well as in financial markets have been few, and it may be some more time before this country is able to address its pressing economic problems.

. . . . .

ISAS Working Paper

No. 128 – 10 May 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Inflation in India: An Empirical Analysis

Pratima Singh[1]

Abstract

High inflation in India has become a major issue with both academics and policymakers. It is one of the biggest hindrances to growth and a major policy challenge for incumbent governments. This paper analyses trends in inflation over the past five years, particularly food inflation, and examines the demand and supply side factors behind surging food prices. It argues that demand for several food items in India exceeds their current supplies, and leads to high prices. It further contends that this demand-supply imbalance is attributable to structural inefficiencies, including distribution of food products. Pointing out that monetary policy responses are unlikely to prove effective in reducing food prices, the paper emphasises on the importance of increasing agricultural productivity and reforming retail trade policies for long-term results.

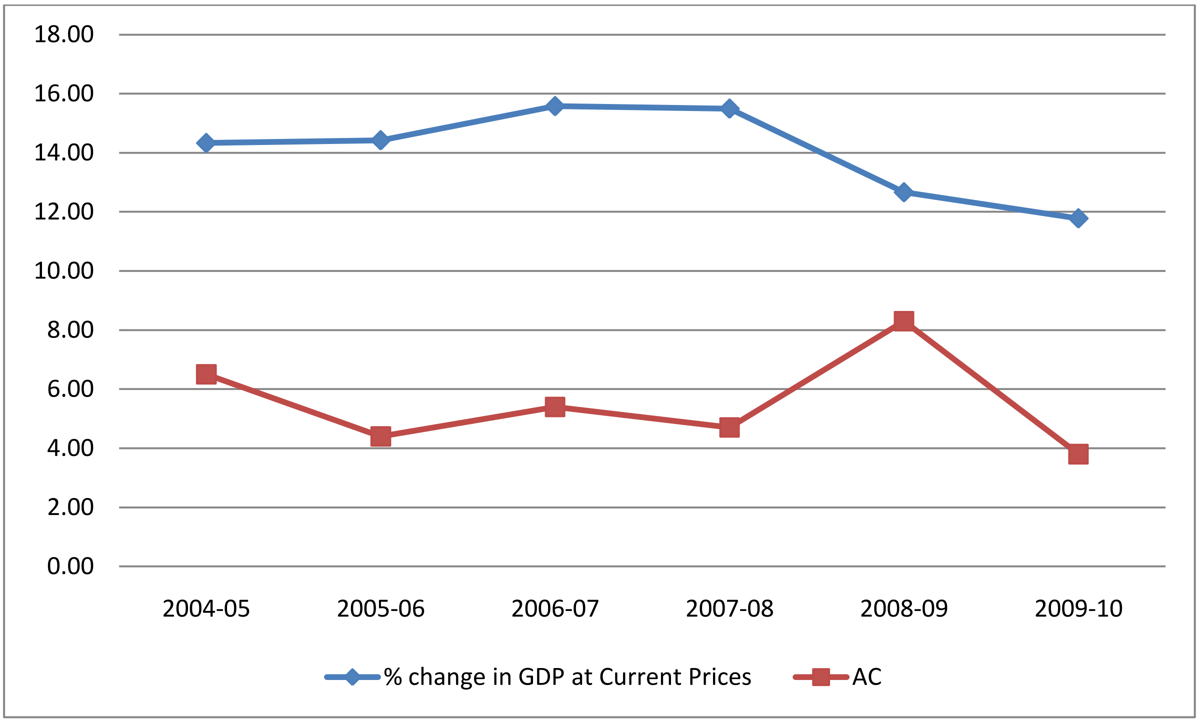
Inflation has long been a concept that excites politicians and laymen alike. More than gross domestic product (GDP) growth, it is inflation that affects the common man on a daily basis and therein lies its power. Inflation is defined as a sustained increase in the overall level of prices, eroding the purchasing power of income, increasing the cost of living and lowering the real value of savings.[2] India has five different measures of inflation; the Wholesale Price Index (WPI) and four measures of the Consumer Price Index (CPI), which include the CPI

[1] Pratima Singh is Research Associate at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). She can be reached at isasps@nus.edu.sg. The views reflected in the paper are those of the author and not of the institute

[2] Deepak Mohanty, 'Measures of Inflation in India: Issues and Perspectives', presented at the Conference of Indian Association for Research in National Income and Wealth (IARNIW) at the Centre for Development Studies (CDS), Thiruvananthapuram (9 January 2010), www.bis.org/review/r100125f.pdf. Accessed on 4 April 2011.

for Industrial Workers (IW), for Agricultural Labourers (AL), for Rural Labourers (RL) and for the Urban Non-Manual Employees (UNME). The headline inflation measure in India is the WPI, which measures the change in the average price of goods traded in the wholesale market. The WPI tracks data for a total of 435 commodities (with different weightings) is indicative of the movement in prices of commodities, used in almost all trade and transactions. It is also used because of its easy availability on a weekly basis. Of late, inflation figures in India have been progressively hardening. The year on year increase in WPI in March 2011 was nine per cent while food inflation was 9.5 per cent. Figure 1 shows the percentage change in GDP at current prices plotted with the year on year percentage changes in WPI (All Commodities).

Figure 1: Change in GDP and WPI

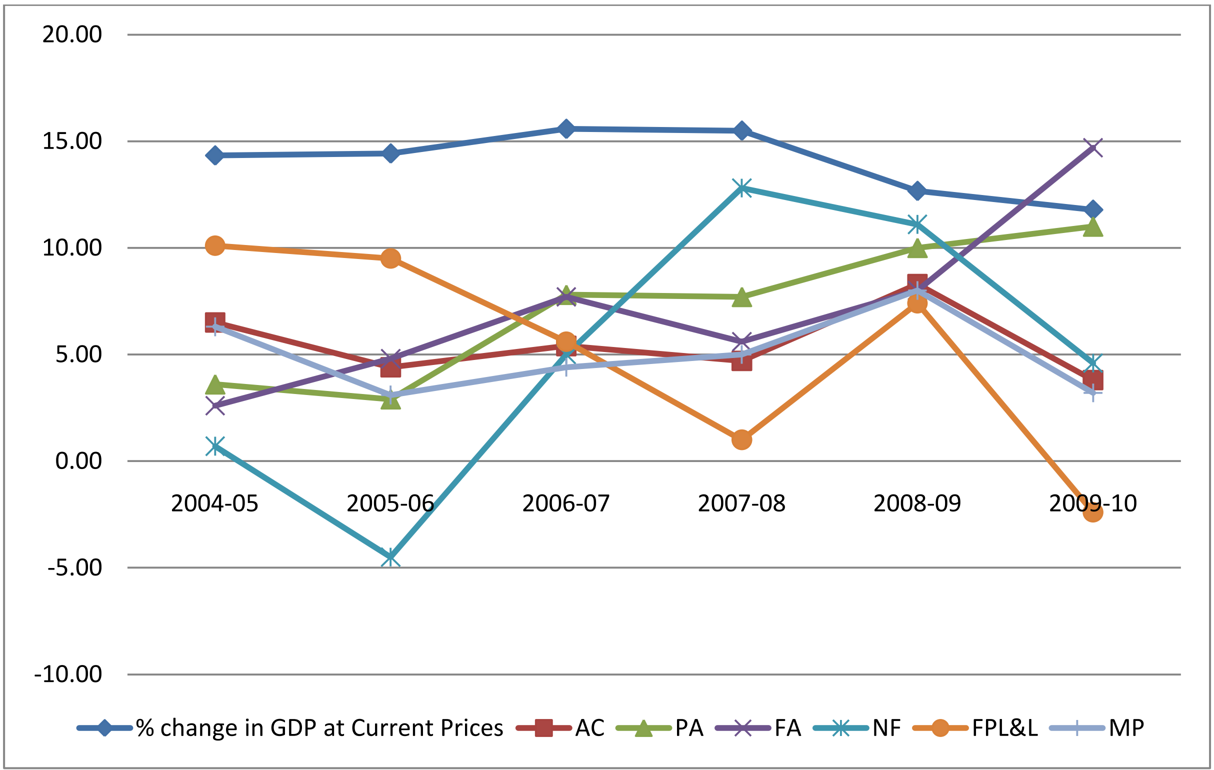


Source: Office of the Economic Advisor, Ministry of Commerce and Industry, http://eaindustry.nic.in/. Accessed on 9 May 2011.

As shown in Figure 1, inflation averaged a little over five per cent for the past five years. From 2004-05 to 2007-08 inflation followed the trend in GDP. This could be a reflection of high growth inducing an increase in prices – a phenomenon that several analysts refer to as the 'growth-inflation' association in India. The sharp rise and fall over the last three years stands out not only because of its large fluctuation but also because it digresses from the GDP trend. To understand this abnormality the All Commodities (AC) WPI is broken up further into its sub-components. These include: primary articles (PA), consisting of food articles (FA) and non-food articles (NF); fuel, power, light and lubricants (FPL&L); and manufactured Products (MP). By plotting these with the change in the GDP it is possible to study which component differs from the trend set by the latter.

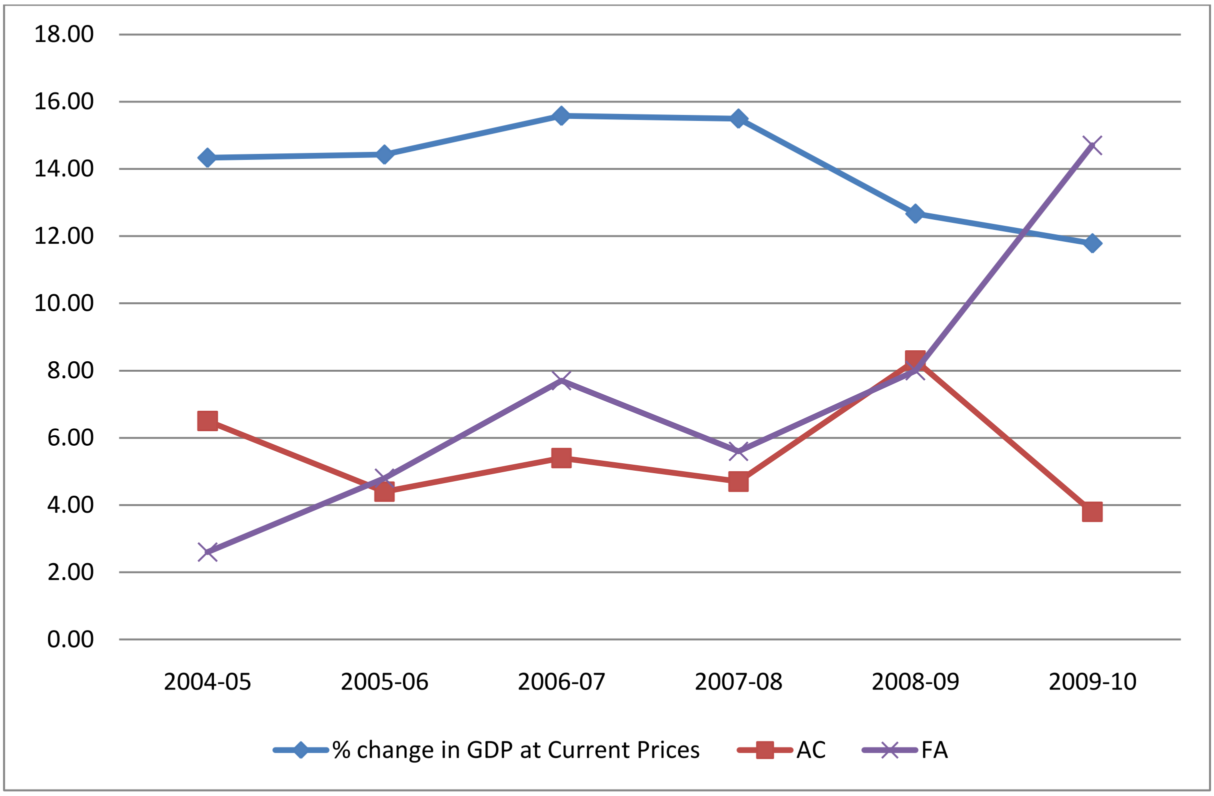
Figure 2 explains the movement of WPI over the last two years a little more clearly. The line representing energy and petroleum resource inflation fluctuates from 2007 onwards, following the pattern of overall inflation and can be attributed to high world prices of natural resources and commodities. The overall inflation is therefore largely 'imported'. Non-food article inflation also varies over the five-year period (shown in Figure 2) but is fairly timid over the last two years and is following the change in the GDP trend. The most interesting observation, though, is the movement of the line capturing the change in food prices over the years. There is a considerable rise in inflation in food articles over the last two years and even more significant is the pattern of rise. Food article prices are seen to change at a rate faster than change in the GDP. These prices rising at an increasing rate is a major contributor to high prices in India and current public discontent. Food inflation has risen at a little over eight per cent on average for the last five years but the sudden 14.7 per cent increase in the last year is striking (Figure 3). Food articles constitute 15.4 per cent of the entire WPI basket. Thus, an in-depth study of food prices is necessary to study inflation in India.

Figure 2: Change in GDP and Components of the WPI



Source: Office of the Economic Advisor, Ministry of Commerce and Industry, http://eaindustry.nic.in/. Accessed on 9 May 2011.

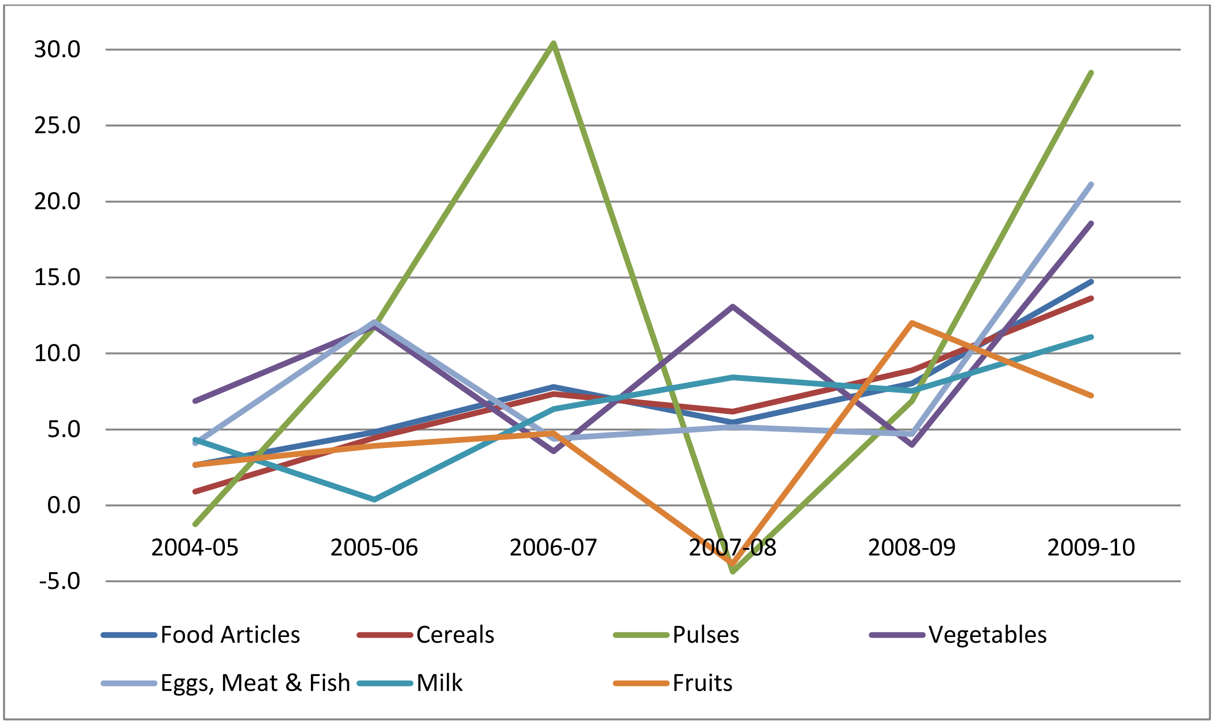
Figure 3: Change in GDP and AC, FA Inflation



Source: Office of the Economic Advisor, Ministry of Commerce and Industry, http://eaindustry.nic.in/. Accessed on 9 May 2011.

Food Articles in the WPI comprise of cereals, pulses, fruits, vegetables, milk, eggs, meat and fish, condiments and spices, and other food articles each with a different weight to help determine its contribution to the WPI. The impact of each of these items on change in WPI depends not only on the amount its price fluctuated over the last two years but also on the percentage weight of the commodity. Eggs, meat and fish are found to contribute the most to food inflation as they account for 2.2 per cent of WPI and the price fluctuation is significant as well. The other influential commodities are vegetables, followed by cereals and milk. Pulses come in fifth as determinants of food inflation since despite having highly volatile prices they account for only 0.6 per cent of WPI (Figure 4). It is noteworthy that except for eggs, meat and fish, all the categories experiencing high inflation constitute the staple diet in India.

Figure 4: Components of FA



Source: Office of the Economic Advisor, Ministry of Commerce and Industry, retrieved from http://eaindustry.nic.in/

Factors Affecting the Price Rise

While examining factors behind high food prices it is important to back up a couple of years, starting from 2004, to identify the reasons. Rising prices are only partially a result of high liquidity and are manifestations of certain structural problems in the economy. The factors behind the structural inefficiencies leading to price rise can be categorised into demand-side causes and supply-side causes.

Of all demand-side factors, income is most crucial. India is an emerging market economy with a high GDP growth rate. High growth rates mean higher incomes which increase propensity to consume and translate into more expenditure. Consumer expenditure from the National Sample Survey Organisation's (NSSO's) latest (2007-08) report on household consumer expenditure in India is used as a proxy to study demand.

Real GDP grew at an average rate of 9.2 per cent during 2004-05 to 2007-08 while the real monthly per capita consumer expenditure (MPCE) (base year 1987-88) was estimated to grow by 8.0 per cent for rural India and by 11.4 per cent for urban India during the same period, as shown in Table 1. Thus, it is seen that as GDP grows, incomes increase resulting in more consumption and expenditure.

Table 1: **Growth in MPCE at Current and Constant Prices since 2004-05, All-India**

	2004-05	**2005-06**	**2006-07**	**2007-08**
MPCE: rural (₹) (current prices)	579.2	624.5	695.2	763.1
Price deflator for rural sector	319	334	362	389
MPCE: rural (₹) (base 1987-88)	181.6	187.0	192.0	196.2
MPCE: urban (₹`) (current prices)	1104.6	1170.6	1312.5	1463.7
Price deflator for urban sector	338	355	380	402
MPCE: urban (₹) (base 1987-88)	326.8	329.8	345.4	364.1

Source: National Sample Survey Organisation, Ministry of Statistics and Programme Implementation, http://mospi.gov.in/nsso_4aug2008/web/nsso.htm. Accessed on 28 March 2011.

MPCE can be divided into two categories based on the spending characteristic, food expenditure and non-food expenditure (Table 2).

Table 2: Food and Non-Food Components of MPCE, All-India, 2004-05 to 2007-08

		Monthly Per Capita Expenditure (₹)			**Per Cent Share in Total MPCE**		
Sector	**Year**	**Food**	**Non-Food**	**Total**	**Food**	**Non-Food**	**Total**
Rural	2007-08	395	368	763	51.8	48.2	100
	2006-07	363	332	695	52.3	47.7	100
	2005-06	333	291	625	53.3	46.6	100
	2004-05	308	271	579	53.2	46.8	100
Urban	2007-08	575	889	1464	39.3	60.7	100
	2006-07	517	795	1312	39.4	60.6	100
	2005-06	468	703	1171	40	60	100
	2004-05	447	658	1105	40.5	59.5	100

Source: National Sample Survey Organisation, Ministry of Statistics and Programme Implementation, http://mospi.gov.in/nsso_4aug2008/web/nsso.htm. Accessed on 28 March 2011.

Food expenditure comprises 51.8 per cent of total MPCE for rural population but this proportion dropped from 53.2 per cent in 2004-05. For the urban population food expenditure comprises 39.3 per cent of the total MPCE which is slightly lower than the 40.5 per cent share it had in 2004-05. Despite these declines in the shares of food in the total MPCE, the absolute expenditures on food are increasing. Non-food expenditure is slowly occupying an increasingly larger share in the consumption baskets in both rural and urban areas. This probably reflects proportionally higher weightage of non-food items in the consumption basket and an increase in their prices as well. Regardless, the increase in absolute food expenditure, (seen in Table 2) indicates a higher demand for food in both urban and rural areas.

Tables 3 and 4 give a more detailed break-up by item groups of the MPCE over the four years.

<u>Table 3</u>: Break-Up by Item Group of MPCE, All-India Rural, 2004-05 to 2007-08

Value of Per Capita Consumption in 30 days (₹)_RURAL				
Item	**2004-05**	**2005-06**	**2006-07**	**2007-08**
Cereals	100.7	106.3	114.8	124.1
Gram	0.7	1	1.2	1.1
Cereal Substitutes	0.4	0.4	0.5	0.5
Pulses and their Products	17.2	20	22.7	23.7
Milk and Milk Products	47.3	50.9	56.2	60.2
Edible Oil	25.7	25.5	27.2	33.3
Egg, Fish and Meat	18.6	24.3	24.3	26.3
Vegetables	34.1	37.9	43.1	48.5
Fruits and Nuts	10.4	11.8	12.5	13.6
Sugar	13.3	14.8	14.	12.4
Salt and Spices	13.9	13.2	16.3	17.8
Beverages etc.	25.4	26.1	30.7	42.9
Food Total	**307.6**	**333.2**	**363.4**	**404.3**
Pan, Tobacco and Intoxicants	15.0	15.9	17.7	19
Fuel and Light	56.8	60.4	66.1	75.1
Clothing	39.1	39.3	42.4	49
Footwear	5.9	6.2	6.5	7.3
Misc. Goods and Services	133.1	147.7	172.9	190
Durable Goods	21.7	22	26.2	27.7
Non-Food Total	**271.6**	**291.4**	**331.8**	**368**
Total Expenditure	**579.2**	**624.5**	**695.1**	**772.4**
Price Deflator (43rd Round, 1987-88 = 100)	319	334	362	389
MPCE: Base 1987-88	**181.6**	**187**	**192.0**	**198.6**

<u>Source</u>: National Sample Survey Organisation, Ministry of Statistics and Programme Implementation, http://mospi.gov.in/nsso_4aug2008/web/nsso.htm. Accessed on 28 March 2011.

Table 4: Break-Up by Item Group of MPCE, All-India Urban, 2004-05 to 2007-08

Value of Per Capita Consumption in 30 days (₹)_URBAN				
Item	**2004-05**	**2005-06**	**2006-07**	**2007-08**
Cereals	105.8	109.8	118.8	130.6
Gram	1.1	1.2	1.7	1.8
Cereal substitutes	0.5	0.5	0.5	0.5
Pulses and their Products	22.5	25.6	30.1	31.2
Milk and Milk Products	83.3	84.9	97.5	106.6
Edible Oil	36.4	35	37.5	46.4
Egg, Fish and Meat	28.5	32.3	34.2	39.5
Vegetables	46.8	49.7	56.9	64.3
Fruits and Nuts	23.7	25.5	28	31
Sugar	15.9	17.5	17.3	14.7
Salt and Spices	17.7	17.4	20.5	22.2
Beverages etc.	65.3	68.3	74.4	93.6
Food Total	**447.4**	**467.8**	**517.3**	**582.4**
Pan, Tobacco and Intoxicants	17	17.2	18.6	19.7
Fuel and Light	104.6	109.6	117.4	125.7
Clothing	61.9	63.8	70.3	80.1
Footwear	11.4	11.9	13.1	14.7
Misc. Goods and Services	415.2	453.5	516.7	586.7
Durable Goods	47.2	46.8	59.2	62.2
Non-Food Total	**657.2**	**702.8**	**795.3**	**889.1**
Total Expenditure	**1104.6**	**1170.6**	**1312.5**	**1471.5**
Price Deflator (43rd round, 1987-88 = 100)	338	355	380	402
MPCE: Base 1987-88	**326.8**	**329.8**	**345.4**	**366.1**

Source: National Sample Survey Organisation, Ministry of Statistics and Programme Implementation, http://mospi.gov.in/nsso_4aug2008/web/nsso.htm. Accessed on 28 March 2011.

Expenditure on all items in the consumption has increased over the years, except sugar. A major difference between rural and urban expenditure is the expenditure on miscellaneous goods and services in rural and urban India. This category includes spending on education, medical care, rent and taxes (none of which are included in the WPI), which is bound to be higher in urban India than in the rural areas because of higher living costs in the former. All five of the food items, identified in section one of this paper, contributing majorly to food inflation show positive upward trends in both rural and urban India. These include eggs, fish and meat, vegetables, cereals, milk and milk products, and pulses and their products.

A second demand-side factor leading to the food price rise is changing tastes and preferences and new consumption patterns with increases in consumption levels. The NSSO's report displays data on the percentage share of different food items in consumer expenditure across the population, divided into ten MPCE classes or deciles, starting from the lowest MPCE to the highest.

The share of cereals, pulses and vegetables in total consumption expenditure was higher in rural India than urban India. Both cereals and vegetables follow a similar pattern with changes in income level; percentage share of cereals in consumer expenditure declines from 20.9 per cent (first decile) to 3.9 per cent (tenth decile) and from 27.8 per cent (first decile) to 8.2 per cent (tenth decile) for the urban and rural populations respectively while percentage share of vegetables falls from 7.5 in the first decile to 2.4 in the tenth decile for the urban population and from 8.7 to 4.0 for the rural population. Share of pulses drops from 3.9 to 1.1 for the urban MPCE deciles and 3.8 to 2.1 for the rural MPCE deciles, indicating that the urban poor spent a higher percentage share of their income on pulses than the rural poor but this reverses with increasing income resulting in the rural populations spending a larger share of their income on pulses. It is, thus, observed that cereals, vegetables and pulses are fairly income inelastic, i.e. quantity demanded of these three products (or share of income spent on them) does not significantly increase with an increase in income.

On the other hand, milk, fruits, and eggs, meat and fish display a different story. The share of milk and milk products in expenditure was found to rise with an increasing income in both urban and rural India declining only in the last decile class with the percentage share increasing from 5.8 per cent (first decile) to 7.7 per cent (ninth decile) before falling to 5.6 per cent in the tenth decile for the urban populations and increasing from 2.8 per cent (first decile) to 9.9 per cent (ninth decile) before falling to 8.7 per cent in the last decile for the rural population. This indicates a fair amount of income elasticity and a higher demand for milk and milk products throughout the country. The share of fruits in total consumption for urban populations (rising from 1.0 for the first decile to 1.8 in the tenth) was higher than rural populations (rising from 0.7 in the first decile to 1.9 in the tenth) with the exception of the last decile. Nonetheless, both were positively sloped indicating larger income elasticity in both rural and urban India. The percentage share of eggs, meat and fish for urban populations rises from 3.2 per cent to 3.7 per cent for the first four deciles and then falls to 1.8 in the tenth decile, while its rural counterpart increases from 2.7 to 3.8 per cent for the first nine deciles before falling to 3.3 per cent in the tenth decile. Thus, the urban poor spent a larger share of their expenditure on eggs, meat and fish than their rural counterpart, though the rural rich spent a higher share of their expenditure on the same. The share of consumption expenditure on eggs, meat and fish by rural India is upward sloping, indicating income elasticity. Although the share of spending on eggs, meat and fish in urban India is declining, it has a gradual slope, suggesting more income elasticity than cereals or pulses. It is therefore clear that these foods are superior goods and are still more or less a luxury for many in rural India and as incomes increase the demand for these products will increase as well.

It is from the above analysis that one can spot the changing tastes and preferences of consumers. By studying their spending patterns, it can be concluded that the share of total consumption expenditure is on the rise for food items like milk, eggs, meat and fish and fruits. As the country grows and incomes increase, the demand for these items is going to increase positively, thereby adding to inflationary pressures on these food items. This changing pattern of consumption could also explain the current rising prices in food, especially for milk and milk products, and eggs, meat and fish.

After examining the two demand-side causes it is necessary to study the supply-side factors affecting rising food prices. An analysis of the output of agricultural goods is undertaken to check for shortages in production.

The Ministry of Agriculture data shows that the production of cereals declined in 2009-10 to 203.6 million tonnes after increasing at 18.7 per cent from 2004-05 (185.2 million tonnes) to 2008-09 (219.9 million tonnes).[3] Production of pulses declined from 14.8 million tonnes in 2007-08 to 14.6 million tonnes in 2008-09 and remained almost unchanged in 2009-10. Vegetable production grew at 26.6 per cent from 101.4 million tonnes in 2004-05 to 128.5 million tonnes in 2007-08. It remained more or less constant at 129.1 million tonnes in 2008-09, with production only 0.5 per cent higher than the previous year. The supply shortages, and falling output of these food items adds to inflationary pressures. The output of these food products, either constant or declining, is unable to meet the demand for these food items. Albeit gradually, the demand for cereals, pulses and vegetables is growing and therefore outpacing supply, which falls much short of the demand in the country. This mismatch in supply and demand in the recent past has led to an upward spiralling of prices for the abovementioned food items.

On the other hand, fruits, milk, eggs, meat and fish displayed increasing output from 2004-05 onwards. Production of fruits increased from 49.8 million tonnes in 2004-05 to 68.5 million tonnes in 2008-09. Milk production increased from 92.5 million tonnes in 2004-05 to 108.5 million tonnes in 2008-09. The output of eggs increased from 45.2 billion in 2004-05 to 59.8 billion in 2009-10, meat production rose from 2.3 million tonnes in 2006-07 to 3.8 million tonnes in 2008-09 and the production of fish increased from 6.3 million tonnes in 2004-05 to 7.6 million tonnes in 2008-09. The prices of these items are increasing, nonetheless, due to the changing consumption patterns in India as was explained earlier in the paper. Higher incomes in the country are increasing demand for these products, for which the supply is increasing but at a rate slower than the demand. More and more people are consuming these products, both in rural and urban India, and the supply is unable to meet the demand, thereby intensifying the rising prices for these food items.

A discussion of supply-side factors would be incomplete without analysing the export situation. Agricultural exports along with agricultural production are the two main factors affecting the supply of food items (others include hoarding, monsoons etc.). An increase in agricultural exports at a rate higher than an increase in production would indicate a diversion of food from domestic consumption to exports, thereby increasing domestic prices. Table 5 shows details of agricultural exports from 2004-05 to 2009-10.

[3] Directorate of Economics and Statistics, Department of Agriculture and Cooperation, Ministry of Agriculture, Government of India, http://dacnet.nic.in/eands/latest_2006.htm. Accessed on 31 March 2011.

Table 5: Break-Up of Exports (in Crore ₹), 2004-05 to 2009-10

Commodity	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Pulses	602.6	1115.2	773.3	526.4	540.2	407.4
Rice Basmati	2823.9	3043.1	2792.8	4344.6	9477	10838.9
Rice(Other than Basmati)	3945	3178.2	4243.1	7410	1687.4	414.8
Wheat	1459.8	557.5	35.4	0.2	1.5	0.00
Other Cereals	793.8	453.8	599.3	3002.3	3920.6	3004.9
Total Cereals	9022.6	7232.6	7670.5	14757.2	15086.4	14258.6
Poultry and Dairy Products	458.8	794.6	497.1	960.2	1130.1	549.3
Poultry Products	282	313.4	313.8	429.5	413.5	365.9
Dairy Products	176.8	481.2	183.3	530.7	716.6	183.4
Fruits/Vegetable Seeds	66	93	121.6	142	120	145.3
Fresh Fruits	862.3	1120.7	1414	1446.6	1945.2	2269
Fresh Vegetables	863	919.8	1546.5	1477.9	2454.2	2904.4
Processed Vegetables	362.5	494.5	650.2	602.2	711.2	752.2
Processed Fruit Juices	369.2	599.9	711.4	773.4	1099.2	1156
Miscellaneous Processed Items	908	989.5	1125.1	1362.4	2077.4	2136.9
Meat and Preparations	1905.3	2750.2	3314	3749.5	5371.4	6285.4
Marine Products	6469.2	7035.9	8001	6926.7	7066.4	9891.1
Total Agricultural Exports	41602.7	49217	62411.4	79039.7	85951.7	89522.6
Total National Exports	375339.5	456417.9	571779.3	655863.5	840755.1	845125.2
Per Cent Share of Agricultural Exports in National Exports	11.1	10.8	10.9	12.1	10.2	10.6

Source: Directorate of Economics and Statistics, Department of Agriculture and Cooperation, Ministry of Agriculture, Government of India, http://dacnet.nic.in/eands/latest_2006.htm. Accessed on 31 March 2011.

Table 5 shows agricultural exports fluctuating over the years. Exports of pulses reduced in the last year and a similar decline was seen for total cereals. Poultry and dairy product exports fell by half in 2009-10, mainly because of the sharp fall in dairy product exports. Fresh fruit and vegetable exports experienced a gradual growth with a similar growth in meat and preparation exports, as well as, marine product exports. Overall, there was a small increment in agricultural exports in 2009-10, with the percentage share of agricultural exports in national exports going up by a marginal 0.4 per cent. Thus, exports of cereals and pulses reduced, due to a fall in their production, while fruit, vegetable, poultry and dairy products, meat and marine product exports continue to rise. Therefore, agricultural exports do not increase disproportionally and hardly contribute to the inflationary pressures yet, as exports are regulated based on domestic demand. High-end food items like dairy products, meat and marine products are likely to see higher domestic demand with increases in income and, although currently there is not much evidence of diversion of food from domestic demand to exports, this trend must be maintained in order to avoid worsening inflation.

A point to consider would be the inflation in India measured by the WPI, gives food articles only 15.4 per cent weight in the index while manufacturing products get 63.7 per cent. Most households in India still spend a majority of their income on food and to give it only a 15.4 per cent weight seems to underestimate the impact it has on the daily lives of consumers. Unlike most other countries, India does not use the CPI to measure inflation as the CPI reflect the cost of living conditions for only a homogenous group of consumers, based on retail prices.[4] The WPI is an outdated measure of inflation with unchanged weightings to different products that are now affecting consumers very differently. For example, services, such as education and real estate are not included in the WPI. Increasingly, the share of consumption expenditure spent on services is rising in both urban and rural India. Thus, an important future study on inflation might include creating an appropriate measure of inflation in India to replace the current but outdated WPI.

To conclude, inflation seen in India is a consequence of certain structural inefficiencies playing out simultaneously. The Reserve Bank of India's latest measure of increasing interest rates cannot contain inflation, since high liquidity is not the main cause of the inflationary pressures in the economy. Eventually, a long term policy must be put in place to curb inflation and ensure that the structural problems are dealt with for good. Each of the factors behind the rising prices must be examined in detail. The demand for food in India is not satiated by the current supply, thereby leading to the upward spiral in food prices. A thorough study of the demand patterns must be undertaken to avoid prices for certain commodities rising more than average. The supply of food items must also improve to keep up with the demand. Not only is supply unable to meet demand, it is in some cases constant or even declining, further exaggerating inflationary pressures.

While demand-side factors should be taken into consideration when constructing a policy to curb inflation, detailed research must be undertaken to overcome the supply-side constraints on food production. According to the Ministry of Agriculture, the sector witnessed a growth rate of 3.8 per cent for the first half of 2010-11.[5] Annual growth in food-grain production for the period between 1950-51 and 2006-07 was 2.5 per cent, which exceeded the 2.1 per cent population growth for the same period. However, for the sub-period of 1976-77 to 2006-07, when growth in food-grain production fell to 1.2 per cent and population grew at 1.9 per cent.[6] The agricultural sector in India has, for a long time, been suffering from relatively low

---

4 Deepak Mohanty, 'Measures of Inflation in India: Issues and Perspectives', presented at the Conference of Indian Association for Research in National Income and Wealth (IARNIW) at the Centre for Development Studies (CDS), Thiruvananthapuram (9 January 2010), www.bis.org/review/r100125f.pdf. Accessed on 4 April 2011.

5 Department of Agriculture and Cooperation, 'Annual Report 2010-11', *Ministry of Agriculture, Government of India* (March 2011), p.3., http://agricoop.nic.in/Annual%20report2010-11/AR.pdf. Accessed on 5 May 2011.

6 Johannes Jansen, Dipak Dasgupta and Abhijit Sen Gupta, 'Food Price Increases in South Asia', *The World Bank* (March 2011), www.worldbank.org.in/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/INDIAEXTN/0,,contentMDK:22812432~menuPK:50003484~pagePK:2865066~piPK:2865079~theSitePK:295584,00.html. Accessed on 5 May 2011.

productivity. A shift from the current policy of agricultural subsidies to direct cash transfers is needed on the grounds of efficiency – the subsidies imply large costs both implicit and explicit to the Government – and equity, since it is mainly the richer farmers that benefit most from the former. Investments in rural infrastructure, especially irrigation, electricity and roads are crucial. Equally important is access to financing and improved technology. A majorly overlooked but critical aspect in reviving and sustaining agriculture productivity in India is public spending on agricultural research. Basic farming research can help improve productivity by sparking a new agricultural revolution with better technology, higher crop yields and cheaper fertilisers.

It is also necessary to consider the organisation of agricultural producers into more consolidated and cohesive bodies, to increase their negotiating capacities in critical aspects like marketing and selling of produce.[7] Supply-side shortages get exacerbated due to distribution bottlenecks. Hoarding is rampant in the country, as are leakages from the public distribution system. An estimated 40 per cent of perishable foods, like fruits and vegetables, are also wasted due to lack of quality storage, cold chain and transport infrastructure.[8] Much of these inadequacies can be addressed by expansion of organised retail businesses, which requires more liberal foreign investment policies in domestic retail trade. However, that is an outcome which depends more on political courage than economic foresight.

.....

7 Adolfo Brizzi, 'Food Price Crisis', *The World Bank* (April 2008), www.worldbank.org.in/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/INDIAEXTN/0,,contentMDK:21743688~menuPK:295605~pagePK:141137~piPK:141127~theSitePK:295584,00.html#3analysis . Accessed on 5 May 2011.

8 *Prokerala News* (28 Feb 2011), www.prokerala.com/news/articles/a205268.html. Accessed on 5 May 2011.

ISAS Working Paper
No. 129 – 26 August 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

India's Engagement with ASEAN: Beyond Trade in Goods

Shankaran Nambiar[1]

Asia has experienced a surge of regional trade agreements (RTAs) in recent years particularly in East and Southeast Asia. Production across the region has become further integrated due to the institutionalisation of RTAs. The domain of integration now extends to South Asia with India and other South Asian economies connecting to East and Southeast Asia through formal trade arrangements. Proliferation of RTAs has revived the debate on multilateralism and regionalism. While most regional economies have adopted the multilateral framework of the World Trade Organization (WTO), their pursuit of RTAs have raised questions over whether they repose greater faith in regional trade networks. The Economics and Trade Policy research cluster at ISAS organised a workshop in Singapore on 20 October 2010 on 'Trade Policies in South Asia and Southeast Asia: Encouraging Regionalism?' It examined different aspects of the theme including comparative dimensions of trade frameworks, bilateral trade relations and country perspectives on regional trade. The papers are being brought out by ISAS as a working paper series. This paper is the fourth in that series.

Abstract

India has actively engaged the Association of Southeast Asian Nations (ASEAN), reaching a zenith with the signing of ASEAN-India Free Trade Agreement (AIFTA) on 13 August 2009. Further, India has plans for bilateral free trade agreements (FTA) with select ASEAN member nations. Broadly speaking, the comparative advantage of ASEAN member countries is in manufacturing, while that of India is in services. Hence both ASEAN and India can exploit their relative strengths. The paper will seek to look beyond trade in goods to flag

[1] Shankaran Nambiar is Head (Policy Studies Division) and Senior Research Fellow at the Malaysian Institute of Economic Research, Kuala Lumpur, Malaysia. He can be reached at nambiar@mier.po.my. The views expressed are those of the author and do not necessarily reflect the views of the institute.

other areas that might offer scope for broader engagement in the future. The paper argues that trade in services, security, the environment and infrastructure offer wider opportunities for collaboration between ASEAN and India.

Introduction

Since the early 1990s, the economic relationship between India and ASEAN has improved significantly. In 1992, India was admitted as a sectoral dialogue member of ASEAN and was granted the status of a full dialogue partner by December 1995. The year after, it became a member of the Asian Regional Forum (ARF). Subsequently, India was invited to be a member of the East Asian Summit in 2005.[2] The ties between the two entities have progressed substantively, providing a strong baseline for cooperation in various fields.

The 'Look East Policy' adopted by India in 1991, along with its liberalisation program and economic reforms, has become important not only with regard to trade flows in goods but also in the trade of services. At the beginning of 2010, the AIFTA came into effect promising greater bilateral trade.[3] The FTA only covered the trade in goods between the two parties with the prospect of liberalising regulations on more than 90 per cent of traded goods.[4] It is noteworthy, that the FTA will eventually include products such as crude and refined palm oil, coffee, tea, and black pepper, all of which are protected in their domestic markets. Tariffs on 4,000 products will be eliminated by 2016 at the earliest.[5] Tariffs on the highly sensitive products such as palm oil, coffee and tea will not be reduced until 2018. India will cut the tariffs on crude palm oil by 37.5 per cent and tariffs on refined palm oil by 45 per cent.[6] Also, concessions on sensitive products will be granted for a period of ten years.[7] The FTA will contribute towards the reduction of India's accumulated trade deficit with ASEAN.[8]

India now stands as ASEAN's fourth biggest trading partner and accounts for ten per cent of India's global trade.[9] The bilateral agreements that have emerged in the recent years demonstrate the extent of India's interest in engaging with Southeast Asia. In 2005, Singapore and India signed a Comprehensive Economic Cooperation Agreement (CECA)

---

2 Due to political differences, India had twice refused to become a dialogue partner with ASEAN (1975 and 1980). After the collapse of the USSR, the Indian economic crisis in 1990 and the success of the ASEAN development model, India changed its position.

3 Bilateral trade meaning ASEAN as one entity conducts trade with India. In the following, single countries will be named when certain aspects only apply to them as countries, otherwise ASEAN will be treated as one entity in order to take account of its activities as one international player.

4 See *ASEAN*, www.aseansec.org. Accessed on 22 March 2011.

5 'ASEAN-India Dialogue Relations', *ASEAN*, www.aseansec.org/14802.htm. Accessed on 22 March 2011.

6 Shankari Sundararaman, 'India-ASEAN FTA: To be or not to be', *Deccan Chronicle* (14 April 2009), www.deccanchronicle.com. Accessed on 12 October 2010.

7 Amita Batra, 'India-ASEAN FTA: A Critique', *IPCS*, Issue Brief No.116 (September 2009).

8 Suparna Karmakar, 'India-ASEAN Cooperation in Services: An Overview', *Indian Council for Research in International Economic Relations*, Working Paper No.176 (November 2005).

9 Pranamita Baruah, 'India-ASEAN Scale New Frontier Following FTA', *Global Politician* (20 August 2009).

that included bilateral investment promotion, double taxation avoidance, air services and an FTA.[10] India has plans to sign individual FTAs with Brunei, Malaysia and Indonesia by the end of 2011.

India and ASEAN have different economic foci. While India's comparative advantage is in services, ASEAN, broadly speaking, has its strength in light manufacturing. The economic complementariness and the socio-cultural affiliation with the region offer an opportunity for deeper engagement. Mukul G. Asher et al. argued that India has not only proved to be a reliable partner but a co-investor of political and economic stability in the region. The imperative for stronger ties stems from the political and security environment, globalisation and its associated technological changes, and institutional foundations.[11]

Several scenarios are possible with regard to the emerging architecture, where ties between India and ASEAN member countries can be formalised. On one hand, India and ASEAN could allow the free hand of market forces to determine their trade volume without formally engaging in designed economic cooperation. Alternatively, India might become a member of the ASEAN+3 and transform this forum into an ASEAN+4. Conversely, rather than seeking an inclusion in a grouping that, by definition, does not include India, it would be more plausible to push for an ASEAN+6 which would yield the largest gains to India and East Asia in the form of an Asian Economic Community (AEC). The latter is often seen as the ultimate goal of Asian regional integration and perhaps it is in this context that India should attempt to play a role.

The following will discuss these possible future scenarios of Asian cooperation and integration. The first section will deal with the trade in services between India and ASEAN states as it was not included in the recently signed FTA. Since India is a service-based economy, it is fairly reasonable to take trade in services as a starting point for future ASEAN-Indian cooperation. This will be followed by a discussion on some of the broader issues of engagement with ASEAN. The issue of infrastructure development for example, will be discussed in the context of political and geostrategic considerations. An analysis of India's future role in the ASEAN integration process will be discussed

[10] India also has trade agreements with Myanmar and Thailand.
[11] Mukul G. Asher, Rahul Sen and Sadhana Srivastava, 'ASEAN-India: Emerging Economic Opportunities', *Centre for Freedom and Development Studies* (May 2001), www.cpdsindia.org/emergingeconomic.htm. Accessed on 22 March 2011.

Trade in Services between India and ASEAN

ASEAN does not figure very prominently as India's trading partner. Hong Kong and Singapore are among the top 10 export destinations for India, while only Singapore ranks among the top ten as an importer. India accounts for barely three per cent of ASEAN's share of international trade.[12] In 2009, ASEAN accounted for nine per cent of India's total imports and 11 per cent of total exports.[13] However, it can be expected that growth in demand for ASEAN goods is likely to rise given India's increasing domestic demand, favourable demographics and rising domestic investments. India's recent growth trends are likely to continue in the future and hence evolving to become an important market for ASEAN goods. The recently signed FTA on goods will certainly boost trade between ASEAN and India.

ASEAN member states have signed the ASEAN Framework Agreement on Services (AFAS). They have made commitments in the fields of tourism, air-transport, business, construction, healthcare, information and communication technology (ICT), and telecommunication services. Of these, healthcare, tourism, travel and e-ASEAN[14] are considered to be the 'priority sectors' in which liberalisation should have been achieved by 2010, while the other service sectors shall be liberalised by 2020 at the latest.[15] There are two ways in which India can seek entry into the services markets of ASEAN. The first possibility is by taking advantage of the AFAS. This will require a formal agreement on services with ASEAN. The second, and more tedious process, is through bilateral negotiations with individual ASEAN countries. At any rate, India should formalise its links with ASEAN to encourage trade in services because of the huge potential that exists.

Two factors will drive the growth for trade in services. First, services play an increasingly important role in international trade. Second, India's economy is significantly based on services (seen in Figure 1). Consequently, one can expect India to be an important exporter of services to ASEAN, since the more developed economies in this region will be a source of demand for the services sector in India.

---

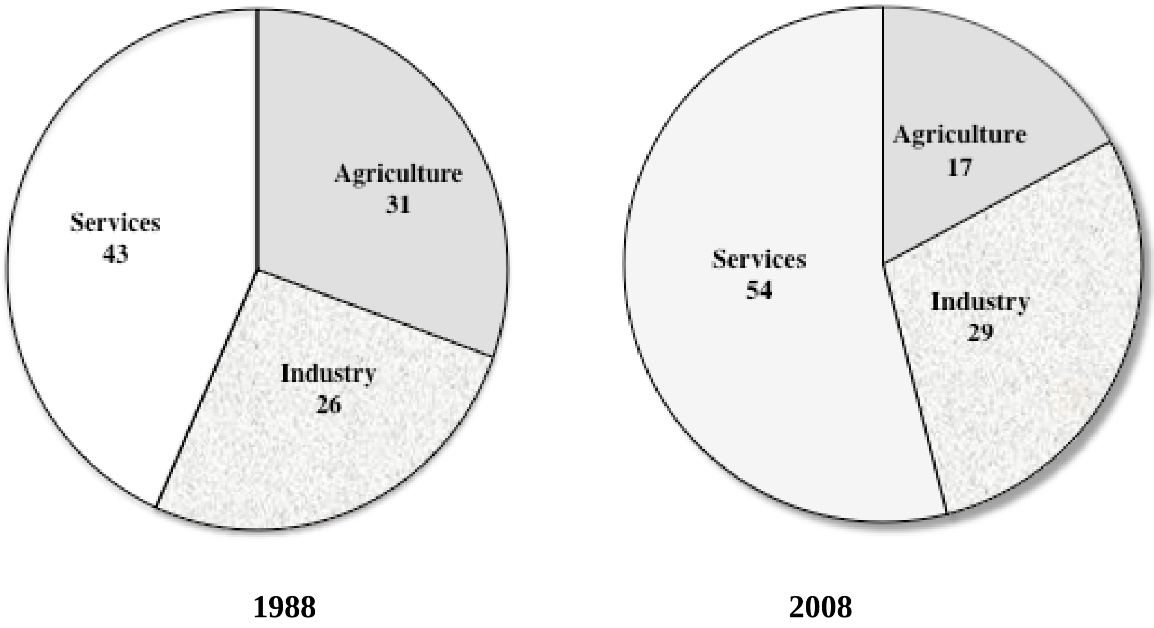
[12] Amita Batra, 'India-ASEAN FTA: A Critique', *IPCS*, Issue Brief No. 116 (September 2009).

[13] Rohini Malkani and Anushka Shah, 'India Macroscope: India's Growing Labor Force – Boon or Bane?', *Monthly Monitor*, *Citigroup Global Markets* (23 July 2010).

[14] E-ASEAN is an initiative that is meant to facilitate and promote the growth of electronic commerce in the region.

[15] Suparna Karmakar, 'India-ASEAN Cooperation in Services: An Overview', *Indian Council for Research in International Economic Relations*, Working Paper No.176 (November 2005).

<u>Figure 1</u>: India: Economic Contribution, By Sector



<u>Source</u>: 'India at a Glance', *World Bank* (2009), www.devdata.worldbank.org/AAG/ind_aag.pdf. Accessed on 22 March 2011.

Among the WTO members, India is eleventh with regard to its share in world commercial services and ranks among the top export countries in financial services, telecommunications and information services, and construction, as well as the cultural, personal and recreational services. In addition, exports of commercial services in Asia have seen double-digit growth rates in the areas of commercial, transportation and travel over the past few years.[16]

In contrast to other countries, ASEAN states have been lukewarm in their demand for India's competitive advantage in services. Many developed countries have outsourced services, such as customer phone services or call centres, to India and have thereby kept their competitiveness. ASEAN states have not followed these trends yet. In part, this could be prompted by the stage of development of specific ASEAN economies. The less developed among them might not be in a position to have the demand for the services produced in India. Their stage of development has not matured sufficiently to embrace the outsourcing strategy. This reluctance can also be explained by the fact that some of the emerging economies have a better chance to be producers of services. For example, Malaysia has attracted outsourcing activities and therefore would not consider India as an outsourcing partner.

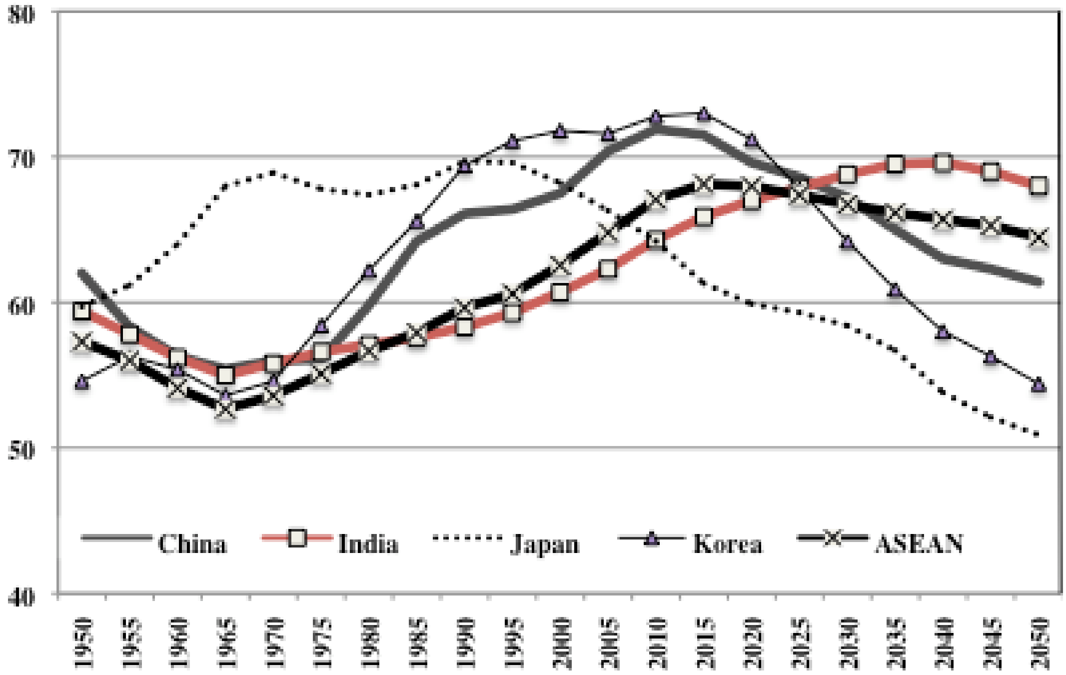
The above mentioned FTA between the two parties was only on goods and did not include services. This can either mean that services account for such a small share of bilateral trade

[16] 'International Trade Statistics 2010', *World Trade Organization,* www.wto.org/english/res_e/statis_e/its2010_e/its10_toc_e.htm. Accessed on 12 May 2011.

that the two parties did not see a necessity to include them. It could also mean that trade in services is sufficiently covered in the WTO General Agreement on Trade in Services **(**GATS). In the future, however, services might become a crucial part of trade between ASEAN and India.

India's age structure favours development for variable fields in the service sector. In contrast to the other major Asian nations, India's working population will increase rather than decrease for another 30 years (see Figure 2). Within ASEAN, only Cambodia and Laos have an increasing working population while the share of people aged 15 to 64 will decrease in all other ASEAN nations by 2020 (see Figure 3).[17] This trend will lead to increasing demand of services in ASEAN and India will prove to be a good partner to reduce and maybe even overcome this shortage. Additionally, ASEAN nations will face a lack of skilled labour, a factor that could be filled by India. Due to their enormous growth in the past years, economies like Malaysia, Singapore and Thailand face shortages in manpower at all skill levels.[18]

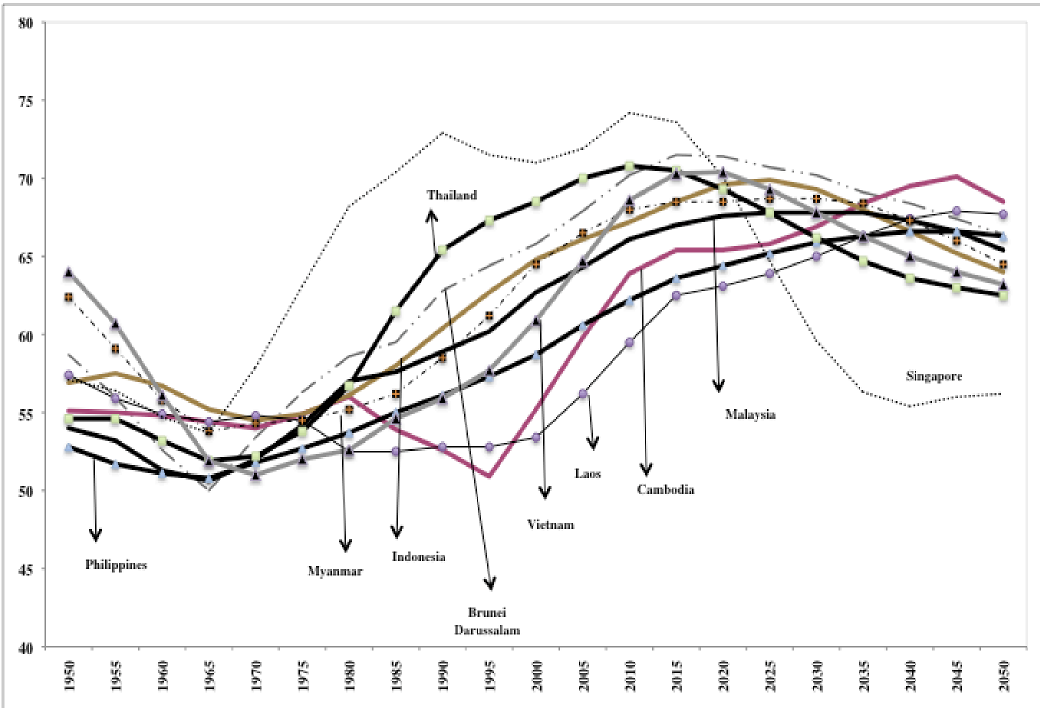
Figure 2: Population Growth Trends: Age Group of 15-64



Source: *United Nations, Population Division*, http://esa.un.org. Accessed on 22 March 2011.

[17] See, *United Nations, Population Division*, http://esa.un.org. Accessed on 22 March 2011.
[18] Mukul G. Asher, Rahul Sen and Sadhana Srivastava, 'ASEAN-India: Emerging Economic Opportunities', *Centre for Freedom and Development Studies* (May 2001), www.cpdsindia.org/emergingeconomic.htm. Accessed on 22 March 2011. Data for graphs from *United Nations, Population Division*.

<u>Figure 3</u>: ASEAN Population: Age Group 15-64



<u>Source</u>: *United Nations, Population Division*, http://esa.un.org. Accessed on 22 March 2011.

Although, the demographic outlook for India is very promising, its labour supply has to be planned and managed prudently. Even though India might have one of the largest labour markets on the world, India's Ministry of Labour warns that employment has to rise by at least 2.5 per cent per annum in order to match the growing labour force.[19] Even if India exports workers abroad, the domestic labour market still needs to grow at a considerable rate to keep pace with demographic trends. Considering a scenario in which India and ASEAN member countries liberalise not only trade in goods but also in services, it is likely that an agreement on labour mobility would be needed. Such an agreement might be viewed with circumspection by ASEAN states, due to the possible excess supply of labour originating from India. This might not be a concern in respect to skilled labour since, although, India is abundant in skilled manpower, some of the ASEAN countries have shortages. The situation will be more complex in reality since a free flow of the workforce could lead to imbalances in the labour market in the destination countries. Nonetheless, greater flexibility with regard to skilled labour will help ASEAN economies upgrade their production processes and move up the development ladder.

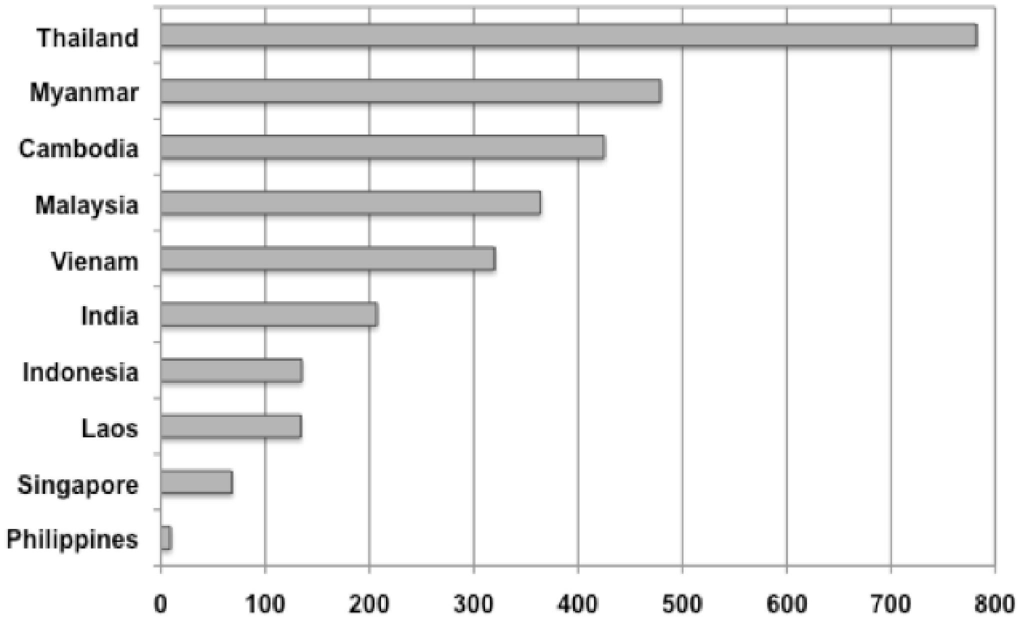
For ASEAN member countries, liberalising the movement of professionals and specialists across country borders is among the top priorities, since it would make it easier to provide high quality services. It is argued that India needs to engage on a bilateral basis with ASEAN

[19] Rohini Malkani and Anushka Shah, 'India Macroscope: India's Growing Labor Force – Boon or Bane?', *Monthly Monitor, Citigroup Global Markets* (23 July 2010). Numbers based on a labour elasticity of 0.29 as was the average from the years 1994-2005 and a GDP growth of 9 per cent YoY (year on year).

member countries on services. This suggestion is made because the service sector integration within ASEAN has yet to be accomplished and ASEAN is relatively closed to foreign service providers that unless India and ASEAN sign an agreement on free movement on service providers.[20]

Within ASEAN, the ASEAN-5[21] economies have exported services in fields such as construction, healthcare, engineering, infrastructure development, and real estate services to name just a few. India's main exports to ASEAN regarding services are focused on software, technical education, audiovisual, finance and healthcare.[22] Healthcare is an area which holds much promise at various levels. As India has become internationally competitive in the production of pharmaceuticals, stronger cooperation with ASEAN states might increase India's export value in health products and healthcare systems in many ASEAN countries. A crucial aspect in this regard is the provision of affordable generic and other drugs for diseases such as HIV (human immunodeficiency virus) and AIDS (acquired immune deficient syndrome) in ASEAN states – as generic drugs are much cheaper than branded drugs and therefore a highly attractive import product.

Figure 4: Prevalence of HIV per 100,000 Population, 2005



Source: Author's calculations based on 'Global Report: UNAIDS Reports on the Global AIDS Epidemic 2010', *UNAIDS*, Annex 1 (2010), p.187.

[20] Suparna Karmakar, 'India-ASEAN Cooperation in Services: An Overview', *Indian Council for Research in International Economic Relations,* Working Paper No.176 (November 2005).
[21] ASEAN-5 consists of Philippines, Malaysia, Singapore, Indonesia and Thailand.
[22] Suparna Karmakar, 'India-ASEAN Cooperation in Services: An Overview', *Indian Council for Research in International Economic Relations,* Working Paper No.176 (November 2005).

As can be seen in Figure 4, the prevalence of HIV-AIDS is quite high in ASEAN countries and has likely increased since 2005.[23] Due to an aging population and the increasing spread of sexually transmitted diseases, healthcare costs are constantly rising in most ASEAN countries. With these factors in place, ASEAN states become more and more dependent on the import of drugs for these diseases. As living standards begin to evolve and improve, modern diseases such as diabetes and hypertension are also on the rise and need treatment. Thus, the import of drugs for these 'modern' diseases becomes even more important. There are two levels at which India can find its relevance within ASEAN member states. First, it can find a ready market for export and production of generic drugs for some of the lifestyle diseases that are increasing in numbers and importance. Second, it can venture into the supply of healthcare services.

Rahul Sen, et al., see great potential for a close cooperation between India and ASEAN states (such as Malaysia, the Philippines and Singapore) since these states have developed a comparative advantage in the field of electronic hardware production. India, with its focus on software development and applications, can explore opportunities in complementing the activities in these countries.[24] These complementarities can be developed in various directions. Malaysia's electronics sector is home to innumerable multinational corporations (MNCs). In the course of the development of the hardware industry, many local companies have benefited from the technology transfer and some of them have grown to become vendors to the MNCs. It is possible for Indian companies to gain access to markets through these firms. With the extension of technology and capital, it is possible for Indian companies to extend their reach into the hardware industry. The scope for entry into the Philippines could take a different track. The Philippines has a labour force that is relatively cheap, educated and fluent in English. Indian software companies could capitalise on these qualities to extend the operations of their companies and take advantage of the availability of the labour force in the Philippines and Malaysia.

Many of the countries in ASEAN have made GATS-plus commitments. Suparna Karmakar argues that they are likely to profit from even freer trade regimes than in those listed as priority sectors (air transport, business services, construction, financial services, maritime transport, telecommunication and tourism). As India has come to be the outsourcing hub in the region, most MNCs (and even smaller enterprises) have begun to heavily outsource not just their call centres and customer services but also back-end business process operations.[25] This includes services such as routine data-entry, crunching and handling, research and development activities, patent writing, financial portfolio analysis, medical transcriptions, payroll management, product design, accounting and book-keeping, processing of tax returns and insurance claims, and legal transcriptions.

---

[23] The World Health Organization (WTO) has not included the Philippines, Brunei Darussalam, Japan, China and Korea are not listed, since prevalence is below 100 per 100,000 population.

[24] Rahul Sen, Mukul G. Asher and Ramkishen S. Rajan, 'ASEAN-India Economic Relations: Current Status and Future Prospects', *Institute of Southeast Asian Studie*s (April 2004).

[25] *Ibid*., p.15.

Despite the growing importance of information and communication technology, there are other services that are crucial to the future development of the economies of India and ASEAN and that offer mutual benefits as a consequence of greater cooperation. These fields include food security and energy. With regards to food security, India could support ASEAN countries in agricultural research and biotechnology. These areas of study have gained considerable importance over the past years, since improved methods in food production provide prospects of producing adequate amounts of food for populous states. By simply relying on traditional food production several states would most likely sooner or later face severe food supply shortages. However, benefits from cooperation in food related issues will not be one-sided since some ASEAN countries have attained expertise in fields such as deep-sea fishing (Thailand) and palm oil production (Indonesia and Malaysia). In the case of the latter, India is heavily dependent on palm oil and oleochemical for consumption purposes. Furthermore, the two parties could benefit from mutual cooperation in research and development, to engage in more value-added production activities.

With regard to energy, countries such as Indonesia, Malaysia and Brunei Darussalam provide prospects for mutually beneficial cooperation. This is possible in activities such as oil and gas exploitation and down-stream processing activities. Cooperation in the area of civilian nuclear power as a source of energy is another possible area for cooperation. Countries, such as Malaysia, are keen to explore the use of nuclear energy as an alternative source of energy and with India's expertise in this area it would be able to contribute. India's engagement in this field could help ASEAN achieve sustainability in energy supply. Various projects are being conducted in which India might support ASEAN nations, such as the Trans-ASEAN Gas Pipeline (TAGP) networks or the ASEAN Highway (AH) Network. Also, the Asia-Pacific Energy Cooperation (APEC) is a long-term project in which India can play an important role.

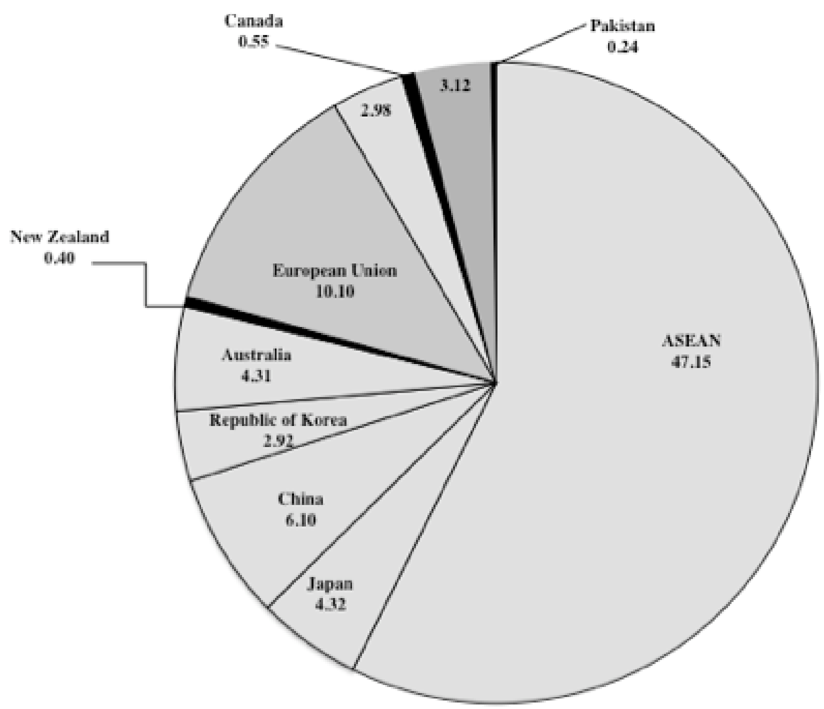
India's potential as a tourist destination is severely under-utilised. The target for visitors from ASEAN to India has been set to one million in 2010. Given that this number had only been 332,925 in 2008, this year's target will pose some challenges.[26] According to Sen, Asher and Ramkishen, India is neglected as a travel destination for ASEAN citizens due to the lack of an integrated approach that makes visiting India's vast geography and its diverse culture quite difficult.[27] It has been suggested that simplifications in the visa system could contribute to the growth of the tourist industry. Tourism to India has been mainly concentrated in metropolitan areas and tourists from East Asia only account for slightly above seven per cent of all tourists. Since India is highly interested in promoting development in rural areas, tourism could act as a suitable catalyst to direct investment to infrastructure in these areas. The

[26] 'India Tourism Statistics 2009', *Government of India, Ministry of Tourism, Market Research Division,* http://tourism.gov.in/statistics/Stat09-eng.pdf. Accessed on 6 May 2010.

[27] Rahul Sen, Mukul G. Asher and Ramkishen S. Rajan, 'ASEAN-India Economic Relations: Current Status and Future Prospects', *Institute of Southeast Asian Studies* (April 2004).

positive effects arising from an increase in tourism can only be realised if the Indian government boosts the promotion of visiting. It is also necessary to allocate more investment toward infrastructure in remote areas. Vice versa, India is not among the top origin countries of tourists travelling to ASEAN countries. The largest share of tourists visiting ASEAN states in 2009 originated from other ASEAN member countries (42 per cent), while only slightly more than three per cent originated from India (see Figure 5).[28]

Figure 5: Tourists into ASEAN by Country of Origin

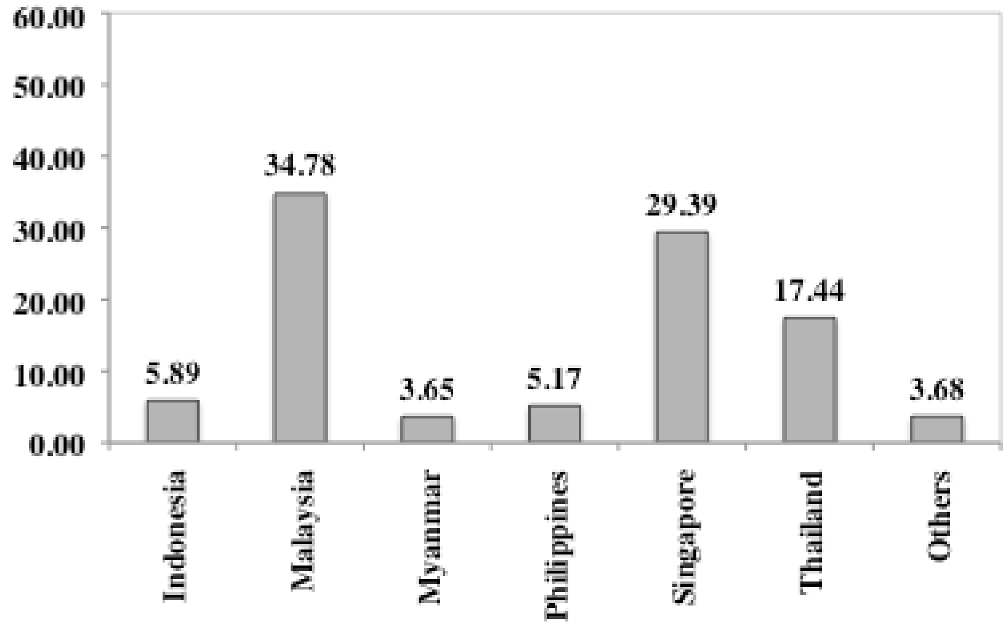


Source: 'Tourism Statistics', *ASEAN Secretariat*, www.aseansec.org/stat/Table29.pdf. Accessed on 6 May 2010.

As an effort for improvement, India has opened up air travel for ASEAN carriers and granted them 21 direct connections as well as unlimited landing clearance in four metropolitan cities during peak travel months.[29] These changes are highly important since airfares between India and ASEAN were among the highest on a per air-mile basis and a higher competition of these routes will lower passengers' costs considerably and, thereby, raise India's attractiveness as a travel destination. The fact that the number of tourists to India has increased considerably over the past three years gives reason to expect further increases the more tourism is facilitated (see Figure 6).[30]

[28] 'Tourism Statistics', *ASEAN Secretariat*, www.aseansec.org/stat/Table29.pdf. Accessed on 6 May 2010.
[29] Rupa Chanda and G. Sasidaran, 'Understanding India's Regional Initiatives within Asia', ISAS Working Paper No.48 (15 August 2008).
[30] Bureau of Immigration, India.

<u>Figure 6</u>: Country-Wise Shares in Tourist Arrivals to India from Southeast Asia, 2008



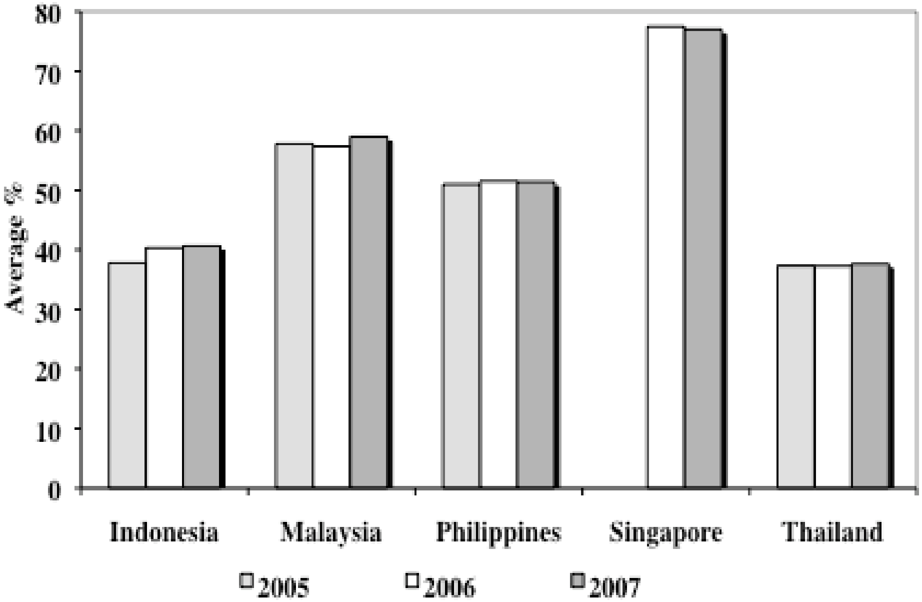
<u>Source</u>: 'India Tourism Statistics 2009', ***Government of India, Ministry of Tourism, Market Research Division*****, http://tourism.gov.in/statistics/Stat09-eng.pdf. Accessed on 12 May 2011.**

De and Raychaudhury (2008) has also found a close correlation between the export in services and poverty reduction.[31] In his study, Raychaudhury found that a one per cent increase in service exports would result in a seven per cent increase in per capita income. Thus, by enhancing their cooperation in services, India and ASEAN members would be able to reduce poverty among the population and improve living standards. As the service sector accounted for about half the entire production in 2007-08 and provided about two-thirds of employment in India, enhancing cooperation in this field, therefore boosting these sectors will affect a large share of the population. In the ASEAN-5 states, employment in the service sector rose from 45 per cent to 53 per cent on average from 2005 to 2007(see Figure 7).[32]

[31] Prabir De and Ajitava Raychaudhury, 'Is India's Services Trade Pro-Poor? A Simultaneous Approach,' *Macao Regional Knowledge Hub*, Working Papers No.16 (December 2008).

[32] World Bank. For Singapore, no data was available for 2005.

Figure 7: Employment in Services



Source: Author's chart created using *World Databank*, http:databank.worldbank.org. Accessed on 12 May 2011.

As incomes rise, household consumption will also be boosted. Thus, the Indian economy will face an upswing accompanied by more investment and consumption that in turn will spur even more demand. However, Raychaudhury also finds that while poverty decreases, the unemployment rate and inequality will increase, due to the fact that most service exporters are situated in metropolitan areas. Within the urban areas, inequality will rise as service exporters are able to gain large profits and pay higher wages while other enterprises might not be able to follow this trend. Regional disparities have increased over the past several years and if India and ASEAN enhance their cooperation in services these disparities are likely to increase further. The Indian government should strengthen investment in rural areas to avoid these disparities from becoming too large. Additional education and advanced vocational training programs could help to prepare workers for these possible challenges.

Even though India has enormous potential for trade in services, Malkani and Shah mention several factors that could hinder a smooth development in service.[33] The growing Indian population will face a geographical mismatch in the upcoming years as the work force will continue to grow – the Indian population is expected to hit roughly 1.35 billion by 2015 – but the share of skilled workers will decline and the concentration will be in agriculture and the unorganised sector. These facts underline that the Indian government will need to broaden investment into human capital and the development of remote regions in order to exploit the full potential of closer cooperation with ASEAN states.

[33] The following arguments are cited from Rohini Malkani and Anushka Shah, 'India Macroscope: India's Growing Labor Force - Boon or Bane?', *Monthly Monitor, Citigroup Global Markets* (23 July 2010).

The agreement recently signed by India and ASEAN states only covers trade in goods and there is little doubt that it will be followed by one in services. Taking into account the discussion of possible benefits from enhanced cooperation in services it is only natural that the Indian Commerce and Industry Minister, Anand Sharma, in a meeting with the Singaporean Trade Minister, Lim Hng Kiang, in early July 2010, called for an agreement on services and investment.[34] This call did not come unexpectedly as in January 2010, ASEAN deputy Secretary-General said that the first agreement was not the end of the road but instead an agreement on services in trade should also be completed later that year.[35] Prospects for such an agreement seem quite possible at the moment and chances are quite high that it will be signed in the near future.

Other Areas of Engagement

Areas such as security, the environment and infrastructure do not directly impinge upon trade in services, yet they cannot be ignored. First, these issues, although peripheral to trade and economic cooperation, hold the potential to be constraining factors if not addressed constructively. Second, security and infrastructure provide the foundation for effective trade in goods and services. Third, there are economic opportunities that can emerge through activities in these areas, especially with respect to environment and infrastructure.

The 1,600 km border shared by Myanmar and India is a useful example of the intersection between security and economic spillovers. The recently signed FTA (the AIFTA) will most likely boost regional trade in this border region and, therefore, contribute to the development of India's northern provinces. However, this will not be possible unless the underlying security issues are effectively managed. James R. Roulngou argues that unless the infrastructure, communication, industries and agriculture throughout India's northeast have to be developed first before trade relations can flourish.[36] Since the region is rich in resources and is of strategic importance, the development of infrastructure is a necessary component of any development process. While this region is a possible route through which India’s engagement with ASEAN can progress, a precondition for this is the satisfactory development of the north-eastern states in India. Amita Batra argues that India's northeast can only optimally profit from the AIFTA when it is ‘lifted out of its current economic equilibrium first.’[37] Chanda and Sasidaran point out that China has gained influence in Myanmar and the AIFTA can, perhaps, be used as a platform to foster those India-Myanmar ties. The full benefits of the AIFTA cannot be reaped unless India maintains a secure border with Myanmar but it also has to manage China’s early engagement with Myanmar.

---

[34] ‘India for early investment, services pact with ASEAN’, *The Economic Times* (10 July 2010).
[35] Veeramalla Anjaiah, ‘India, ASEAN must “enhance connectivity” to reap benefits’, *The Jakarta Post* (23 January 2010).
[36] James R. Roulngul, ‘India-ASEAN FTA: Implications for India's Northeast’, http://www.articlesbase.com/authors/james-r-ruolngul/82285. Accessed on 8 October 2010.
[37] Amita Batra, ‘India-ASEAN FTA: A Critique’, *IPCS*, Issue Brief No. 116 (September 2009).

There are at least two points of entry for India to penetrate into the Southeast Asian market. One point would be through ASEAN member states that surround the Straits of Malacca. The states that are clustered around this area include the older ASEAN members, which are the more developed economies. The other strategic point is via Myanmar. Myanmar has the possibility of being a very important market in the long-term, after it opens up more freely to trade and gains a more stable political structure, viewed in this perspective connectivity and ties with Myanmar become significant.

The creation of infrastructures is an excellent instrument through which India can engage with ASEAN, while also laying the foundation for further economic relations. The building of the Trilateral Highway Project (THP) linking India and Thailand through Myanmar is a good example of India's engagement in Southeast Asia. The project was first launched under the Mekong Ganga Cooperation and was later incorporated into The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (known as BIMSTEC). Several problems have hindered the completion of this project. They include financial restrictions which have prevented central parts of the highway from being constructed. Besides, issues along the Indian-ASEAN border such as illegal trade, drug trafficking and insurgencies continue to hamper cooperation. But other considerations weigh over purely economic figures. China claims that the region of Kachin as its own and it has a strong influence there. Further, completing the highway might also flood the area with Chinese goods and weapons. These concerns go against India's security interests and would contribute to a reluctance to proceed with the construction of the highway, notwithstanding the undeniable economic advantages. However, as India is Myanmar's second largest export market accounting for 12.3 per cent of its total exports,[38] its interest to broaden economic ties should be pronounced.

However, the THP combines India's economic interests with strategic objectives. The THP will encourage the economic development of India's north-eastern states and it will secure trade routes that will create a link with the western part of Southeast Asia. By strengthening infrastructure links with Myanmar, India will ultimately be able to gain easier access by land to Thailand. It will also contain China's rising influence in that region. As Pate argues, the completion of this project is crucial for the realisation of India's 'Look East Policy' while a failure will very likely be interpreted as a failure of the Indian-Asian integration.[39] Apart from the completion of the highway, a closer cooperation between ASEAN and India will show their interest in the peaceful management of future power balance in Asia.[40]

---

[38] Thailand is the most important export market and accounts for 52 per cent of Myanmar's total exports. See, *CIA World Factbook* (2010), www.cia.gov/library/publications/the-world-factbook/geos/bm.html. Accessed on 12 May 2011.

[39] Tanvi Pate, 'India-Myanmar-Thailand Highway', *IPCS*, Article No. 3115 (6 May 2010).

[40] Prashanth Parameswaran, 'Strengthening ASEAN-India Relations in the 21st Century', *Project 2049 Institute*, (27 May 2010).

Roulngul argues that the AIFTA will not be able to achieve its goals unless this region is developed and becomes the centre of Indian-ASEAN trade. Although, it might be true that India's north-east will not become the ‘gateway’ of trade unless the region is developed with a stable infrastructure, such an argument misplaces the importance of that part of the region; and it might be an exaggeration to perceive it as being the centre of Indian-ASEAN trade. Trade has long been conducted through seaports and it will most likely continue to be done in that way. Indeed, trade will expand with lower tariff rates and with the removal of other trade barriers. The development of the northeast will provide additional trading routes but will not displace trade through seaports or airports.

With regard to security issues, especially ASEAN members bordering the Malacca Straits, have a growing common interest in securing the sea trade routes, reducing piracy and fighting terrorism. As an example, Singapore and Malaysia have signed maritime security treaties with India, these being the two states that have invested the most in India.[41] Thus, along with Indonesia and the Philippines, these ASEAN countries have the strongest interest in ensuring that trade along the Straits of Malacca can function without disruption. India's interest in this regard was demonstrated by its naval forward presence of joint operations and compatibility with Southeast Asian navies.

A crucial aspect of India’s engagement with ASEAN can be accomplished through initiatives to close the development gap among the less developed Southeast Asian states. In particular, India can take part in helping ASEAN members such as Cambodia, Myanmar, Laos or Vietnam (CMLV states) to catch-up and close the development gap with 'older' ASEAN members. India has undertaken efforts to improve living conditions in Indochina. This functional cooperation includes human resource development, science and technology, health and pharmaceuticals, transport and infrastructure, information and communication technology, agriculture, energy and people-to-people exchanges. These initiatives are funded by the ASEAN-India Fund (AIF).[42] For example, it financed the establishment of entrepreneurship development centres (EDC) and Centres for English Language Training (CELT) and granted credits especially to the poorer CLV (Cambodia, Laos and Vietnam) ASEAN member countries. In general, the cooperation is conducted under the framework of the ASEAN-Indian Partnership for Peace, Progress and Shared Prosperity adopted in November 2004.

According to Trewin, it is essential for less-developed ASEAN members to receive substantial capacity building in infrastructure and establish institutions in order to successfully join in the liberalisation process. It would be in India’s favour to contribute to the process of capacity building. Yet, it may not be practical to expect India to support ASEAN's capacity building, since India had a per capita GDP of 46,116 (approximately

[41] Rupa Chanda and G. Sasidaran, ‘Understanding India's Regional Initiatives within Asia’, ISAS Working Paper No.48 (15 August 2008).
[42] ‘ASEAN-India Dialogue Relations’, *ASEAN*, www.aseansec.org/14802.htm. Accessed on 22 March 2011.

US$980) in 2008.[43] This figure is much lower than the average per capita GDP in ASEAN, which amounts to US$6,565.21.[44] Comparing the per capita GDP across ASEAN countries and India, India ranks among the lower income countries. Notwithstanding this fact, attempts should be made, where possible to contribute towards the capacity-building process of ASEAN, particularly of those who are at the lower stages of development. The CLMV countries are prime targets for such capacity-building efforts.

In the light of India's technical expertise, it is possible for it to cooperate in the areas of natural disaster forecasting and relief. As was seen in 2004, when the tsunami hit Indonesia, joint action eased the burden on India. Since most ASEAN members have large shares of their population living along coastlines and depending on agriculture and fishing, natural disasters can easily wipe out the livelihoods of these people. Rising sea levels, tropical storms, droughts and heat waves can deteriorate agricultural production in India and ASEAN states substantially. Thus, the two parties could benefit from concerted preventive measures and enhanced environmental protection. Such actions will also be favourable to the tourist sector since rising sea temperature causes, for example damage to diving sites and thereby hinders tourists from spending their holidays in the region. By initiating joint action against climate change this will reduce the number of natural catastrophes. It will also ensure that agricultural production is sustained and maintaining a sufficient supply of food.

Although not directly linked to the AIFTA, Rupa and Sasidaran argue that India has a strategic interest in fostering relations with Japan as it could support Japan in securing trade routes through the Indian Ocean. This route is important for Japan, as its trade flows and energy supply follow this path. In return, India needs Japan's support in order to lift international restrictions on civil nuclear trade with India.[45] Another noteworthy point is that India's own need for energy is also constantly increasing and has led India to enter negotiations with most parts of the world including the European Union (EU), the United States (US), energy-rich African states, Latin America and the Gulf region. In a certain sense, Japan's cooperation will help India explore the nuclear option for its energy needs in the long-run. Quite clearly, both Japan and India have an economic interest in ASEAN. This suggests, as we will be discussed in what follows, that an architecture that involves both countries may be to the mutual benefit of the region.

[43] According to the exchange rate of 20 July 2010.

[44] The CIA *World Factbook* and *Asian Development Bank*. When calculated as the total GDP of ASEAN divided by its total population, the per capita GDP is only US$2,582.64. This substantial difference is due to the comparatively high per capita income in Singapore contrasting the low per capita incomes in most other ASEAN countries.

[45] Rupa Chanda and G. Sasidaran, 'Understanding India's Regional Initiatives within Asia', ISAS Working Paper No.48 (15 August 2008).

Future Prospects of ASEAN Integration

The AIFTA has obvious advantages for India because it can now import products from ASEAN more cheaply than before. Furthermore, India can diversify trade ties and enlarge its export market by an additional 600 million consumers, thereby reducing its dependence on the EU and the US as delivery markets. As ASEAN started engaging in international trade earlier than India, they are much more integrated into the world economy. India has enhanced its activities toward more integration and engagement in global trade and ASEAN could serve as a multiplying force for India to catch up. Concerning trade agreements, India only recently began to pursue bilateral negotiations, as it had to follow up on the international trend towards regionalisation. ASEAN also profits for a trade agreement with India as it can serve the extensive Indian demand.

However, there are not only economic but also political aspects to the AIFTA. Firstly, ASEAN wants to attain more bargaining power on the international stage. In the past years, ASEAN signed FTAs not only with India, but also with China, South Korea and Japan (November 2007). Thereby, ASEAN has managed to strengthen its ties with all of the major powers in the region. As the US hegemony diminishes these are the powers that will determine the change in the global power distribution.

For ASEAN, it is important not to be marginalised by the four large powers surrounding it. By signing FTAs with all four major regional powers, ASEAN is able to ensure that it will not be left out regardless of which of the four countries assume leadership over the region. Additionally, China has increasingly gained influence in Asia over the past decades. Thus, ASEAN has to counterbalance this growing influence by strengthening its ties with India. This action seems necessary since not only economic ties but also socio-cultural ties are strong with China as many overseas Chinese live and work in Southeast Asia[46]. India does not enjoy the same advantage since the Indian diaspora, as Asher et al. argue, does not enjoy a strong political position and has thus not had much influence on Indian-ASEAN relations and investment flows. Rather there seems to be a trend of emigrating professionals and specialists of Indian origin especially from countries such as Singapore and Malaysia.[47]

The implementation of India's ‘Look East Policy’ has coincided with China's rise and growing global influence. This policy has also taken shape at a time when as Southeast Asia has emerged as a vibrant market. As India is geographically located to the west of the Asian region, it could be legitimately concerned that it would be excluded from the benefits of a dynamic market. Although, relatively, ASEAN countries are small India would not want to be 'left out' of the integration process. This brings into question the mechanism through

[46] With more than 28 million Chinese living on Southeast Asia, that accounts for 70 per cent of all overseas Chinese.

[47] Mukul G. Asher, Rahul Sen and Sadhana Srivastava, ‘ASEAN-India: Emerging Economic Opportunities’, *Centre for Freedom and Development Studies* (May 2001), www.cpdsindia.org/emergingeconomic.htm. Accessed on 22 March 2011.

which India can engage with ASEAN.

With regard to the prospects of future integration in the region, a more fundamental question is that of ASEAN's future integration. It must be recognised that the ASEAN Secretariat is not a decision-making body. Indeed, ASEAN functions of the basis of a loose cooperation among member states. Since these states have different levels of development and varying degrees of engagement with China, there are some issues where they have common challenges. The effects of China’s investment in the high-speed train running from Kunming, China to Singapore cannot be discounted. While connectivity will be improved between China and ASEAN, the threat of an excess supply of Chinese goods will be an issue to be confronted. Also, the undervaluation of the Chinese yuan against the US dollar hampers the competitiveness of the less-developed ASEAN states such as Cambodia and Laos, presenting ASEAN and the US with a common challenge. Thus, the US and ASEAN have a common interest in pressuring the Chinese government to revalue the yuan. States such as Malaysia and Indonesia are no less susceptible to the effects of an undervalued yuan. A revaluation might also help to improve the trade balance of states as Indonesia with China that changed from a surplus in 2003 to a trade deficit in 2008 because China rose up the value chain unexpectedly fast and is increasingly attracting FDI away from Southeast Asia.[48] These issues present an argument for a more consolidated common position in ASEAN. They also point to the need for an approach that has a wider cooperative framework.

The ASEAN+6 approach provides the basis for a broader degree of involvement in the region. This will allow ASEAN to pursue its objectives while also drawing upon the resources of New Zealand, Australia and India. The +6 approach includes all the major players in Asia, but the same concerns that plague ASEAN+4 cannot be discarded. As long as ASEAN itself does not follow a common approach, enhance regulatory frameworks and create tighter integration among its own members, it will be difficult to conceptualise its cooperation with six powerful economies. Nevertheless, this framework offers the best opportunity for responding to future challenges, without forsaking the opportunities that abound.

The foreign ministers of the ten ASEAN member states have been discussing an expansion of the East Asian Summit to include Russia and the US States. This move offers the possibility of counteracting the rising Chinese influence in the region. The engagement of the US and Russia in regional affairs would significantly increase the importance of the East Asian Summit. Such an expansion would provide for an ASEAN+8 framework, but as Daly argues, it would perfectly fit into the ASEAN strategy, ‘remain independent, keep linking up, build off from existing points of agreement, remain pragmatic.’[49] Daly even argues that the consultative body of ASEAN+8 might be the only chance to fill the strategic and power

[48] Sean Daly, ‘Obama's ASEAN Policy Looks Auspicious’, *Policy Innovations* (19 May 2010), www.policy innovations.org/ideas/commentary/data/000189. Accessed on 15 September 2010.
[49] *Ibid*.

vacuum created after the end of the Cold War in South China Sea. In May 2010, a US trade representative had also named the ASEAN states to be the most important destination for US direct investment, with the investment being three times larger than that in China and ten times that in India. Also, the US seeks a transpacific agreement to further foster relations with Asia in the upcoming years.[50]

Asher, Sen and Srivastava argue that India should approach ASEAN in two ways. On the one hand, it should enhance its cooperation with ASEAN as an organisation. On the other, it should seek further bilateral and country-specific engagement with ASEAN's members. The reason for this two-track approach is that ASEAN as an organisation was not granted much authority and hence decisions and agreements signed by ASEAN might not result in the close cooperation envisaged in the beginning. This fact might provide an answer to why India continues to seek bilateral FTAs with ASEAN members despite the fact that the AIFTA has come into effect in January 2010. However, they conclude that the potential of bilateral cooperation between India and ASEAN states will not be fully realised as long as far-reaching political commitments are not made, especially in Thailand and the Philippines.[51]

According to Batra, the best route to follow for India is via an ASEAN+1 alignment first. As this has been put into place in form of the AIFTA one could argue that the next step lies in the formation of ASEAN+4. However, the question arises whether the creation of the AIFTA or its completion – which is set for 2016 – should be seen as the point after which the creation of ASEAN+4 seems appropriate. When following an ASEAN+1 alignment India should enhance its already existing cooperation with ASEAN members in initiatives such as the Mekong-Ganga Cooperation Initiative on tourism, culture and development. This approach would give India the chance to improve its relations with the subregions of ASEAN and might gain support for projects on broader scale. At a more practical and immediate level, India can realise these goals by organising more visits of high-level politicians and representatives to and from India and by providing substantial scholarships to students and research fellows to strengthen sentiment of common cultural heritage. Certainly, increasing the trade volume with ASEAN subregions is also a fundamental part of enhancing cooperation.

Also, domestic reforms are needed to maintain current growth rates in the future but implementing such reforms will demand many resources and will delay negotiations on cooperation. Along these reforms are changes in the bloated, inefficient and corrupt Indian bureaucracy, infrastructure investment and institutional fixes to enhance competitiveness and boost export resilience. Last but not least, grassroots connections between Indian and ASEAN citizens must be strengthened to ground cooperation and relations not just on

[50] Lalit K. Jha, 'US FDI: ASEAN beats China and India', *Rediff* (4 May 2010), http://business.rediff.com /report/2010/may/04/us-fdi-asean-beats-china-and-india.htm. Accessed on 22 March 2011.
[51] Mukul G. Asher, Rahul Sen and Sadhana Srivastava, 'ASEAN-India: Emerging Economic Opportunities', *Centre for Freedom and Development Studies* (May 2001), www.cpdsindia.org/emergingeconomic.htm. Accessed on 22 March 2011.

agreements signed by the governments but also on the will and support of the people. Partnerships of universities, businesses and art institutions are needed to boost mutual understanding.

On the part of ASEAN, it might show its goodwill towards India by supporting India's request of membership in the APEC in the APEC convention in November 2010 or allowing India to join the Chiang Mai Initiative Multilateralisation (CMIM) Agreement.[52] Since India's as well as ASEAN's interests are related to maritime security issues – be it securing the Malacca trade routes, securing sea-related food production or managing China's rising naval build-up – this area would be an ideal issue to start with.

Concluding Remarks

This paper has tried to explore the future prospects of Indian-ASEAN relations. The agreement on trade in goods that came into effect at the beginning of 2010 was possibly a starting point in this respect. The next stage in India’s economic relations will be to seek completion of an agreement on trade in services. This is an area in which India’s contribution to the region can be fully realised. Even though services prove to be a very good starting point to enhance cooperation further, there are several political as well as organisational obstacles that have to be resolved before India and ASEAN can take their cooperation to the next level.

On the one hand, an agreement on services trade would be well advised, since it might help to overcome the bias in benefits from the current agreement towards ASEAN states. On the other hand, ASEAN states need to come to terms with the direction in which ASEAN integration will precede. If this question remains unsolved, it is unlikely that ASEAN states will be able to represent themselves as one body in global negotiations. Nevertheless, given their different levels of development, India will have to engage with the states with due consideration to their economic conditions.

In addition to the possibilities that India can find within the services sectors of the respective ASEAN member states, there are other areas for cooperation. These areas include capacity building and the improvement of connectivity through infrastructure development. India’s technical expertise can also be extended to ASEAN by cooperating in disaster forecasting and management. Indeed, India’s engagement with ASEAN should be comprehensive and wide-ranging. Nevertheless, the question of how this involvement will be executed depends on the framework that is selected. The two options that are possible are ASEAN+4 and ASEAN+6. Since there are political barriers that may have to be overcome in accessing these regional

---

[52] Prashanth Parameswaran, ‘Strengthening ASEAN-India Relations in the 21st Century’, *Project 2049 Institute*, (27 May 2010). This agreement came into effect in March 2010 and membership is restricted to ASEAN+3, thus far.

architectures, it would be to India's benefit to initiate its engagement with ASEAN member states on a bilateral basis. This will give India the opportunity to build a firm basis for involvement with ASEAN regardless of the framework that eventually emerges.

. . . . .

ISAS Working Paper

No. 130 – 26 August 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

An Outsider's View of Some Issues in Contemporary Indian Foreign Policy

David M. Malone[1]

Abstract

Anand Giridharadas wrote in 2009 that India is 'a country harder to describe than to explain, and easier to explain than to understand', and that 'India is a place for seeking, not concluding'.[2] *This is a profoundly true but also humbling observation for a non-Indian author addressing a topic such as Indian foreign policy.*

Some History as Prologue

Foreign policy formulation requires a conciliation of ends and means conditioned by the specifics of the country involved and of the wider international situation at any given time. It draws on history, geography, economic performance, regional and global ambition, and many other factors. It is much easier to analyse at the remove of several decades. Thus, foreign policy during India's first four decades is more readily captured than its current directions, which are subject to much white noise.

Independent India's early foreign policy, nearly completely dominated by Prime Minister Jawaharlal Nehru, sought to create some margin of manoeuvre for the new state facing challenges to national cohesion and struggling with abject poverty. Nehru believed it was

---

[1] Mr David Malone is President of the International Development Research Centre. He is Canada's former High Commissioner to India, and former Canadian Ambassador to the United Nations. He is the author of '*Does the Elephant Dance? Contemporary Indian Foreign Policy*, published by *Oxford University Press*. He can be contacted at dmalone@idrc.ca. The views expressed are those of the author and do not necessarily reflect those of the institute.

[2] Anand Giridharadas, 'Once-Clear Thoughts Are Clouded', *International Herald Tribune* (19 June 2009).

essential for India to maintain a healthy distance from power politics and the bloc rivalry that was soon to crystallise into the East-West Cold War. With hindsight of 60 years, this still seems the best choice at the time. Thus, for India, the non-aligned stance was essentially a defensive posture.

India's policy was resented in the West, which, driven by the assumption that any democracy worthy of the concept should align accordingly, indulged quite frequently in bullying tactics towards New Delhi (while also assisting it economically, particularly with food aid). Russia was eventually able to acquire India as an ally, virtually by default, through a largely non-ideological posture, with patience over Indian rhetorical flourishes, and driven by a realist appreciation that India mattered in the balance of power in Asia. Indian needling of the West, particularly of the United States (US), the fruit of its anti-imperialist sentiment, and the high-minded nature of much Indian speech-making at the United Nations (UN) and elsewhere, was congruent with its eventual alliance with Moscow, but the latter was unable to assist India much with several of its pressing needs.

Western envoys in India, including Alva Myrdal, John Kenneth Galbraith, Walter Crocker and Escott Reid, while deploring New Delhi's propensity for doublespeak and morally charged grandstanding, did their best to explain India to their capitals during the 1950s and 1960s, but few were receptive back home. Octavio Paz, the great Mexican writer and poet, and his country's ambassador to India between 1962 and 1968, adopted a more philosophical tone in his elegant and rich essays on India.

Although foreign and defence policies may not have been Nehru's strongest suit, competing as they did with often much more urgent domestic challenges, much of his foreign policy writing makes for compelling reading today. It was more in the application of his principles than in their formulation that he stumbled. This was particularly the case towards the end of his life, as India's options grew more constrained. However, the mistakes he made in foreign as in domestic policy do not, in my view, diminish his greatness overall, which seems to me more evident with each passing decade.

India was no natural ally of the Soviet Union. Indeed, many in India's foreign policy establishment viewed the prospect of New Delhi's alignment with Moscow with distress. India's concerns over Washington's systematic support of Pakistan and also its reservations over an unbridled capitalist economic model were misunderstood or rejected outright by Washington and by some others in the West. New Delhi's impatience with the obtuse insistence of Portugal, under a military dictatorship coddled by Washington, to hold on to Goa until 1961, was a factor, especially as Western powers at the UN defended Portugal on narrow legal grounds (akin to India's own hypocrisies over Hungary). India backed into its largely unprofitable alliance with Moscow in part due to Western condescension. Indira Gandhi's autocratic nature also fit better with Moscow's ordered view of domestic governance than it did with Washington's. Finally, the readily outstretched hand of friendship from Moscow helped. But the implosion of the Soviet Union in late 1990 put paid to the Indo-Soviet alliance.

Independent India, from the outset perceived the need for global reach. Indeed, spurred by decolonisation elsewhere, it established a global diplomatic footprint few others had rivalled. It also made its mark in the multilateral sphere, participating with rhetorical brilliance in the major international debates of the Cold War era, and contributing meaningfully to the UN's capacity through its frequent provision of military and civilian peacekeepers.

Yet, in the absence of widely appreciated economic and social achievements, and with its military might mostly applied to internal conflicts and those in its immediate periphery, it was viewed as a cantor of the non-aligned countries, but not always a very committed or convincing one given its own great power entanglements. After the Berlin Wall fell, non-alignment became irrelevant, much Western aid was diverted to Eastern Europe, and India's barter trade with Russia suffered.

Fortunately, the sudden end of the Cold War coincided with other tectonic shifts affecting India: the conclusion of the Indira Gandhi years; the mildly positive but largely inconclusive results of the tentative economic reforms of Rajiv Gandhi's years in power; and, above all, the balance of payments and exchange rate crisis of 1990-91. It was the bold reforms instituted to counter the crisis, and their positive outcomes, that brought about a profound reassessment of India's significance and potential internationally.

In spite of parliamentary turbulence in 1989-91, a sense took hold internationally of India's growing political maturity and the lasting nature of its democracy, the country's institutions having survived the misguided emergency rule of Mrs Gandhi in 1975-77, and the assassinations of both Indira and Rajiv Gandhi.

India's Foreign Policy Today

India is not primarily outward-oriented. Goings-on within India could readily absorb the sum total of attention Indians devote to public affairs. But today, India is reaching out: its private sector is doing so aggressively, carving out markets for itself globally, investing widely, and subsuming industrial and service icons of other regions. Indeed the frustrations of corporate India are more likely to focus on the business conditions and domestic barriers to effective inward investment that it must endure within India, as steel magnate Lakshmi Mittal (of Arcelor-Mittal) and Ratan Tata, leader of the Tata conglomerate, often emphasise with asperity.

With the emergence of the Group of twenty leaders in 2008 as a key assembly of significant countries, India was offered an opportunity to play a major global role. Even earlier, it had joined Brazil, China, Mexico and South Africa as a 'dialogue partner' of the Group of Eight, the forum for policy discussion among leading industrialised countries. In the G-20, they were not only equals, they clearly mattered more than a number of the traditional Western participants in economic global discussions.

Key Positive Elements of Change

Thus, it was India's economic significance that lent weight to the country's international profile (while its nuclear status served both as an asset and as a drawback during its period of 'emergence' as of the mid-1990s). And because of its economic rise and new value to the US as a commercial and potentially geo-strategic partner, in 2008, India escaped from the partial international purdah into which its 1974 nuclear test had consigned it thanks to multilateral acceptance of its nuclear cooperation agreement with the US, turning a page on frequently contentious relations of the past. This shift, in my view, represents a victory for both sides.

While some in India still worry that it could abdicate its freedom of manoeuvre and side with the US reflexively in international affairs, this seems far-fetched to an outside observer. A more realistic concern is that Washington will not always understand India's inability to agree with it, creating a perception of New Delhi as a false friend. But even these anxieties seem ill-founded, rooted as they are in fears arising from the past rather than the possibilities of the future. The US today needs to court Indian support on a range of issues, just as India values American support in tackling many of its own challenges. And Indians are reassured, in this relationship, to know that the brief unipolar moment has largely passed, allowing for more balanced links with key partners.

It is not unreasonable to anticipate a large degree of mutual accommodation, however frustrated each capital may be at times with the other on individual files. US demand for information technology and other services has been extremely helpful to India, and India's capacity to absorb American exports has greatly strengthened American commerce (at a time when much militates against continued unfettered global US economic dominance).

Although each country will seek to improve and manage its relations with China separately, their challenges in doing so will likely draw them together at times. The outcome of the US-led Western military intervention in Afghanistan, and developments in Pakistan, will influence the tone and content of US-India ties in ways that are unknowable today, but that need not undermine a bilateral relationship that is now more mature and should be mutually confident. The generally steady approach of China to relations with Washington may deserve more attention in India than it receives, as pointed out by former Indian Foreign Secretary Maharajakrishna Rasgotra.[3] China's relationship with the US need create no anxiety in India, and might best be viewed in terms of future opportunities.

[3] Maharajakrishna Rasgotra, 'Foreign policy must meet the needs of the 21st century', *The Tribune* (Chandigarh), *India at Sixty* – Special Supplement, 15 August 2007.

India's improved relationship with Washington complements its 'Look East Policy', launched in the early 1990s to increase its engagement with Asia, and greatly intensified since the turn of the century with some success.[4] With China's rise not recently being seen as particularly harmonious by all of its neighbours, for example, Vietnam with which Beijing has clashed in the past and with which it entertains a continuing dispute over the Paracel and Spratly islands, a growing Indian role in Asia and a continuing US projection there of its strategic power, will reassure a number of Southeast Asian countries. A brief but sharp clash between China and Japan in 2010 over fishing rights in the Senkaku/Diaoyu islands unsettled China's Asian neighbours beyond Japan much more than it likely intended.

For the US, its newly improved relationship with New Delhi does not make Washington an 'ally' in the classic military sense (although military cooperation is likely to intensify) and for Indians, it does not make the US a South Asian power. The US will want to avoid presuming on the relationship, particularly given India's sometimes prickly diplomatic personality. New Delhi, meanwhile, must accept that India is not always at the centre of Washington's concerns and refrain from interpreting its every international move and statement as a comment on the US relationship with India. It also needs to accept as a given Pakistan's historically rooted ability to play Washington as a violin at times, extracting from that relationship much more than Islamabad contributes.

Continuing Challenges

Manmohan Singh has doubtless been right repeatedly to describe India's Maoist, Naxalite insurgency involving up to a third of the country's districts with greater or lesser severity, as the greatest challenge to India's security today. However, there is no evidence of foreign involvement in fuelling this insurgency, so, while it affects India's image somewhat, it hardly impacts on its foreign policy.[5] Support for it from local, often tribal, populations derives from poverty, and its resolution is unlikely to be secured by traditional counter-insurgency tactics. Rather economic development of the regions involved holds the key to eliminating the threat.

Relations with Pakistan remain vexed, in spite of recent efforts by Prime Ministers Atal Bihari Vajpayee and Manmohan Singh, and at different times several Pakistani leaders, to move beyond a state of mutual allergic reaction. While India's effort in recent years not to allow individual incidents linked to Pakistan directly or indirectly drive its policy, domestic reactions to future events could cause Pakistan to consume a lot of India's foreign policy

---

[4] See Archana Pandya and David M. Malone, 'India's Asia Policy: A Late Look East', *ISAS Special Report* No.2 (25 August 2010), www.isas.nus.edu.sg/Attachments/PublisherAttachment/ISAS_ Special_Report_02_-_Email_-_India's_Asia_Policy_-_A_Late_Look_East_26082010093309.pdf. Accessed on 28 June 2011.

[5] While there had been concern that Nepal's Maoist insurgency might be supporting Naxalite elements by supplying weapons and in other ways, since the Nepali Maoist leadership renounced violence and joined elective politics in 2006, the Naxalite phenomenon is widely understood within India to be homegrown.

bandwidth. This is particularly so as today friction extends well beyond Kashmir and individual terrorist acts to include India's reconstruction programme in Afghanistan and suggestions from Islamabad that India might be contributing to undermining Pakistani cohesion through support of nationalist elements in Baluchistan.

Contrary to some foreign perceptions, India does not actually much fear a nuclear war with Pakistan. Pakistan would have everything to lose in such a dire eventuality and, as pointed out by G. Parthasarathy, has been more prudent in arrangements for the storage and maintenance of its nuclear arsenal than is widely supposed.[6] But India's resilience to provocation is not infinite. M. J. Akbar notes: 'The calmative effect of common sense can, under pressure, surrender to anger. The present stalemate has the potential of becoming toxic as other options fail.'[7]

Yashwant Sinha advocates a two-pronged approach given the current deadlock in the relationship: ignoring Pakistan and equipping India in such a way as to be less vulnerable to terrorist attacks. The restraint displayed by India following both Kargil and 26/11 is a sign of a vibrant democracy breeding self-confidence, versus a less democratic and less self-confident neighbour.[8] Mr Sinha's proposed strategy suggests that India can insulate itself successfully from Pakistan. Currently, this seems unlikely. Thus, attempts to seek an accommodation with Pakistan are likely to continue (and to be strongly supported internationally).

Meanwhile, more pressing for both India and Pakistan are other challenges they face. Shiv Shankar Menon, while out of office in 2009, suggested:

Pakistan has allowed an obsession with India and Afghanistan to destroy its own polity and internal balance. India must not allow an obsession with Pakistan to do the same to its foreign and domestic policies. For India (and, I dare say, Pakistan as well though to a lesser extent) the real issues are elsewhere. India's overriding task is her own domestic transformation, as is Pakistan's.[9]

Overall, India's twin instincts of seeking to improve relationships within its own region while simultaneously seeking to exert influence well beyond South Asia are sound. It can and should work harder to persuade its neighbours that it wants them to benefit from India's strong economic growth. It is in India's interest to be generous to countries on its periphery in this regard (just as, on balance, it is in India's interest, as the stronger party, to offer generous gestures to Pakistan if only to improve the overall dynamic). This is particularly so as some

6 G. Parthasarathy, 'Afpak for Dummies: A Primer', *World Affairs*, Vol.172 No.3 (January/February 2010), p.72.
7 Correspondence with the author (18 April 2010).
8 Interview with the author (February 2010) and correspondence (23 March 2010).
9 Shiv Shankar Menon, 'Hostile Relations India's Pakistan dilemma', *Harvard International Review* (22 September 2009).

countries in the region, for example Bangladesh under the leadership of Sheikh Hasina since 2009, seem to understand that prospects for their own prosperity are strongly linked to those in India.

Difficult relations with China are also a constant, at least from the 1950s onward.[10] Were China mired in backwardness and failure, Indians would probably not obsess about the bilateral relationship so much. But China's economic success, its growing ease in international relations, its advantageous position as a permanent member of the UN Security Council, and its increasing self-confidence (or, depending on one's view, controlled arrogance) rankle Indians tremendously. While China's presumed brittleness stemming from its totalitarian political system gives its Indian rivals some comfort, and while India's democracy provides its society with political shock-absorbers that China does not possess, most Indians recognise the significance of China's economic success, not only preceding that of India and exceeding it in extent – but also with the gap between them compounding every year. Further, the nature of India's polity, the frequent sensationalism of its free press, and the plethora of its public voices often lead India to overreact to developments that China's highly controlled system can tackle more subtly (however sharp Beijing can decide to sound, on occasion). Reflecting on the unequal state of the relationship, Jaswant Singh argues that, when push comes to shove with its rival: 'China can deliver government far more efficiently than either India or the USA.'[11]

Informed Indians worry about India's access to natural resources and energy in other parts of the developing world, including Africa.[12] India has longstanding trade links with Africa and Indian communities have for several centuries dotted the African coast, with large numbers in East and South Africa. Some Indians consider that China's determined push into Africa, particularly in countries endowed with natural resources, should be emulated by New Delhi. However, worries about China crowding out India in Africa may be misplaced. For one thing, China's African ventures, however much dressed up in diplomatic niceties, are clearly above all a business proposition, and the Chinese modus operandi (relying on home base for most inputs, including often labour) will not make them many friends in Africa beyond the self-interested elites. China's useful and generous offer of scholarships to Chinese universities, on the other hand, may. India need not replicate all of China's strategies and actions in Africa. Rather, it should identify and reinforce approaches that continue to serve its own interests in its own ways, leaving sometimes risky economic decisions in the hands of its capable private sector whenever possible.

One melancholy shift affecting India's international relations in slow motion has been the decline in relative terms of its relations with Europe. Russia will remain a trusted interlocutor, if only out of habit. Economic relations can be conducted unsentimentally on the basis of

---

[10] See A. G. Noorani, *The India-China Boundary Problem* (New Delhi: Oxford University Press, 2011), pp.219-232.
[11] Interview (January 2010) and correspondence (18 February 2010).
[12] See John Cherian, 'Grabbing Africa', *Frontline* (7 May 2010).

mutual interest. But the parties are definitely out of love, if they were ever smitten. As for the European Union (EU), in spite of the extent of its economic and investment ties to India, impetus is deflating gently, while its leading member states vie with one another for New Delhi's ear and contracts. The EU as an institution with a formal mandate to speak for its member states has in recent years, in spite of the ratification in 2009 of the Lisbon Treaty, largely been ignored by countries such as India and China except in the realm of multilateral trade negotiations. On other issues, Beijing and New Delhi mostly conduct business with the leading European capitals which, conveniently, can be played off against one another. It is in Asia that the hollowness of much European rhetoric about unity and integration is most noticeable. Asians have no particular stake in the EU's success and feel no need to pay it unwarranted tribute. That said, the United Kingdom (UK), France and Germany (the former two were colonial powers in India prior to its independence) have each forged distinctive, meaningful relationships with New Delhi (see all others) at the economic level, with the UK and France also seen as security partners and sources of defence procurement.

Largely unnoticed by the rest of the world, India's attention on the Middle East has paid significant dividends. Many reasons might be adduced for this: ancient and meaningful ties through cultural, dynastic and other forms of migration; a reluctance to yield influence in the heart of the Islamic world to Pakistan; a desire to accommodate its own large Muslim community by cultivating a region to which it might be assumed to relate (although, beyond the Haj to Mecca, it is not clear how much Indian Muslims care about the Arab world); long-standing trade relations with the region; Indian requirements for energy supplies; and an attempt to ensure the welfare of India's large diaspora in the Persian Gulf. Nevertheless, this traditionally inhospitable terrain for the diplomacy of non-regional actors has yielded highly successful results for India. India has worked hard on maintaining civil ties with Iran even though it has voted against that country's apparent nuclear ambitions within the UN system. And recently, it has placed new emphasis on its links with Saudi Arabia (while also tending to a highly substantive defence procurement relationship with Israel). But with the Arab world in ferment, as it was during the 1950s, India will need to remain nimble in responding to popular sentiment there while protecting its economic interests and those of its migrant workers, as events in Libya in early 2011 demonstrated.[13]

[13] When India was newly elected to the UN Security Council, it was required to take a position on two seminal council resolutions in addressing the civil strife in Libya, joining all others in referring allegations of human rights abuses by the Libyan leadership to the International Criminal Court. While later abstaining with four others, including China and Russia, on the creation and enforcement of a no-fly zone over the country designed to protect rebel forces against reprisals by the government.

Multilateral Diplomacy

Indians generally cleave to engagement with others, and this works wonders at the bilateral level, where the parameters of national interests are perhaps most clearly defined on both sides. In bilateral diplomacy, India has made many friends. Multilaterally, however, while generating for itself a reputation as a country that always needs to be contended with, India has achieved less to date.

Multilateral relations, often thought of in India as the country's diplomatic strong suit during the heyday of the Cold War, are today more controversial. Where India has performed very well is in financial diplomacy, in forums such as the G-20, at the World Bank and at the International Monetary Fund (IMF), where it engages with global challenges and trends on merit.

Indeed, the competence in this realm of many Indian officials and scholars, as exemplified on these issues by the quietly assured Prime Minister Manmohan Singh, is widely recognised and appreciated.

However, New Delhi's negotiating style too often exhibits no 'give' while rarely hesitating to communicate non-negotiable principles and demands. Edward Luce, a generally fond and an acute observer of India, notes: 'It would be tempting to conclude that India is rising in spite of its diplomacy.'[14]

The impatience of India to increase its formal role (as opposed to its substantive profile) in a number of international bodies, including the UN Security Council and through greater voting rights in the IMF, has bumped up against the interests of others and, at the IMF, the gross over-weighting of Europe. Entertainingly, Martin Wolf suggests that 'exhausted by the burden of its pretensions, the UK should soon offer its seat [on the Security Council] . . . to its former colony'.[15]

On these institutional issues, the US is likely to be India's greatest ally over time. China was careful not to challenge overtly India's candidacy for a permanent seat on the UN Security Council, instead turning all of its ire on Japan, one of India's three partners in its quest to increase the number of permanent seats in 2005. China continues to subscribe to alliances of convenience with India multilaterally where their interests largely coincide, as in 2009 on climate change. However, these alliances are probably unstable because of their very different styles of national decision-making and diplomacy, and the greater weight of China in the world. Nevertheless, China is unlikely systematically to frustrate India's rise to greater prominence at the various high tables of international diplomacy because it has more vital interests to promote and protect.

[14] Edward Luce, *In Spite of the Gods: The Strange Rise of Modern India* (London: Abacus Books, 2007), p.288.
[15] Martin Wolf, 'India's elephant charges on through the economic crisis', *Financial Times* (3 March 2010).

Thus, for India, time and its generally prudent policy stance are its greatest assets in attaining its aspirations for international recognition, as exemplified by the emergence of the G-20 at leader level in 2008, and Dr Singh's prominent role therein. This could be hastened by a creative (and cost-free) Indian offer to sign on to the Non-Proliferation Treaty if it can negotiate terms that place it on an equal footing with the existing five legitimate nuclear-weapon states under the treaty framework (as presaged in a statement by India's prime minister on 29 November 2009).[16] The path for this step could be paved by Indian signature of the Comprehensive Test Ban Treaty (CTBT), which its public pronouncements and new arrangements with the International Atomic Energy Agency (IAEA) and the Nuclear Suppliers Group suggest is no longer in conflict with Indian policy. However, India's security establishment is dead set against Indian involvement in a set of treaty obligations it has long seen as discriminatory.

What Kind of a Power will India be?

Srinath Raghavan points out that scholarly analysts 'want behaviour to be guided by general principle, and they place a high premium on consistency'.[17] Scholars today are sometimes confounded to conclude, as did George Tanham in 1992, that India has no grand plan, no strategic vision for its foreign policy.[18]

For a long time, India was able to cloak its interest-based short-term decisions governing its international relations in pronouncements setting itself on a high moral plane above the hard calculus of the Cold War's reductive struggle between opposing ideologies. In fact, Nehru improvised thoughtfully and with considerable flexibility as foreign policy challenges claimed his attention, mostly by lucidly assessing the scope of action afforded by available means to shape India's often shifting ends. Indira Gandhi also improvised, but found her margin of manoeuvre constricted by circumstances and some of her own mistakes. Non-alignment did not represent much of an ideology, but it allowed India (and many others, each interpreting the concept in its own way) to multiply its options. Sociologist Dipankar Gupta notes: 'Much of what India does in terms of diplomacy actually depends on a peculiar combination of memories of hurt and the desire to be recognised. That is why we are usually reacting to issues and rarely ever setting the stage, or the terms of reference for international relations. There is more "tactic" than "strategy". Indeed, the Indian foreign office's long institutional memory may keep it from thinking imaginatively.'[19]

The cacophony of Indian debate, the frequent contradictions in Indian official pronouncements, and the wealth and diversity of Indian commentary defy easy

---

[16] See M. Vidyasagar in 'A Nuclear Power by any name', *Pragati* (1 January 2010).
[17] Srinath Raghavan, 'Virtues of being vague', *The Asian Age* (8 January 2010).
[18] See George K. Tanham, *Indian Strategic Thought: An Interpretive Essay* (Santa Monica: Rand, 1992).
[19] Correspondence with the author (3 May 2010).

generalisations about either strategic thought or its close cousin, wider foreign policy. This bothers few Indian practitioners: the country's foreign policy is not formulated for the convenience of analysts or of armchair strategists.

And is the lack of a clear framework necessarily a bad thing for India? Not necessarily. Efforts by political leaders the world over to lay out their distinct foreign policy orientations invariably wind up being torpedoed by unexpected events, insufficient resources, short attention spans and frequently embarrassing incompetence at many levels of government. This was the case for both US Presidents Clinton and George W. Bush. Zubin Mehta comments on the discrepancy between grand strategies and the instruments available to states in order to achieve them: 'The strategy is often determined by assumptions about their own power – in reality the power of power is often overestimated. In this sense grand strategy can be more a potentially illusory statement of objectives, than a feasible plan of action.'[20]

Efforts to lay out in great detail a compendium of objectives, policies and proposed actions in 'foreign policy reviews' and in 'white papers' in Western countries invariably pall within months as fantasy meets hard reality. As time passes, there is generally a wide gulf between stated intent and actual performance.

The Neighbourhood

India's global role remains constrained by its unsatisfactory regional dispensation. The violent end of British Imperial India yielded enduring and corrosive divisions that the region has not yet fully learned to live with, and on which India has, by and large, failed to lead imaginatively or strongly. Most Indian prime ministers have inclined more towards domestic consensus-building than bold regional initiatives. As it seeks to reach beyond its own region, an emergence welcomed by most of the world, it runs the risk of leaving its own neighbourhood an orphan lacking for vision and leadership, a risk that is greater insofar as its neighbours are all too often hostile. Actively undermining creative approaches to the region has been India's dynamic, knowledgeable, but deeply conservative security establishment. In any event, as Christophe Jaffrelot comments: 'India's aspiration to be recognised as a global player is not only due to an obvious pull factor, global power, but also to a push factor, that of escaping its region, South Asia, where it is surrounded by quasi-failed states, civil war-torn countries, guerrilla-plagued societies and overtly antagonistic governments which tend to join hands against New Delhi, making SAARC (South Asian Association for Regional Cooperation) a non-functioning entity. But neither Pakistan, nor Nepal will allow India to ignore them.'[21]

India traditionally has been averse to outside intervention in the region, but it has become more flexible in recent years, reluctantly accepting an active if limited UN political role in

[20] Correspondence with the author (6 April 2010).
[21] Correspondence with the author (20 June 2010).

Nepal's complex domestic affairs, and essentially welcoming US and NATO (North Atlantic Treaty Organization) involvement in Afghanistan. On Afghanistan, New Delhi radiates apprehension. It worries that, in Afghanistan, Pakistan may get the better of the US, pocketing its financial and military aid while undermining any prospect of a genuinely independent government in Kabul. On Pakistan, it understands that a failed state is not in its own interests but fears a stronger hostile neighbour (even though a stronger, more confident Pakistan might be more readily able to settle its differences with India). Despite Pakistan's provocations, it would doubtless serve India well to reach out, explain itself better to Pakistanis, and take more of the 'risks for peace' of which past leaders in the Middle East used to speak. If India were to do so, perhaps Washington would be more inclined to spend its ultimately limited capital in Islamabad by pressing that capital to meet New Delhi halfway.

Significant forces favouring inertia are at play. Few politicians publicly advocate accommodation of Pakistan in any concrete form (although some do so in private). Further, the standoff between the two countries benefits a number of state actors in Pakistan, notably the armed forces and the intelligence community. Dialogue between the two countries, which is often interrupted by security incidents, should be structured in such a way that it is mostly insulated from incidents of terrorism or other serious 'bumps in the road', rendering it, in the words of Mani Shankar Aiyar, 'uninterrupted and uninterruptable'.[22] Easier said than done, given political pressures and intermittent policy leadership in both countries at best.

China has been more helpful than not to India at moments of high tension with Pakistan in recent years, remaining studiedly neutral during the Kargil episode of 1999 and making clear privately at the UN that it did not support Pakistan's resistance to international interest in the role of its citizens following the 2008 Mumbai attack. Indeed, China is not in an entirely comfortable position vis-à-vis Pakistan, having empowered it over many years, not least with nuclear technology, only to see the country spawn ever more Muslim extremism, which is hardly to China's taste. Nevertheless, in the complex geostrategic games afoot in Asia, the China-Pakistan alliance is likely to endure, while China also mostly accommodates India's rise.

India's evolving relations with other South Asian states range from the serene (with the Maldives and Bhutan) to improving (with Bangladesh) to often tense under a veneer of comity (with Sri Lanka and Nepal). Forward momentum will, in every case, breed rewards. India's benign (if economically and geostrategically self-interested) approach to Bhutan could serve as a model, albeit one that is not easily replicated in its specifics, for its relations with others in its periphery.

The difficult challenge India faces in Myanmar of protecting its interests in and relationship with the country, at a time when the weight of China is marginalising all other international actors there, evokes sympathy. Nevertheless, India can do more to reflect its own political

[22] Correspondence with the author (24 June 2010).

and societal values in its stance vis-à-vis Naypyidaw, rather than seeking to occlude all possible bilateral differences in the relationship. Myanmar, which needs to retain more strings in its international relations fiddle than Chinese strategic and Thai business interests, needs India nearly as much as New Delhi needs it.

Three issues or relationships seen as essentially regional in international circles may warrant more detailed comment.

Kashmir

Kashmir is widely seen as an international issue in dispute between Pakistan and India on which foreign parties can succeed only in offending one side or the other, if not both. India remains very sensitive to outside intrusion on the issue, as foreign involvement conflicts with its position that the topic must remain a strictly bilateral one. It has remained so with dismal results for many years.

Rash as it is for a foreign voice to express any views on the topic, it may suffice to suggest that India could change the game on its own terms by seeking radically to improve the living conditions of the inhabitants of the Kashmir valley and its environs. Timid measures to de-escalate India's security deployment in Kashmir were trumpeted in 2009 and 2010, but, on such a scale, little was achieved. Moreover, impunity for the security forces in Kashmir remains worryingly prevalent.[23]

An effort to re-imagine Indian Kashmir as the proud and prosperous place that it was for so much of its history, rather than as a security problem to be met with overwhelming force, might well prove salutary. India's alluring freedoms, including for women, would doubtless appeal to young Kashmiris, given a chance.

Of course, any relaxation of security control over the Kashmir valley and its surrounding areas could be interpreted as a threat to their *raison d'être* and as an invitation to respond by Pakistan-based militants. Further, Indians are used to thinking of Kashmir as both the central prize up for grabs, and a pawn in the India-Pakistan relationship. The notion of bold unilateral action – without any reward from Pakistan – to give effect to the autonomy the Indian constitution promises the region strikes a number of Indians as foolish at best.

Nevertheless, such a unilateral step would give Pakistan much to think about while New Delhi experiments with exchanging its ever-present 'red lines' for green lights.

[23] See Siddharth Varadarajan, 'This is not zero tolerance, Mr. Prime Minister', *The Hindu* (4 June 2010).

Afghanistan

At the time of writing, Afghanistan has become a conundrum for India. The Soviet invasion of the country in 1979, to prop up an unpopular communist regime in Kabul, was an embarrassment for New Delhi in view of its close ties to Moscow. After the Taliban's accession to power in Kabul, the hijacking of Air India flight 814 in December 1999, resulting in serial climb-downs by India to secure the release of hostages, reinforced the conviction in India that a radical Islamist regime in Afghanistan was a dagger pointed at its own heart. It thus welcomed the rout of Al Qaeda and the Taliban following the events of 11 September 2001, and invested heavily thereafter in President Hamid Karzai.

However, by 2010, the NATO forces propping up Karzai's government in Kabul were facing determined opposition from a resurgent Taliban with whom some in NATO, notably the UK, were increasingly inclined to negotiate a degree of power-sharing in Kabul. For India, whose embassy and nationals in Afghanistan were subjected to frequent attacks, and which was rarely consulted by NATO countries, the options were unattractive. The US wavered dangerously between praise for the risks India was taking in order to help Afghanistan and its willingness to accommodate Pakistan by signalling that it might be useful for Indian friends to lower their profile in that country.

The likelihood of at best a hybrid regime in Kabul with strong links to Islamabad, possibly resisted by a revival of the 'Northern Alliance', raised the possibility in the minds of some Indian and international strategists of a return to the dispensation of the 1990s (with forces in Afghanistan's northern provinces to be supported by India, Russia and, perhaps, Iran). Thus, India consulted conspicuously on Afghanistan with Russian Prime Minister Vladimir Putin during his visit to India in early 2010. Pointing to India's currently limited options in Afghanistan, Pankaj Mishra notes that, given New Delhi and Islamabad's reciprocal suspicions, 'India may have miscalculated in Afghanistan, now that not only Obama wants it to be discreet but Karzai himself has decided he will have to trust Pakistan to stabilise southern Afghanistan.'[24]

However, in a country such as Afghanistan, given to sudden shifts of mood and perspective, New Delhi's prospects could improve suddenly in the months and years ahead, depending in part on Pakistan's future path.

China

As Nehru had hoped, India and China today work alongside each other and frequently partner on multilateral issues such as climate change, more than either country might have expected only a few years ago, and this in spite of their border dispute and fears of mutual

[24] Correspondence with the author (20 June 2010).

encirclement.[25] Both countries have moved, in the words of Commonwealth Secretary-General Kamalesh Sharma, from the international status of 'demandeurs' to that of 'demandees', of whom the global system wants policy decisions and actions.[26] But as argued by Shyam Saran, India is enjoying 'premature' power, akin to 'being dealt a hand in the geopolitical game, but refusing to play'.[27] The same might be said of China.

The two countries are, of course, profoundly different in their political and economic systems, and it is the asymmetry between them that is often most striking, not least China's advance on India to date (that some, with strong arguments, are convinced will be reversed in the decades ahead).[28] In international economic relations, China's model is essentially mercantilist while India allows the impulses of its private sector to predominate.

In the wake of the financial and economic crisis of 2008-09, the notion that power is shifting from West to East became fashionable beyond what prophets of this view, like the compelling Kishore Mahbubani, had earlier argued. Lost in this new consensus, however, is the reality that India and China will need to accommodate each other and actively cooperate on some issues, rather than compete head-on for power, if the prediction is to come true.

This is possible on a range of issues. Both countries fear Islamic extremism and although each will tackle it in its own way domestically, their shared anxieties could breed deeper cooperation internationally. Both countries have been more 'rule takers' than 'rule makers' internationally, but they share an interest in the enforcement of a number of those rules, in areas such as piracy (where each has cooperated further to a UN call for action against attacks on commercial traffic through the sea-lanes near Somalia).[29] But cooperation will not be instinctive. Princeton University scholar Rohan Mukherjee comments: 'India's competition with China is not just economic or geo-strategic; in a sense it is existential – a clash of two competing political systems, bases of state legitimacy, and ways of ordering state-society relations.'[30]

China and India today are straining to advance and protect their own interests without upending global rules. At the conclusion of his excellent book *Rivals*, which also discusses Japan, Bill Emmott, former editor of the *Economist*, writes: 'How will the Asian drama end? The answer is that it won't: it is now going to be a permanent feature of world affairs, and arguably the most important single determinant of whether those affairs proceed peacefully

[25] On the great encirclement debate, see P.S. Das, 'India and the Indian Ocean Littoral: Opportunities and Challenges', *Indian Foreign Policy Journal*, Vol.4, No.4 (October–December 2009), pp.1-32.
[26] Correspondence with Kamalesh Sharma (16 July 2010).
[27] Shyam Saran, 'Premature Power', *Business Standard* (17 March 2010).
[28] See a striking presentation by Arvind Virmani, (10 March 2010), http://info.worldbank.org/etools/docs/WBI videos/avirmani/avirmani.html. Accessed on 5 June 2011.
[29] The idea of Asians as 'rule takers' rather than 'rule makers' is one that Ramesh Thakur has frequently developed. For example, see Ramesh Thakur, 'Law, Legitamacy and United Nations', *Melbourne Journal of International Law* (2010), http://www.austlii.edu.au/au/journals/MelbJIL/2010/1.html. Accessed on 28 June 2011.
[30] Correspondence with the author (27 July 2010).

and prosperously or not. The drama will pit new, rising powers against the world's long-established powers in America and Europe; and it will pit Asia's new powers against each other and against the region's first modernizer, Japan. In economics and business, the competition will have overwhelmingly positive results. In politics, we cannot be so sure.'[31]

Values and Soft Power

India's growing belief that the political values enshrined in its constitution, which the country tries hard to live up to within its borders, can make it attractive to others – the 'soft power' of its democracy, its multi-ethnic make-up, the vibrancy of its civil society and the fierce freedom of its press – is well founded. Indeed, the struggle for development, justice, adequate representation and respect that lies at the heart of Indian politics can be recognised anywhere in the world as both familiar and positive. However, for now, rather like China, it prefers to avoid unnecessary controversy with its neighbours, even ones whose behaviour can be repugnant to large numbers of Indians, in order to get on with the country's own development and the gradual rise of its global influence.

Given its noisy democracy, India has found it very challenging to build domestic political support for foreign policy initiatives purely by invoking the argument of power. The argument of national interest is more compelling to Indians. But New Delhi has also continued to need a set of values and norms to justify its actions on the world stage. As a consequence the tension between 'power and principle' remains an enduring one in India's foreign policy strategy. Nevertheless, India's democratic credentials and values are unlikely to be subordinated to key strategic interests – the principal insight of a useful recent volume by S.D. Muni on the democracy dimension of India's foreign policy.[32]

India, like China, has generated a significant global diaspora, estimated at 25 million, that plays a strikingly limited role in the country's life. But non-resident Indians (NRIs) play an important role at all levels of international business and increasingly in political life. The role of Indian-Americans in not only creating synergies for trade, investment and technology transfers between the US and India, but also in mobilising political support for a profound shift in US policy towards India from the 1990s onwards is one notable example. And India is the largest recipient of remittances in the world, receiving US$43 billion in 2008.[33]

[31] Bill Emmott, *Rivals: How the Power Struggle between China, India and Japan will Shape Our Next Decade* (London/New York: Allen Lane, 2008), p.274.
[32] S.D. Muni, *India's Foreign Policy: The Democracy Dimension* (New Delhi: Foundation Books, 2009), pp.125–39.
[33] Government of India, Ministry of Overseas Indian Affairs, *Annual Report* 2008–2009, http://moia.gov.in/writereaddata/pdf/Annual_Report_2008-09.pdf. Accessed on 28 June 2011.

Despite this, and recent efforts to make leading NRIs more welcome in policy circles, India, like other countries with large and successful diasporas, does not wish to be unduly influenced by them.

Engaging the World

India's capacity to play on its power of attraction is significant. Yet, its international influence and acceptance in the halls of power remains tentative. This may have to do with the flipside of the warmth and intelligence of so many Indians – an overinflated desire, sometimes insistence, on winning every argument and, if this cannot be achieved, a disposition to obstruct. Domestically, this leads to the Indian government being under much media, parliamentary and consequently sometimes even public pressure to 'say no', in key negotiations with China, Pakistan and the US.

A seeming reluctance *a priori* to be 'part of the solution', as Prime Minister Singh argued India should be on climate change in 2009, doubtless stemmed in large part from India's colonial experiences and its weak negotiating position during the early decades of independence. With impressive Indian economic accomplishments in recent decades, the global success of its artists and writers, and much else to its credit, a more self-confident approach by New Delhi internationally would now seem in order, with Indian creativity at the service not only of its own interests but also of wider stewardship of international management of global challenges.

India, in much of the world, beyond continuing associations with grinding poverty, evokes the glamour of its past, the grandeur of its monuments, the glory of its colours and Himalayan peaks, all of which conveyed to great effect in the country's highly successful 'Incredible India!' tourism promotional campaign. All of these Indian particulars deserve their place in the world's imagination. India has also worked hard to superimpose on these characteristics international understanding of a more modern, private sector-driven country featuring fast growth, groundbreaking service and high-tech industries, and a 'can do' spirit among its young professionals and corporate leaders. Although this has worked, up to a point, there is no sense yet of an overall Indian project – as there is with China's relentless drive towards modernisation and growth. And non-stop reports of government-related mismanagement (eg., of preparations for the Commonwealth Games of 2011) and alleged gross corruption (eg., on access to telecommunications bandwidth) exact a serious toll on India's international standing.

Sophisticated commentary on foreign relations is increasing as some of India's smartest younger scholars choose to return to India rather than to ply their trade in the great universities and research institutions of the West. This yields the added benefit of relieving the excessive weight that retired officials have played (by default) in commenting in the media on policies they helped shape.

Global Burden-sharing

Now that India is, on the strength of its economic successes, taken seriously by other major global players, it will need to grapple with whether, when, how and in what proportions it can and wants to share global burdens, such as the fight against climate change. This dilemma is at the nub of India's discomfort in discussion of the issues at the international level. In 2009, Prime Minister Singh and India's Environment Minister Jairam Ramesh made clear that India must act for its own reasons to curb pollution of various sorts in India and accept that India (like several of its neighbours) is threatened by global warming patterns. As opposed to the Copenhagen circus that unfolded in 2009, thinking globally and acting locally without engaging in treaty-making and binding international obligations may well be the path forward internationally. At the same time, the complex minuet in which India engaged prior to Copenhagen, seeking to placate domestic nationalists while striking a more open pose internationally, cannot be replicated indefinitely. For an emerging economic power to shelter itself behind appeals to its own poverty and a purported common line with other developing countries is not only ineffective, but also, perhaps, somewhat unworthy.

By underwriting an official assistance programme for neighbouring countries and some other purposes, by volunteering for dangerous peacekeeping duties abroad and, at the policy level, by contributing to G-20 policy commitments, India signals that it is not inherently obstructionist. Rather, it makes a meaningful mark on collective international efforts. The step from here to taking on more extensive obligations is one that cannot be forced on India by external actors. It is one that India must want to execute. The day when India takes this step may not be far off.

Envoi

India's diplomacy often has been understandably focused on issues of status. Today, because its growing significance is universally recognised, both its contributions and its objectives are more likely to be rewarded if pragmatically advanced than if done so on the basis of entitlement. Shyam Saran comments: 'India's relative power has outstripped the indices of personal and social well-being, unlike in the established industrialized powers where they have historically moved in sync. We will need to overcome the ambivalence this creates and embrace a more proactive regional and global role in line with our national power. A seat at the high table should be sought not as an end in itself, but as an opportunity to negotiate arrangements conducive to our economic and social development ...'[34]

---

[34] Shyam Saran, 'Premature Power', *Business Standard* (17 March 2010).

India today advocates no particular ideology beyond the assertion of national self-interest generally focused on the economic sphere. Given the recent splintering of international relations into a genuinely multi-polar system and the acceleration of change in the relative weight of contending powers, India will likely continue to organise its diplomacy through issue-driven ad hoc coalitions and in some cases evanescent groupings of countries. While it is often associated with China, Brazil and South Africa, it will, when its interests dictate, disagree with them publicly. A recent example was its decision in April 2010 to join Brazil in criticising China's exchange rate policies.[35] More widely, while seeking to advance its interests and increase its influence globally, it is likely to continue to engage in a 'hedging strategy' between other significant powers.[36]

One welcome by-product of altered global circumstances and of India's own rise is that New Delhi is much less likely to indulge in a spoiler role. Sunil Khilnani argues that India's approach, precisely because it is iterative and rests on no particular conception of power, will likely take shape in an unsystematic way. He believes, rightly in my view, that India's greatest asset remains its 'accumulated political legitimacy' rather than any hypothetical or real accumulation of power.[37]

Time and history are on India's side as it struggles to recover from several centuries of foreign domination and its consequences. Its re-emergence, particularly if it manages its significant domestic challenges with success, will be one of the major shifts of the 21st century. It will have been hard won and should gladden both students of history and of foreign affairs the world over. Twenty or 30 years from now, the tentative, contingent nature of many of my judgements today may well seem over-cautious. I certainly hope so.

. . . . .

[35] Geoff Dyer, 'Brazil and India join renminbi protests', *Financial Times* (22 April 2010).
[36] From a speech by Shyam Saran at the India Habitat Centre (26 April 2010).
[37] Correspondence with the author (6 April 2010).

ISAS Working Paper

No. 131 – 1 September 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

How Well Has South Asia Coped With the Global Financial Crisis: Monetary Management, Regulation and Market Discipline

D. M. Nachane
and
M. Shahidul Islam[1]

Abstract

The global financial crisis affected most economies primarily through three channels–declining trade volumes, exchange rate pressure and asset deflation. The paper focuses on the impact of the crisis in the four major economies of South Asia viz. Bangladesh, India, Pakistan and Sri Lanka and how by a combination of swift actions on the monetary, fiscal and exchange rate fronts the worst consequences of the crisis were averted. The regulatory and supervisory systems in these four economies are then benchmarked against certain desirable norms, which have emerged out of post-crisis international deliberations. It is felt that South Asian regulatory systems perform fairly well vis-à-vis these norms. The paper also discusses three major unresolved issues on the regulatory and supervisory dimensions. With regard to the Principles versus Rules-based regulation controversy, it recommends that a more promising and safer course of action would be to make the existing (rules-based) system more flexible and dynamic. Secondly, with a view to strengthening market discipline, several new initiatives seem to be in order, the most important being the switchover to a risk-based premium of deposit insurance. Finally, the paper discusses the crucial issue of independence of regulators and supervisors from official (government) interference and

[1] D. M. Nachane is Professor Emeritus and former Director of the Indira Gandhi Institute of Development Research, Mumbai. He is also an Honorary Senior Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore. M. Shahidul Islam is Research Associate at ISAS. D.M. Nachane can be contacted at nachane@gmail.com and M. Shahidul Islam at imonsg@gmail.com. The views expressed are those of the authors and do not necessarily reflect the views of the Institute.

market "noise", in executing their mandate of financial stability. The authors are of the view that the future success of financial reforms in South Asia will be crucially contingent upon how successfully the regulatory architecture adapts to the twin dictates of financial development and financial stability, the extent to which market discipline can be usefully deployed as a pillar to support this architecture; and the degree to which regulatory and supervisory independence is not compromised.

I. Introduction

In recent years, there has been a marked shift in attitude towards financial development among economic growth theorists. The earlier scepticism on the role of financial development for economic growth[2] has given way to a growing realisation that financial markets and institutions play a defining role in the economic evolution of societies. Empirical evidence based on both cross-country as well as micro-level studies lends support to the view that financial development crucially affects the speed and pattern of economic development. The financial system is traditionally viewed as performing the following five functions (see Levine (1997), Archer (2006), etc.)[3]: (i) allocating resources; (ii) mobilising savings; (iii) expanding goods and services markets; (iv) facilitating risk pooling, hedging and diversification; and (v) monitoring managers and exercising corporate control. To this list one must append an extra function, which has assumed a great deal of importance in recent years in least developed countries (LDCs) and emerging market economies (EMEs), viz., (vi) providing credit to the informal sector (rural as well as urban) via microfinance institutions.

However, even within the broad consensus of recognising the role of financial systems for economic development, important areas of disagreement persist, viz., the type of financial system most conducive to growth, private versus public ownership of financial institutions, the degree of regulation and supervision, the role of financial innovations and the pace and extent of financial liberalisation. The Latin American crises of the 1980s and 1990s, the Asian financial crisis of the late 1990s and the current global recession have once again brought the critical role of financial institutions under the scanner, and introduced important caveats to the consensus. The present paper aims to take stock of some of these issues in the South Asian context. While it is certainly not being claimed that the South Asian experience is representative of EMEs in general, it is nevertheless felt that some of the lessons drawn here would have some relevance transcending their immediate context.

[2] Several well known tracts on development economics, for example, frequently make no reference to the financial system at all. See Meier, G. & D. Seers (1984) (Ed.), '*Pioneers in Development'*, Oxford Univ. Press, New York, Stern, N. (1989) 'The Economics of Development: A survey' *Economic Journal*, vol. 99, p. 597-685.

[3] Levine, R. (1997), 'Financial development and Economic Growth: Views and Agenda', *Journal of Economic Literature*, Vol. XXXV, June, p. 688-726.

The rest of the paper is organised as follows. The next section examines the financial system in four South Asian economies, viz., India, Pakistan, Bangladesh and Sri Lanka. The macro-economic management in South Asia during the recent global crisis is discussed in section three. The fourth section is devoted to a study of the region's regulatory and supervisory response to the financial crisis. Three major regulatory and supervisory issues—principles versus rules-based supervision, role of market discipline in financial regulation and regulatory and supervisory independence—are examined in section five. The final section provides some concluding remarks.

II. South Asian Financial System: A Helicopter Overview

<u>Indian Financial System: Major Highlights</u>

The financial system in India comprises the Reserve Bank of India (RBI) at the apex, numerous financial intermediaries, money market, debt market, foreign exchange market and equity market. Financial intermediaries include commercial banks, co-operative banks and non-bank financial institutions (NBFIs). Commercial banks constitute the largest segment of India's financial system and a characteristic feature of this sector is the dominance of the public commercial banks (PCBs) both in terms of branch offices and banking operations. Other types of banks include regional rural banks, local area banks and co-operative banks. Co-operative banking is also an integral component of India's banking system. It comprises two major segments, viz., urban co-operative banks (UCBs) and rural co-operative credit institutions (RCCIs). Of these, RCCIs have a far more extensive branch network and a more diverse and complex structure than UCBs that maintain a single-tier structure. NBFIs are an important segment of India's financial system, embracing a heterogeneous group of diverse institutions, including development finance institutions (DFIs), insurance companies, non-bank financial companies (NBFCs), primary dealers (PDs) and capital market intermediaries such as mutual funds. NBFIs offer a variety of products and services which play an important role in providing access to financial services to a vast section of the population. Recent years have also witnessed a phenomenal growth in the number of microfinance institutions (MFIs).[4] The RBI plays an instrumental role in the Indian financial sector. Being the country's monetary authority, it formulates, implements and monitors India's monetary policy. As a prime regulator and supervisor of India's financial system, it uses and prescribes broad parameters of banking operations within which the country's banking and financial system functions. The RBI supervises, among others, commercial banks, cooperative banks, development finance institutions (DFIs) and non-banking financial companies (NBFCs). Through its monetary policy, it aims to secure stability in the internal and external value of

[4] Nachane and Islam (2010), 'Financial Sector Reforms in South Asia - A Perspective' in *South Asian Perspectives* (Singapore: Institute of South Asian Studies, January 2010).

the Indian currency and manages the foreign exchange market. It is also the banker to the government. It provides merchant banking services to both the central and state governments. The RBI also does other traditional central banking activities such as currency issuance and promotional functions, etc.

Till the early 1990s, the Indian financial system was characterised *inter alia* by administered interest rates guided by social concerns, high intermediation costs, low base of capital, directed credit programmes for the priority sectors, high degree of non-performing assets, low intensity of technologies, stringent entry barriers for new entrants, and excessive regulations. Since the early 1990s financial sector reforms have been initiated with the explicit objective of developing a market-oriented, competitive, well-diversified and transparent financial system. Financial liberalisation [5] was viewed as an integral component of overall liberalisation, with the twin belief that (i) liberalisation in the real sector could not proceed satisfactorily in the absence of financial liberalisation, and (ii) financial liberalisation was an 'enabling condition' of faster economic growth, as it increases competition, transfer of know-how and transparency. Recent studies such as those by Rodrik et al (2002), Alcala & Ciccone (2004) and Kaufmann et al (2007)[6] clearly indicate the importance of institutional features such as corruption, rule of law and general governance issues (such as political accountability, quality of bureaucracy, etc.) in determining whether the outcomes of financial liberalisation would be beneficial or otherwise. This could be an important part of the explanation as to why liberalisation usually succeeds in developed countries but often fails in the developing world. Some of the deficiencies noticed in the outcomes associated with the financial liberalisation programme in India are attributable to the above factors (though formal studies seem to be lacking in this aspect).

In broad terms, the financial sector reforms encompass six areas: (i) removing the restrictions on pricing of assets; (ii) building of institutional and technological infrastructure; (iii) strengthening the risk management practices; (iv) fine-tuning of the market microstructure; (v) changing the legal framework to remove structural rigidities; and (vi) widening and deepening the market with new participants and instruments. (For an extended review and critique of this process refer to Nachane & Islam (2010).)[7] An idea of the evolution of the financial sector in India can be gained from a look at at a few basic indicators. The size of the

[5] The process of financial liberalisation is usually viewed as encompassing four dimensions- (i) financial deregulation, *(*ii) financial innovation, *(*iii) market making, and (iv) financial supervision.

[6] Rodrik, D., A. Subramanian and F. Trebbi (2002), 'Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development', *NBER Working Paper 9305.*
Alcala, F. and A. Ciccone (2004), 'Trade and Productivity', *Quarterly Journal of Economics,* vol. 119 (2), p. 612-645. Kaufmann, D., A. Kraay and H.Mastruzzi (2007), 'Governance Matters VI: Governance Indicators for 1996-2006' *World Bank Policy Research Discussion Paper 4280.*

[7] Nachane and Islam (2010), 'Financial Sector Reforms in South Asia - A Perspective' in *South Asian Perspectives* (Singapore: Institute of South Asian Studies, January 2010).

financial system (S)[8] in India has nearly doubled from 1.69 in 2000 to 3.33 in 2008, having overtaken not only China (with a value for the ratio S of 3.00 in 2008) but also advanced economies like the US (3.24), UK (2.74), Japan (2.77) and South Korea (2.54).[9] Other notable features of the Indian financial system are that banks form the major source of corporate finance (thus resembling the German rather than the US pattern)[10] with public ownership the dominant structure.[11]

It is also a highly concentrated financial system with the top (by asset size) five banks accounting for about 38 per cent of the total banking assets -- a figure that has remained more or less unchanged over the past decade.[12] For details see Figure 1-3 and Table 1 for the banking and non-banking financial system of India and other South Asia economies.

<u>Pakistan's Financial System: A Brief Overview</u>

The financial system in Pakistan comprises the State Bank of Pakistan (SBP) at the apex, various financial intermediaries, the money market and the capital market. Financial intermediaries include commercial banks and NBFIs. Being the country's central bank, the SBP regulates and supervises Pakistan's banking sector along with all NBFIs, except for *mudarabahs*[13] and leasing companies. It conducts monetary policy, and manages public debt and foreign exchanges. It is also the banker to the government and performs other traditional central banking functions.

Banks, with a combined share of 72 per cent in total assets, dominate the asset base of Pakistan's financial sector. NBFIs are classified into eight different groups of institutions,

---

8 S is defined as $S = \frac{\lfloor CBA+MC+B \rfloor}{GNP\ at\ market\ prices}$ (where CBA represents commercial banks' assets, MC is equity market capitalisation and B stands for bonds outstanding).

9 This is not as counter-intuitive as it seems – much of the paradox being explained by India's relatively low GNP. For example US commercial banking assets in 2009 were about 15 times those of India's whereas those for UK were about four times the Indian figure.

10 Of the total non-food lending to the commercial sector in 2010-11, banks accounted for 58.12 per cent, while the respective shares of domestic non-bank and foreign non-bank sources were 25.37 per cent and 16.50 per cent, respectively. Further, within the domestic sector the share (as a percentage of total commercial sector credit) of equity (public offerings plus private placements) was 7.59 per cent, the share of non-banking finance companies (and housing companies) was 8.79 per cent, that of large all-India financial conglomerates (such as NABARD, NHB, LIC, etc.) was 6.26 per cent, while CPs accounted for a minuscule 2.76 per cent (see Table IV.10 in the Reserve Bank of India (2011), 'Macroeconomic and Monetary Developments in 2010-11'.

11 The share of public sector banks' assets as a percentage of the total banking system's assets has come down from 80 per cent in 2000 to about 69 per cent in 2009. Foreign banks' assets as a percentage of total bank assets are marginal at 8 per cent (as of 2009), having risen slightly over the last decade (the 2000 figure was at 7 per cent).

12 Similarly, the share of the top five listed companies in equity market capitalisation has been more or less constant over the last decade at around 29 per cent.

13 A *mudarabah* is an investment partnership, whereby the investor (the *rab ul mal*) provides capital to another party/entrepreneur (the *mudarib*) in order to undertake a business/investment activity. While profits are shared on a pre-agreed ratio, loss of investment is borne by the investor only and the *mudarib* loses its share of the expected income.

namely, DFIs, investment banks, leasing companies, mutual funds, housing finance companies, discount houses, *mudarabahs* and venture capital companies. Pakistan has a vibrant equity market and the size of the market capitalisation is about 20 per cent of the country's GDP. Figure 1-3 and Table 1 show the state of the banking and non-banking financial system of Pakistan and selected economies.

The supervision of the financial sector in Pakistan has been invested with two regulators, namely the SBP and the SECP. Until December 2002, the SBP was responsible for regulating both the scheduled banks and the NBFIs. However, the SECP's responsibilities overlapped with those of the SBP in some circumstances. Subsequently, the SECP, which was initially concerned with the regulation of the corporate sector and the capital market, was also empowered to supervise the NBFIs (except DFIs and House Building Finance Corporation) from December 2002. In addition, the SECP has been empowered to oversee various corporate and financial-sector service providers, including chartered accountant firms, credit-rating agencies, corporate secretaries, brokers and surveyors.

The financial sector restructuring programmes in Pakistan started in the late 1980s with the twin objectives of strengthening the existing financial institutions, on the one hand, and developing an efficient financial system, on the other. The reform programmes focused on, *inter alia*, privatisation of public sector banks, licensing of new commercial banks, mergers and acquisitions of various financial institutions, rationalisation of interest rate structures, non-performing loan (NPL) resolution, monetary and credit management, current and capital account liberalisation, capital market development, and autonomy of the SBP and its restructuring. (For an extended review and critique of this process see Nachane & Islam (2010).[14]

Bangladesh's Financial System: Salient Characteristics

The financial system of Bangladesh comprises the Bangladesh Bank (BB) at the apex, numerous financial intermediaries, the money market, the debt market and the stock market. Financial intermediaries include commercial banks, specialised banks, NBFIs and MFIs, the last constituting a very special feature of the Bangladesh financial system. The BB, being the central monetary authority of Bangladesh, performs most of the traditional functions of a central bank such as the supervision and regulation of banks and NBFIs, formulation and implementation of monetary policy, management of foreign exchange reserves, and note issuance, besides being the banker to the government.

The financial sector in Bangladesh is highly bank-dominated. NBFIs are an integral part of the financial system of Bangladesh consisting of investment, finance, leasing companies, etc.,

[14] Nachane and Islam (2010), 'Financial Sector Reforms in South Asia - A Perspective' in *South Asian Perspectives* (Singapore: Institute of South Asian Studies, January 2010).

with their operations regulated under the Financial Institutions Act, 1993. MFIs are one of the fastest growing financial intermediaries in Bangladesh, offering micro-credit programmes (MCPs) to approximately 25 million borrowers, located primarily in the rural areas. These micro-credit programmes are implemented by various formal financial institutions, viz., nationalised commercial banks, specialised banks, specialised government organisations and semi-formal financial institutions that include nearly 1,000 NGO-MFIs. The insurance markets in Bangladesh remain small which is regulated under the Insurance Act. Equity market listings and capitalisation in Bangladesh have grown markedly in recent years but account for only 8 to 10 per cent of the country's GDP. Figure 1-3 and Table 1 show the state of the banking and non-banking financial system of Bangladesh and selected economies.

The BB assesses the performance and soundness of the banking sector under the CAMEL framework, which involves analysis and evaluation of the five crucial dimensions of banking operations, namely capital adequacy, asset quality, management soundness, earnings and liquidity. An early warning system (EWS) was introduced in 2004 to streamline the BB's supervision of banks under threat of incipient crises. Measures have been undertaken to beef up risk-based supervisions.

The liberalisation process in the financial sector started in the 1980s with the privatisation of two NCBs. The reform programmes initiated under various auspices focused on several dimensions, most notably privatisation of state-owned banks, recovery of NPLs, interest rate deregulation, increasing autonomy of the BB, enhancing prudential regulation and supervision, rationalisation and merger of bank branches, and effecting improvements in the money and debt markets. For an extended review and critique of this process see Nachane & Islam (2010).[15]

<u>Sri Lanka's Financial System: Basic Features</u>

The financial system in Sri Lanka comprises the Central Bank of Sri Lanka (CBSL) at the apex, numerous financial intermediaries, the money market, the bond market, the foreign exchange market and the equity market. Financial intermediaries include licensed commercial banks (LCBs), licensed specialised banks (LSBs), registered finance companies, specialised leasing companies (SLCs), authorised PDs, insurance companies and venture capital companies.

The task of supervising and regulating banks, finance companies, leasing companies and primary dealers is vested in the CBSL. The Securities and Exchange Commission of Sri Lanka is responsible for supervising the stock exchanges, stock broking and dealing firms, unit trusts, venture capital companies, investment managers, margin providers and credit-

[15] *Ibid.*

rating agencies. The major objectives of the CBSL are primarily two-fold, viz., maintaining economic and price stability, and stability in financial markets. But as with most other central banks, it performs a host of other functions including currency, foreign exchange and public debt management.

LCBs dominate Sri Lanka's banking sector. NBFIs constitute only a small segment of the country's financial system. Sri Lanka has a sizable equity market. Figure 1-3 and Table 1 show the state of the banking and non-banking financial system of Sri Lanka and selected economies.

The CBSL supervises banks and other financial institutions based on a two-pronged approach of off-site and on-site surveillance. Under the off-site surveillance system, the financial condition of LCBs and LSBs is monitored on the basis of a few selected variables.[16] Off-site surveillance works as an early warning system in identifying significant and critical changes in the financial condition of banks, which might require further investigation and examination. On-site supervision is a risk-based examination process, which focuses on identification of banking risks, management of these risks and assessment of adequacy of resources to mitigate these risks, which is supplemented by an examination based on the internationally accepted CAMELS model.

The financial sector reforms in Sri Lanka can be divided into two phases: the 1977-88 period and the post-1989 period. The first phase of reforms focused on banking sector reform, interest rate deregulation and foreign exchange market liberalisation. The reform process was flagged off in 1979 with the removal of operational restrictions on foreign banks. The period also witnessed an expansion of bank branches and, additionally, several new banks and credit institutions were set up in the 1980s. The second phase, by contrast, emphasised issues of stabilisation of the financial system and relaxation of the remaining regulations. Emphasis was placed on the development of specialised financial institutions. Most of the new merchant banks, leasing companies, PDs, etc., have been instituted at this latter phase. For an extended review and critique of this process refer Nachane & Islam (2010). [17]

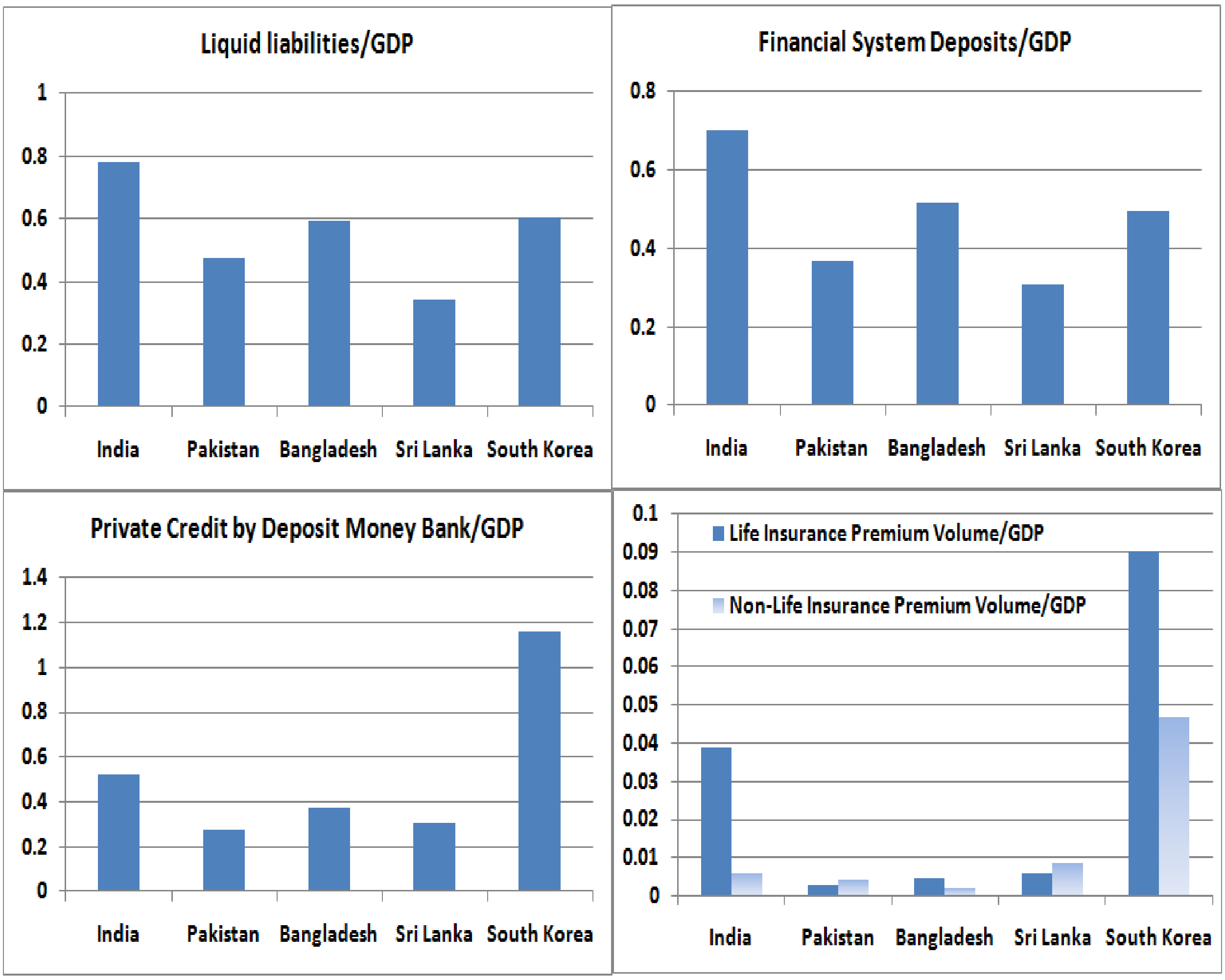
Figure 1 exhibits selected banking and other financial indicators of key South Asian economies, viz., India, Pakistan, Bangladesh and Sri Lanka. We examine the region's financial system with some key financial variables representing banking and non-banking sectors of the respective economies. We also bring the newly industrialised economy of

[16] The variables are weekly interest rates of deposits and advances, monthly returns on selected financial information, assets and liabilities, statutory liquid assets, quarterly returns on income and expenditure, capital adequacy, non-performing advances, classified advances and provisioning for bad and doubtful advances, investments in shares, interest spreads, half-yearly return on share ownership of the banks, and annual audited financial statements.

[17] Nachane and Islam (2010), 'Financial Sector Reforms in South Asia - A Perspective' in *South Asian Perspectives* (Singapore: Institute of South Asian Studies, January 2010).

South Korea into the analysis to see where the region's financial system stands in the global perspective given the fact that India, the largest economy of South Asia, has relatively an advanced financial system. Some other advanced and developing economies are also considered in this regard to examine the degree of development of the region's overall financial structure. The section also offers an intra-regional comparison as far as South Asia's financial sector is concerned.

Figure 1: Selected Financial Sector Ratios vis-à-vis GDP of India, Pakistan, Bangladesh, Sri Lanka and South Korea, 2009.[18]



Source: Database on Financial Development and Structure, World Bank, available at http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20696167~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html. Accessed on 12 March 2011.

[18] The ratio of liquid liabilities to GDP is calculated using the following deflation method: $\{(0.5)*[F_t/P\_e_t + F_{t-1}/P\_e_{t-1}]\}/[GDP_t/P\_a_t]$ in which F is liquid liabilities, $P\_ e_t$ is end-of period CPI, and P_a_t is average annual CPI. Financial System Deposit to GDP ratio is demand, time and saving deposits in deposit money banks and other financial institutions as a share of GDP. The ratio is calculated using the following deflation method: $\{(0.5)*[F_t/P\_e_t + F_{t-1}/P\_e_{t-1}]\}/[GDP_t/P\_a_t]$ in which F_t is demand and time and saving deposits, P_e_t is end-of period CPI, and P_a_t is average annual CPI.

The ratio of liquid liabilities to GDP is a traditional indicator of financial depth. Also known as the broadest available indicator of financial intermediation, the ratio shows that India is clearly ahead of the other South Asian economies, though Bangladesh is catching up rapidly. Financial system deposits to GDP[19] ratio (the liability side of financial intermediaries) that varies positively with the income level of countries does not follow a distinctive trend in South Asia. The ratios for Pakistan and Sri Lanka are lower than the global median but the trends in India and Bangladesh are comparable with some advanced economies. The asset side of the financial intermediaries in South Asia based on the indicator of private credit by deposit money banks and other financial institutions to GDP shows that the ratio is relatively higher in the case of India followed by Bangladesh, Sri Lanka and Pakistan. The size of South Asia's insurance sector is very small though India's life insurance sector is comparatively larger than that of its peers.

India has the most advanced equity market in South Asia followed by Pakistan, Sri Lanka and Bangladesh. The stock market capitalisation to GDP ratio in India is one of the highest in the world (Figure 2).

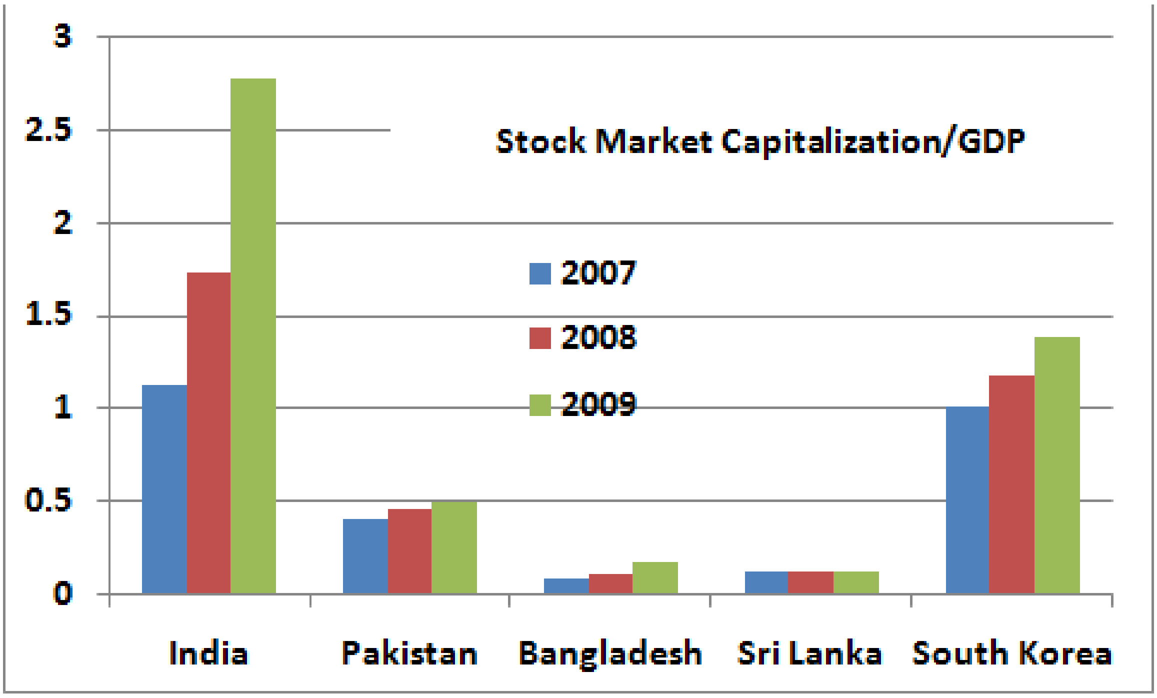
The bond market in South Asia remains very small vis-à-vis most emerging markets and the advanced world. This is one of the major weaknesses of the region's financial depth. While there is a sizeable public bond market, the size of the private bond markets in most South Asian countries is minuscule as compared to their economic output (Figure 3).

Banks remain the most important financial intermediary in almost all South Asian countries. Hence it is important to look at the micro variables of the banking sector. Table 1 shows a number of bank-related financial variables in key South Asian economies and South Korea.

In terms of bank deposits to GDP ratio, the Indian banking sector is comparable with advanced economies like South Korea, and the ratios for other South Asian economies, particularly Pakistan and Sri Lanka, remain smaller while the ratio is sizeable in the case of Bangladesh. Bank credit to bank deposits ratio that exhibits the extent to which banks intermediate the respective economies' savings into private sector credit is fairly unique in India, Pakistan and Bangladesh. Sri Lanka has one of the highest bank credit to bank deposits ratio in the region. The ratio for South Korea is 2.13. Studies found that the ratio increases with the level of economic and financial development. As far as bank concentration (the ratio of the three largest bank assets) is concerned, in Sri Lanka the three largest banks constitute over 60 per cent of the total banking system, while in India three banks comprise one-third of the banking business.

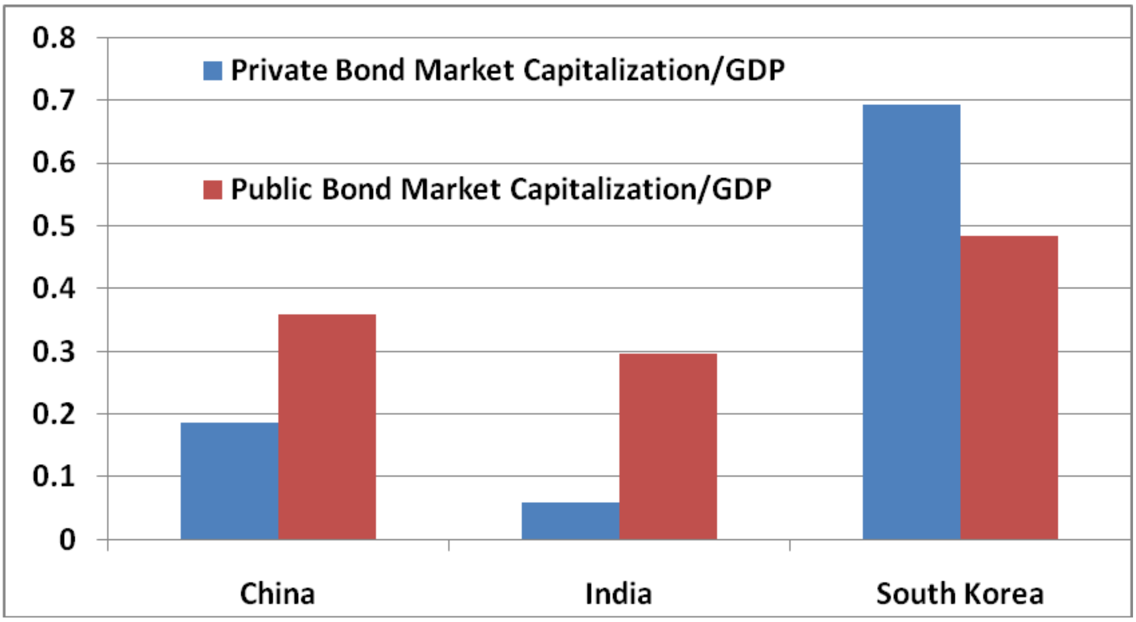
[19] The ratio of all checking, savings and time deposits in banks and bank-like financial institutions to economic activity and is a stock indicator of deposit resources available to the financial sector for its lending activities.

Figure 2: Size of Equity Markets of Selected Economies



Source: Database on Financial Development and Structure, ***World Bank.***

Figure 3: Size of Bond Markets of Selected Economies, 2009



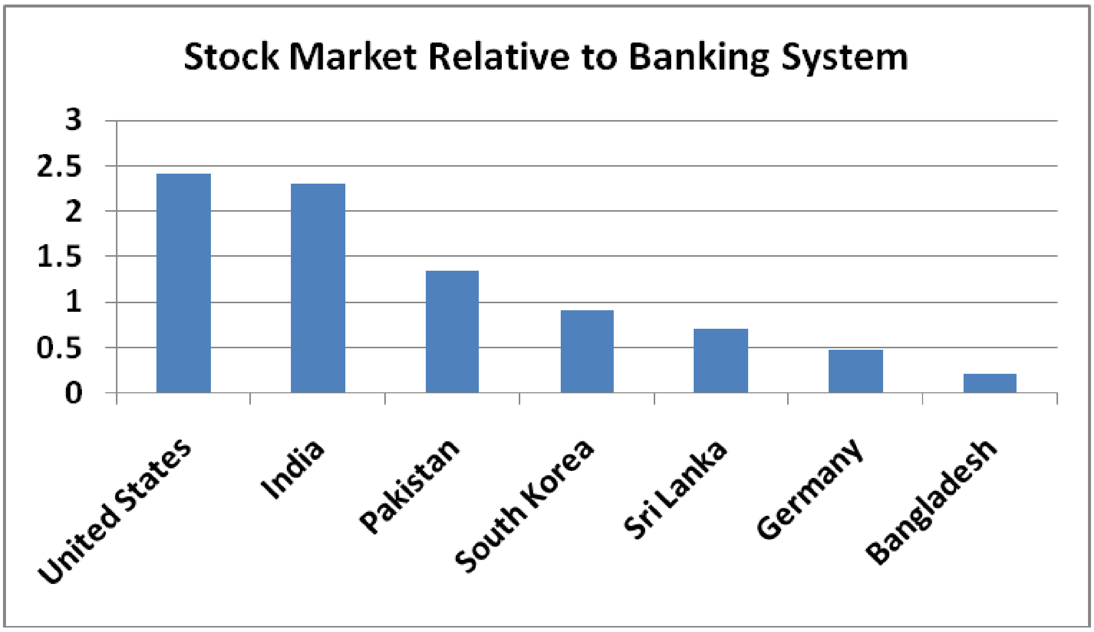
Source: Database on Financial Development and Structure, ***World Bank*.**

Table 1: Selected Banking Indicators of Key Economies of South Asia and South Korea, 2009[20]

	Bank Deposits/GDP	Bank Credit/Bank Deposits	Bank Concentration	Bank ROA	Bank ROE	Bank Z-Score
India	0.69	0.70	0.34	0.013	0.202	8.75
Pakistan	0.35	0.70	0.51	0.002	0.010	5.28
Bangladesh	0.52	0.74	0.45	0.025	0.92	8.2
Sri Lanka	0.31	0.98	0.61	0.001	0.145	14.5
South Korea	0.59	2.13	0.56	0.009	0.560	12.2

Source: Database on Financial Development and Structure, ***World Bank*.**

Figure 4: Financial Structure (Stock Market Relative to Banking System) of Selected Economies



Source: Database on Financial Development and Structure, ***World Bank*.**

[20] Bank Concentration refers to the assets of the three largest banks as a share of assets of all commercial banks. Bank ROA is the average return on assets (net income/total assets). Bank ROE is the average return on assets (net income/total equity). Bank Z-Score is estimated as ROA+equity/assets)/sd (ROA); the standard deviation of ROA, sd (ROA), is estimated as a 5-year moving average.

Studies show that there is a positive but weak correlation between profitability (measured by ROA and ROE) and the stability of the banking sector, as measured by Z-scores. The Z-score value in South Asia ranges from 5.28 (Pakistan) to 9.8 (India) (Table 1). The value across the regions in the world varied from 6.6 to 8.9 in the past 13 years.

Finally, we look at the relative development of the stock market and banking system known as financial structure (stock market capitalisation to GDP divided by bank credit to GDP). In South Asia the importance of the stock market relative to the banking system has grown, notably in India and Pakistan (Figure 4). While Sri Lanka is catching-up fast in this regard, the financial system in Bangladesh remains highly bank-dominated.

III. Macro-Economic Management in South Asia during the Recent Global Crisis

India's Policy Response to the Crisis

Traditionally, the Reserve Bank of India (RBI) has maintained a delicate (and sometimes precarious) balance between the twin objectives of controlling inflation while maintaining the availability of credit to the productive sectors of the economy (output stabilisation). Owing to the overarching fiscal dominance resulting from the financing needs of successive five-year plans, the RBI was not very successful in taming the high inflationary potential generated by the external shocks of the 1970s and 1980s. Simultaneously the growth trajectory also remained subdued till the late 1970s. The 1990s marked a fundamental departure from the previous democratic-socialistic regime, with a wide ranging set of market oriented reforms on both the domestic and external fronts. From the point of view of macroeconomic management, the four most significant developments related to: (i) the deregulation of most domestic interest rates; (ii) the easing of fiscal constraints on monetary policy via a number of important measures including the pricing of government securities at market determined rates (June 1992), the phasing out of ad hoc treasury bills (April 1997) and more recently the passage of the Fiscal Responsibility and Budget Management (FRMB) Act 2003; (iii) the shift from a rigidly administered exchange rate to a more market determined rate; and (iv) substantial liberalisation of capital flows.

These fundamental changes led to a substantial reorientation of monetary (and to a lesser extent fiscal) policy. The prime objectives of monetary policy continued to be inflation control and growth but various other considerations also emerged including: (i) the maintenance of orderly conditions in financial markets (including the forex market); (ii) the maintenance of an adequate level of forex reserves; (iii) the selection of on an appropriate sterilisation strategy in the face of vicissitudes in capital inflows; and (iv) the management of liquidity on a daily basis. By and large macroeconomic management over the period 1995 to

2007 may be considered reasonably successful except for a brief recession brought about in 1997-98[21] by an unduly strong monetary contraction (see RBI, 2008).[22]

Indian macro-policy was put to one of its severest tests by the recent global financial crisis. Of the four transmission channels of global shocks identified in the literature, viz., trade, finance, international commodity prices and expectations, the first two were most marked in the Indian context. As global incomes plummeted, exports growth declined from a robust level of 28.9 per cent in 2007-08 to 13.7 per cent in 2008-09 and then turned negative (-4.7 per cent) in 2009-10. From the last quarter of 2007-08, foreign portfolio investment registered negative growth for five successive quarters before regaining positive momentum in the first quarter of 2009-10. Together these factors cast a shadow on the high growth performance enjoyed by the Indian economy in the previous quinquennium. The rate of growth of gross domestic capital formation in 2008-09 was a third (6.7 per cent) of the rate achieved in 2007-08 (20.6 per cent). As a consequence, GDP growth decelerated sharply to 6.7 per cent in 2008-09 (from the high of 9.2 per cent in the previous year).[23]

The Indian policy response to the global crisis was built on three overriding considerations, viz., (i) revival *sans* stagflation; (ii) erecting firewalls around the financial sector; and (iii) ensuring safety nets for the vulnerable sections. The operational component of the policy may be summed up in a single phrase – easy money and fiscal stimuli. On the monetary policy front the repo rate was reduced in a succession of steps from 9 per cent in September 2008 to 5 per cent in March 2009 (with a corresponding reduction in the reverse repo rate from 6 per cent to 3.5 per cent). The CRR was also reduced from 9 per cent to 5 per cent over the same period, whereas the SLR was brought down by 1 per cent to 24 per cent. Altogether, it has been estimated that these measures released more than R400,000 crores (US$80 billion approximately) of liquidity into the system. There were also three successive fiscal stimuli packages amounting to a total cost of R80,100 crores (US$16.3 billion) to the exchequer.[24] By and large, the fiscal stimuli did succeed in restoring growth to its pre-crisis trajectory. Real GDP at factor cost rebounded smartly to 8.0 per cent in 2009-10 and then firmed up further to 8.6 per cent in 2010-11 (see RBI (2011) p.2).[25] Apart from ensuring adequate

---

[21] This was brought about by a 200 bps rise by the RBI in response to a perceived threat to the Indian rupee in the wake of the Asian crisis. Of course, it must not be forgotten that the alternative was a very serious threat of a currency crisis.

[22] Reserve Bank of India (2008): *Reports on Currency and Finance 2003-08.*

[23] All figures in this paragraph have been sourced from various tables in Reserve Bank of India (2010): *Report on Currency and Finance 2008-09.*

[24] Fiscal Stimulus I (7 December 2008) mainly comprised an across-the-board cut of 4 per cent in excise duty (estimated cost: R31,000 crores). Fiscal stimulus II (2 January 2009) comprised R20,000 crores towards bank capitalisation over the next two years, as well as providing greater market borrowing access to state governments as well as the IIFCL (India Infrastructure Financing Co. Ltd.) (estimated cost: R70,000 crores). The final stimulus III (25 February 2009) provides a 2 per cent reduction in both the excise duty and the service tax and an extension of the previous excise duty cuts beyond 31 March 2009 (estimated cost: R29,100 crores). The total burden on the exchequer at R81,000 crores amounts to nearly 1.82 per cent of GDP (at current prices) or 2.57 per cent (at constant prices).

[25] Reserve Bank of India (2011): *Macroeconomic and Monetary Developments in 2010-11.*

liquidity for the uninterrupted supply of credit to the productive sectors of the economy, the RBI also undertook a number of prudential measures aimed at containing financial contagion risks. The latter included guidelines relating to minimum holding periods and minimum retention requirements for securitised products, augmenting provisioning cushions, counter-cyclical capital buffers, etc. All these measures have been reasonably successful in insulating the Indian economy from the worst consequences of the crisis.

Pakistan's Policy Response to the Crisis

Monetary policy in Pakistan is structured to achieve dual objectives -- promoting economic growth and maintaining price stability. To achieve these goals the central bank of Pakistan targets monetary aggregates -- broad money supply growth as an intermediate target and reserve money as an operational target -- in accordance with the projections of GDP growth and inflation.[26] Apart from traditional monetary management tools, the Pakistani financial system has witnessed some progress after India in terms of product innovation and diversification of monetary management tools. Nevertheless, the Pakistani economy experienced five episodes of high inflation in the past four decades. Two oil shocks in the 1970s and 1980s and poor fiscal management (monetisation of large fiscal deficits) in the 1990s (1988-97) and the global commodity price hikes and structural problems in the economy in the late 2000s (2008-11) led to several periods of prolonged inflation in Pakistan. Growth trajectory in South Asia's second largest economy has taken a different course since the 1990s. While most South Asian economies witnessed relatively high growth rates led by India, Pakistan's economic growth was particularly low in the 1990s (the rate averaged 3.2 in the period 1993-2002) and in the past few years it has been growing very slowly. Owing to structural and political problems in the country the role of the SBP in attaining the dual objectives has been seriously jeopardised in recent years.

Pakistan's economic circumstances in the wake of the global financial crisis had been very different from most South Asian economies, with Sri Lanka being an exception. Faced with both deficits and a record high inflation, the State Bank of Pakistan's priority even in the last quarter of 2008 was to continue its tight monetary stance. Monetary policy in Pakistan had been subservient to fiscal policy due to automatic monetisation of public debt.

The crisis further aggravated Pakistan's economic woes. Its trade deficits widened and current accounts position deteriorated sharply in the last quarter of 2008. As a result, the Pakistani currency depreciated sharply by more than 20 per cent vis-à-vis the US dollar and its foreign exchange reserves declined to US$4.1 billion in October 2008. Output growth in

[26] Monetary Policy in Pakistan, Dr. Shamshad Akhtar Governor State Bank of Pakistan, Federation of Pakistan Chambers of Commerce & Industry Karachi 30 April 2007, http://www.sbp.org.pk/about/speech/governors/dr.shamshad/2007/MP-02-May-07.pdf . Accessed on 16 January 2011.

Pakistan declined sharply to 2 per cent in 2008-09 from 5.8 per cent in 2007-08 fiscal year.[27]

Given the rapid deterioration of its macroeconomic stability, Pakistan sought help from the International Monetary Fund (IMF) in November 2008. With the IMF fund, the country averted its balance of payment crisis. But as part of loan conditionality, the SBP was mandated to stop the automatic monetisation of the Pakistan government's fiscal deficit.

While the reduction of deficits and stabilisation of key macro variables had been the major focus for Paksiatn, the SBP had to revise its monetary stance due to the excessive drain of rupee liquidity from the market (owing to a deceleration of NFA), particularly in October 2008, and strong credit demand. Given the tight liquidity conditions in the domestic market, the central bank reduced the cash reserve requirement (CRR) and exempted time deposits from the statutory liquidity requirement (SLR), among others. But it raised policy rates from 13 to 15 per cent in November 2008 given a high inflation environment.[28] In post-July 2008, the reduction of reserve ratios released close to R270 billion and other measures amounted to a cumulative liquidity of R319.5 billion in Pakistan's financial market. While the stress in the Pakistani economy remains, it registered 4.1 per cent growth in 2009-10 fiscal year.

Bangladesh's Policy Response to the Crisis

Bangladesh's economy, which demonstrated relatively lower economic growth and volatile inflation in the 1970s and 1980s, has experienced a very different course of development in the post-1990s. In the past two decades inflation has moderated and the economy experienced steady growth. Two factors – a relatively stable political system and economic reform -- perhaps have played a critical role in this regard. Owing to these factors the economy attained macroeconomic stability in recent decades. The central bank has emerged as a credible entity that has been entrusted with multiple objectives.[29] Indeed, the Bangladesh Bank's monetary policy statements in recent years have redefined conventional economic growth by emphasising 'inclusive growth' that places a special focus on small and medium-sized enterprises and growth in the agricultural sector. Nevertheless, the central bank applies traditional tools to target high-powered money and credit in pursuit of its monetary objectives.

In the absence of capital account convertibility and Bangladeshi financial institutions' very minimal exposure to credit derivatives and foreign exchange products, the central bank was not required to shift its monetary stance following the collapse of Lehman Brothers in

[27] The Economist Intelligence Unit Database.

[28] For details see various Monetary Policy Statement, 2008-09, State Bank of Pakistan.

[29] Bangladesh Bank's monetary policy statement (MPS) states that it is designed to support the government's policies and programmes in pursuit of faster inclusive economic growth and poverty reduction, while also maintaining price stability. See Monetary Policy Statement, July-December 2010, Bangladesh Bank, http://www.bangladesh-bank.org/. Accessed on 16 January 2011.

September 2008. While equity prices were affected adversely for a brief period, liquidity conditions as well as both long-term and short-term interest rates were stable. The economy was resilient in the midst of the crisis and was reflected in several macro variables -- GDP growth did not decline markedly; export earnings grew 7 per cent and 12 per cent, respectively, in 2008 and 2009, largely due to a surge in demand for low-end apparel products. Private consumption, constituting 75 per cent of GDP, expanded 5.5 per cent and 6 per cent, respectively, in 2008 and 2009.[30] Bangladesh was one of the few South Asian economies that faced less pressure with regards to its balance of payment during the crisis despite the fact that the country's terms of trade sharply deteriorated since 2007-08, largely owing to the global commodity boom. The growth of remittance flows that constitute nearly 10 per cent of GDP was buoyant even in the midst of the crisis. However, the growth of remittances began to decelerate in 2010 owing to the economic downturn in the Middle East.

To offset the demand loss for non-apparel export items, two fiscal packages worth 0.6 per cent and 0.9 per cent of GDP were announced in April and June 2009.[31] As far as monetary action is concerned, the Bangladesh Bank's policy was rather tight as the control of inflation was the major policy goal throughout 2007-08. The central bank adjusted its policy rates upward in September 2008 and November 2008 to rein in rising inflation.

To sum up, the impact of the crisis on the Bangladeshi economy was minimal compared to other South Asian economies. A favourable external position and fiscal space allowed the government to inject two stimulus packages that helped maintain overall stability in the economy. Both exports (5.6 per cent) and GDP growth (5.7 per cent) maintained their pre-crisis growth rates in 2009.[32]

Sri Lanka's Policy Response to the Crisis

Monetary and macroeconomic management in Sri Lanka has been more challenging than most South Asian economies barring Pakistan. The macroeconomic stability in the country has been fragile owing to both deficits (fiscal and current account deficits) and a high level of inflation. This has been largely due to the war bill[33] the government had to finance for decades. While reform in fiscal management is the central focus of Sri Lanka, some efforts have been made to shift its monetary policy. The multiple objectives of the Central Bank of Sri Lanka have been reduced to economic growth and price stability. Monetary policy is based on a framework of monetary targets. In the framework the final target, price stability, is

[30] The Economist Intelligence Unit Database.
[31] Tadateru Hayashi, 'Overview of Fiscal Stimulus', *Regional High-Level Workshop on 'Strengthening the Response to the Global Financial Crisis in Asia-Pacific: The Role of Monetary, Fiscal and External Debt Policies*', 27-30 July 2009 Dhaka, Bangladesh.
[32] The Economist Intelligence Unit Database.
[33] The civil war between the government and the Tamil minorities lasted two decades long.

to be achieved by influencing changes in broad money supply which is linked to reserve money through a multiplier. Reserve money is the operating target of monetary policy.[34]

As skyrocketing inflation became a major threat to Sri Lanka's macroeconomic stability, the Central Bank of Sri Lanka (CBSL) controlled reserve money growth until the third quarter of 2008. The trend was reversed in the last quarter of 2008 following the massive shortfall of net foreign assets owing to a reversal of foreign funds and the fallout from the global crisis. GDP growth in the country contracted marginally to 6 per cent in 2008 and significantly to 3.5 per cent in 2009, from 6.8 per cent in 2007. However, economic growth decelerated markedly in 2009 when the economy grew only 3.5 per cent compared with the previous year. Export growth declined sharply -- from 7.3 per cent in 2007 to 0.4 per cent in 2008 and 12.3 per cent in 2009. Nevertheless, price levels in the domestic market subsided substantially, thanks to the collapse in global commodity prices. This allowed the central bank some room to ease its monetary policy. The CBSL changed its monetary stance -- from contractionary to expansionary -- in October 2008 by cutting interest rates and reducing the statutory reserve ratio (SRR). The central bank cut both repo and reverse repo rates on several occasions to 14.74 per cent and 11.75 per cent, respectively.[35] It intervened in the foreign exchange market by augmenting dollar liquidity and reducing SRR in two steps (by 75 basis points and 150 basis points to 7.75 per cent). To further enhance the rupee liquidity CBSL also purchased treasury bills. Access by commercial banks and primary dealers to the central bank's repurchase facility was extended to 10 times per calendar month. The SRR reduction injected 24.5 billion rupees of liquidity into the market. While the fiscal space in Sri Lanka was severely constrained, two stimulus packages, equivalent to 0.4 per cent and 0.2 per cent of the country's GDP, were injected to contain the external shocks in December 2008 and May 2009. [36]

The Sri Lankan economy has recovered from the global crisis. The export sector witnessed a 5.8 per cent growth in 2010 and gross fixed investment, that stagnated to 23 to 24 per cent of its GDP for many years, have been elevated to 28 per cent. More importantly, the end of the decade-long ethnic conflict is expected to boost the economy. Consequently, the economy is projected to expand 7.6 per cent in 2010.

---

34 Central Bank of Sri Lanka Website, http://www.cbsl.gov.lk/htm/english/04_mp/m_2.html#3. Accessed on 20 November 2010.

35 *Ibid.*

36 Tadateru Hayashi, 'Overview of Fiscal Stimulus', *Regional High-Level Workshop on 'Strengthening the Response to the Global Financial Crisis in Asia-Pacific: The Role of Monetary, Fiscal and External Debt Policies*', 27-30 July 2009, Dhaka, Bangladesh.

IV. Regulatory & Supervisory Response to the Global Crisis in South Asia

The role of national regulatory and supervisory authorities was debated extensively first in the de Larosiere Group (February 2009)[37] in the EU and then in the Working Group 1 of the G20 (March 2009).[38] The deliberations threw considerable light on the existing deficiencies in the global financial system and suggested several measures to mitigate the possibility of recurrence of such amplitude. The suggested measures embraced five distinct areas, viz,,

i. Strengthening and expanding the scope of regulation and supervision (R & S);
ii. Controlling leverage of financial institutions;
iii. Dampening pro-cyclicality of capital requirements;
iv. Reducing costs of financial failures; and
v. Devising market incentives for prudent behaviour.

A. *Scope of R&S*: It was felt that R&S not only be strengthened but that its scope also needs to be extended considerably. For strengthening R & S three measures can be considered, viz.,

- entrusting a special regulatory authority (either an existing one or a newly constituted one) with an explicit financial stability mandate;
- ensuring coordination between different regulatory authorities; and
- expanding the scope of regulation to include credit-rating agencies and private pools of capital (including hedge funds) via a system of registration, disclosure requirements and oversight.

B. *Leverage of Financial Institutions*: An important amplification factor for the current crisis has been not only the high degree of leveraging of many financial institutions but also the fact that this leveraging has very often been quite opaque. Reflecting the need for more accurate measures of balance sheet exposures, the following suggestions have emerged:

- a stronger focus by regulators on loan-to-value ratios (especially for mortgages);
- higher loan-loss provisioning norms;
- Stress-testing exercises to be conducted periodically to monitor leveraging on an on-going basis; and
- Improved disclosure requirements for complex structured products.

[37] De Larosiere Group (2009), *Report of the High-Level Group on Financial Supervision in the EU,* Brussels (Feb.)

[38] G20 (2009), *Enhancing Sound Regulation and Strengthening Transparency,* Final Report of the G20 Working Group 1.

C. *Pro-cyclicality of Capital Requirements:* A fact well-known to economists (see, e.g., Ghosh & Nachane.2003)[39] but consistently ignored by policymakers is the fact of capital adequacy requirements being pro-cyclical and hence a possibility of accentuating factor in any crisis. As the current crisis runs its course, there is a greater realisation among central bankers globally that have to be found to counter this pro-cyclicality. Two operational suggestions have been made in this context:
   - requiring financial institutions to build up capital buffers during economic expansions, which could then be unwound in times of recession to forestall the adverse impact of *fair valuation*,[40] leverage and maturity mismatches; and
   - imposing higher capital requirements on *systemically important* financial institutions.

D. *Reducing Cost of Financial Failures:* The welfare costs of financial crises are generally severe and fall disproportionately on disadvantaged groups in any society, and the current crisis is hardly an exception. With a view to reducing such costs, the following suggestions have been made:
   - an early warning diagnostic system can contribute considerably towards containing collateral damage:
   - the instituting of orderly closure rules for important financial institutions (as prevalent in the US for banks under the FDIC Improvement Act & Competitive Equality Banking Act):
   - under exceptionally turbulent circumstances, the use of credit ratings by private agencies could be temporarily suspended in favour of regulators' ratings: and
   - establishment of clearing houses in OTC derivatives markets.

E. *Devising Market Incentives for Prudent Behaviour:* Market incentives can play an important supplementary role in ensuing prudent behaviour by financial institutions. It is generally recognised that an important triggering factor in the current crisis has been the unregulated corporate compensation framework, which provided perverse incentives for excessive risk taking, resulting in a serious moral hazard syndrome. The solutions to this problem emerging in the deliberations of the Working Group 1 of the G20 are:
   - prudential oversight of financial executive compensation schemes;
   - originators of securitised products may be required to take an equity slice in the products that they sell/distribute; and
   - better separation of ratings and consultancy activities of credit rating agencies.

[39] Ghosh, S. & D. Nachane (2003), 'Are Basel Capital Standards Pro-cyclical? Some Empirical Evidence from *India Economic and Political Weekly*, vol.XXXVIII, No.8, (Feb.22-28), p.777-784.
[40] Such Fair Value Accounting could be on the lines of the SFAS No.133 issued by the US Financial Accounting Standards Board in 1998.

It is not our contention here that that the above schemata constitutes a perfect recipe for insurance against future crises. However, it cannot be denied that the schemata could serve as a useful benchmark for evaluating the degree of preparedness of any national system to deal with an incipient financial crisis. Table 2 examines in detail the extent to which South Asian financial instruments measure up to these benchmark criteria. The table clearly indicates that the financial regulatory and supervisory system in India performs fairly well against these general guideposts for financial stability.

Table 2: Benchmark criteria: Implementation Status in South Asia

Benchmark Suggestion		**Implementation Status in South Asia**
A1	India	BFS (Board for Financial Supervision) established as early as November 1994. The RBI carries out this mandate under the general guidance of the BFS.
	Pakistan	No special regulatory authority. The State Bank of Pakistan regulates and supervises the financial system. NBFIs, are being regulated/supervised by the Securities and Exchange Commission (SECP).
	Bangladesh	No special regulatory authority. The Bangladesh Bank and the Securities and Exchange Commission regulate and supervise the financial system.
	Sri Lanka	No special regulatory authority. The Central bank of Sri Lanka and the Securities and Exchange Commission regulate and supervise the financial system.
A2	India	Coordination between the three major regulators RBI (Reserve Bank of India), SEBI (Securities & Exchange Board of India) and IRDA (Insurance Regulatory Development Authority) is weak and potential for conflicts not ruled out.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do
A3	India	No move in this direction is in sight.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do
B1	India	RBI insists on a cap of 75% on the loan to value (LTV) ratio. Risk weights are varied according to the LTV ratio.
	Pakistan	49.8%
	Bangladesh	50-80%
	Sri Lanka	75%
B2	India	Loan loss provisioning has been steeply raised in the wake of the crisis. (It currently stands at 70%)
	Pakistan	70.9%

	Bangladesh	Loan loss provisioning varies depending on type of Banks. For SCBs the required ratio is 73%
	Sri Lanka	50.8%
B3	India	A pilot stress-testing exercise was done in 2009. More detailed stress tests are proposed to be carried out twice a year.
	Pakistan	SBP started macro-stress testing of credit risk to assess the resilience of the banking system towards credit shocks since June 2008.
	Bangladesh	All banks and FIs are expected to carry out stress testing on half yearly basis (30 June and 31 December) each year with their first stress testing being conducted on 30 June2010.
	Sri Lanka	NA
B4	India	Complex derivative products such as synthetic securitisation have not been permitted so far.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do
C1	India	While a system of capital buffers is not in place, pro-cyclicality is sought to be mitigated via risk weights adjustments.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do
C2	India	Systemically important non-bank financial intermediaries are subject to a higher CRAR (capital to risk-weighted assets ratio) of between 12% and 15% as opposed to the regularly applicable CRAR of 9% for banks.
	Pakistan	14.3%
	Bangladesh	10%
	Sri Lanka	14.5%
D1	India	The RBI introduced the Prompt Corrective Action (PCA) scheme in December 2002. Under the PCA, the RBI will initiate certain *structured* as well as *discretionary* actions in respect of banks, which have hit certain trigger points in terms of capital to risk weighted assets ratio (CRAR), net non-performing assets (NPA) and return on assets (ROA).
	Pakistan	NA
	Bangladesh	NA
	Sri Lanka	NA
D2	India	No such provision exists.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do
D3	India	No such provision exists.
	Pakistan	Do
	Bangladesh	Do

	Sri Lanka	Do
D4	India	About 75% of the OTC derivative contracts are routed through a centralised exchange – the CCIL (Clearing Corporation of India Ltd.).
	Pakistan	No such provision exists.
	Bangladesh	Do
	Sri Lanka	Do
E1	India	Such rules do not exist.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do
E2	India	No provision for such an eventuality exists at the moment.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do
E3	India	No formal legislation to this effect, but safeguards exist to prevent 'cherry picking' credit assessments by banks.
	Pakistan	Do
	Bangladesh	Do
	Sri Lanka	Do

Sources: Various Annual Reports and Circulars of the central banks of India, Bangladesh, Pakistan and Sri Lanka.

V. Major Regulatory & Supervisory Issues

We now discuss three issues which have figured prominently in recent general discussions about the role, jurisdiction and functions of financial regulation and supervision (R&S) bodies. The issues assume special significance in the context of the newly liberalised financial systems in the South Asian region, where the institutional structure though inherited from a colonial past, has evolved in a markedly different fashion in the decades following independence. Most of the discussion in the South Asian context has been located in India but the financial systems in the other countries of the region possess sufficient similarities with that in India (see Section 2 above) to afford the drawing of useful parallels. The three issues that we discuss are:

- principles versus rules-based supervision;
- role of market discipline in financial regulation; and
- regulatory and supervisory independence.

For the reasons just alluded to, we try to maintain the discussion at a fairly general level, with occasional references to the Indian context.

Principles versus Rules-based Regulation

The issue of p*rinciples vs rules* mode of regulation was first introduced (in the Indian context) by the *Committee on Making Mumbai an International Finance Centre*.[41] The committee chastised the RBI for the plethora of rules that financial institutions are required to follow and strongly advocated a switchover to a *principles-based* system. The more recent *Committee on Financial Sector Reforms (CFSR*) reiterated the same position but with less rhetoric and greater attention to detail. Principles-based regulation involves greater reliance on 'principles and outcome-focused, high-level rules as a means to drive at the regulatory aims we want to achieve, and less reliance on prescriptive rules' (FSA, 2007).[42] It is the CFSR's contention that the current rules-based system in India displays 'low tolerance for innovation and excessive micro-management' (Chapter 6, p.2). It therefore recommends a gradual but time-bound movement in the direction of principles-based regulation.

There are several imminent problems with the adoption of a principles-based approach. At least a few of these deserve mention.

- In a principles-based system, the interpretation of principles is often with the regulator, in contrast to a rules-based system, in which interpretation lies equally with the regulator and the regulated, with well-defined mechanisms for resolving conflicts of interpretation. Thus ironically, a principles-based system places greater discretion at the disposal of the regulator. This can lead often to arbitrary regulation, but the greater danger is of attempts by powerful corporate interests at *regulatory capture* and blocking of competition (the recent Wal-Mart case in the US is an example –see *Financial Times* 5 July 2007).
- In a litigious country (such as India, for example), the arbitration/judicial system will be overwhelmed with public interest litigations (PILs), right to information (RTI) queries and *private class actions*.
- Finally, as noted by Wallison (2007)[43], there is the *safe haven* effect of a rules-based system. Compliance with rules, which are fully transparent, gives the regulated entities a sense of absolution, which is never present in a principles-based system. Besides, there is no question of discrimination between different regulated entities in a rules-based system, a problem which is never totally absent in a principles-based system.

---

[41] In recent years the government of India appointed two high-level committees to draw up a future roadmap for financial sector reforms in India -- *The Committee on Making Mumbai an IFC (International Finance Centre)* under the chairmanship of Percy Mistry and *The Committee on Financial Sector Reforms (CFSR)* under the *c*hairmanship of Raghuram Rajan. The latter report in particular is a detailed examination of the Indian financial sector, and makes a number of wide-ranging recommendations.

[42] Report of the Committee on Financial Sector Reforms, *The Planning Commission, India*, http://planningcommission.nic.in/reports/genrep/report_fr.htm. Accessed on 20 February 2011.

[43] Wallison, P.J. (2007), 'America Will Prefer to Rely on Rules, Not Principles' *Financial Times* (6 July).

All this is hardly to say that existing rules-based systems in most EMEs are without defects, and several of these are highlighted effectively in the CFSR report. But instead of a switchover to a principles-based system, a far better alternative is to impart flexibility and dynamism to the existing rules, making them more transparent, and install a system of quick incentives/penalties for compliance/non-compliance.

Strengthening Market Discipline

Financial institutions interact with and are monitored by at least four distinct groups: (i) depositors; (ii) creditors; (iii) shareholders/proprietors; and (iv) market analysts and credit agencies. *Market discipline* is a generic term referring to the monitoring of financial institutions by these four distinct groups. *Direct market discipline* refers to the control/influence that market participants exert over a bank's behaviour via the bank's funding costs, while *indirect market discipline* arises from the price of a bank's securities in the primary and secondary markets (with a demand for higher return in case of an increase in perceived risk).

Pillar III of Basel II lays great emphasis on market discipline and seeks to achieve this by imposing various kinds of disclosure requirements on financial institutions (most particularly banks) relating to their capital, assets, credit risk, market risk, operational risk, etc. Since Pillar III Basel II has gone into implementation in India and Bangladesh in March 2009 and December 2009, respectively; the disclosure component of market discipline seems to be fairly in place. But it is to be remembered that while disclosures do contribute to greater transparency in financial sector operations and, to that extent, to better monitoring by all counterparties, they constitute only a necessary condition for market discipline.

Monitoring of banks and financial institutions by depositors in India is weak, primarily because of the prevalent *flat-rate deposit insurance premium*, which does not deter banks from taking unreasonable risks as they do not incur any additional premium expense in doing so. Thus, the flat-rate premium system subsidises high risk, poorly run institutions at the cost of well-run institutions and ultimately the tax-payer. An ideal deposit insurance premium pricing system should embody (a) banks paying a premium indexed to their own levels of risks, and (b) a premium level that ensures a continually solvent insurance fund (see, e.g., Demirguc-Kunt & Huizinga (2004)).[44] However, it is difficult to price individual banks accurately and it is equally tough to assess risk correctly before problems occur. Further, as bank failures are not evenly distributed over time, it is difficult to estimate long-run revenues to cover long-run costs. Secondly, the level of premium cannot be so large as to threaten the viability of an otherwise sound institution. In short, risk-based premium (RBP) should be viewed as a complement to, rather than a substitute for, other methods of checking excessive risk taking like risk-based capital requirement prescriptions, strong supervision and direct restraints on risky activities. There is an increasing move towards a risk-based premium

[44] Demirguc-Kunt, Asli and Huizinga, Harry (2004), 'Market Discipline and Deposit Insurance,' *Journal of Monetary Economics*, vol. 51(2), pages 375-399.

system (RBP) across the globe and if India also falls in with this trend, considerable work is in progress for developing methodologies for this purpose. Moving towards an RBP system could be an important move in the direction of strengthening market discipline in India. Interestingly, the Bangladesh Bank has recently approved the new risk-based premium rate and the amount of coverage, which will come into force after the government's approval.

Monitoring of banks by shareholders traditionally occurs from the responses of equity values to changes in the perceived risks of banks. If market discipline is effective in improving bank governance, then we must ensure that publicly listed banks (with constantly available market signals from their equity and bond prices) should take less risk than similarly placed non-publicly traded banks. There have been several empirical tests of this and similar hypotheses (see, e.g., Kwan (20002), Flannery (2002), Park & Peristiani (2006)).[45] The empirical testing usually proceeds by regressing measures of bank risk taking, e.g., credit risk, earnings volatility, capitalisations, etc., on a vector of bank characteristics (size and mix of portfolio, funding mix, etc.) and a dummy variable for publicly traded banks. While the empirical conclusions naturally differ widely, nevertheless there seems to be a fairly broad consensus around two propositions:

i. there does not seem to be a significant difference in the risk profile between publicly traded and non-traded banks; and

ii. very often publicly traded banks tend to have worse supervisory ratings than non-publicly traded banks.

There is one additional caveat to the market disciplining role of shareholders. The interests of bank shareholders may often be opposed to those of governmental regulators. While shareholders may be oriented towards maximising bank net worth (and in the process devise incentive schemes for managers that motivate them to greater risk taking), regulators may have financial stability considerations uppermost in their minds and thus try to restrain unnecessarily risky behaviour by bank managers. One additional way to strengthen market discipline is via the so-called Chicago Fed Plan (see Keehn 1989)[46], which proposes the inclusion of a mandatory *subordinated debt* [47] component in bank capital requirements (see

---

[45] Kwan, Simon H. (2002), 'The Promise and Limits of Market Discipline in Banking.' *FRBSF Economic Letter* 2002-36 (13 December). Flannery, Mark J. (2001), 'The Faces of "Market Discipline".' *Journal of Financial Services Research*. 20: 2/3, 107-119. Bliss, Robert R. and Mark J. Flannery (2002), 'Market Discipline in the Governance of U.S. Bank Holding Companies: Monitoring vs. Influencing'. *European Finance Review*. 6, 361-395.Park, Sangkyun and Peristiani, Stavros (2007), 'Are Bank Shareholders Enemies of Regulators or a Potential Source of Market Discipline?' *Journal of Banking & Finance*, Elsevier, vol. 31(8), pages 2493-2515, August.

[46] Keehn, S. (1989), 'Banking on the Balance: Powers and the Safety Net', Monograph, *Federal Reserve Bank of Chicago.*

[47] Subordinated debt (or junior debt) is debt that is unsecured and has lower order of claims than other debts in the event of closure (of a company).

also Calomiris & Powell (2000), Evanoff & Wall (2000) etc.).[48] Interestingly, subordinated debt can act as an important market disciplining factor, since as the perceived risks of a bank increase, holders of subordinated liabilities will require a higher return to compensate for the extra perceived risk. Several studies (Jagtiani & Lemieux (2001), Evanoff & Wall (2002), Sironi (20003), etc,)[49] have noted that issuance and secondary market risk premia on traded subordinated debt are correlated positively with risk measures such as asset portfolio composition, credit ratings, probability of undercapitalisation and/or failure, etc. In India, as in other South Asian countries, as of now, there is no mandatory requirement for subordinate debt, and it is a suggestion worth careful consideration as to whether such a mandatory requirement be imposed in the interests of market discipline.

Regulatory & Supervisory Independence (RSI)

The issue of central bank independence (CBI) has been discussed virtually threadbare in the literature (see Cukierman (1992), Beechey et al (2008), Bernanke (2009) etc.),[50] with an almost universal agreement on its desirability. CBI strictly interpreted refers to the autonomy of a central bank in deciding upon the stance of monetary policy. In recent years there have been frequent concerns expressed publicly (though in guarded language) by RBI officials about the necessity to strengthen RBI autonomy in exercising its monetary policy mandate.
However, as in this paper our focus is on regulatory and supervisory functions of the central bank, the issue of relevance to us is that of *regulatory and supervisory independence* (RSI). RSI is often confused with central bank independence (CBI), though as stressed in the literature the two are conceptually distinct and need not necessarily co-exist even when the regulation and supervision functions and the monetary policy functions are vested in the same authority (see see Lastra,1996, Taylor & Fleming (1999), Quintyn & Taylor,2002).[51] RSI refers to independence of the regulatory and supervisory structure from not only the government but also from the industry and financial markets. In a sense, RSI is to financial

[48] Calomiris, C.W. & A. Powell (2000), 'Can Emerging Market Bank Regulators Establish Credit Discipline?', *The Case Of Argentina 1992-99, NBER Working Paper No*. 7715. Evanoff, D. & L.Wall (2000), 'Subordinated Debt and Bank Capital Reform', *FRB Atlanta Working Paper No*. 2000-24

[49] Jagtiani, J. and C. Lemieux (2001), 'Market Discipline Prior to Failure', *Journal of Economics and Business,* 53, 313-324.Evanoff, D.D. and L.D. Wall (2002), 'Measures of the Riskiness of Banking Organizations: Subordinated Debt Yields, Risk-Based Capital, and Examination Ratings', *Journal of Banking and Finance* 26, No. 5, p. 989-1009. Sironi, A. (2003), 'Testing for Market Discipline in the European Banking Industry: Evidence from Subordinated Debt Issues', *Journal of Money, Credit & Banking, 35, p.443- 472.*

[50] Cukierman, A. (1992), 'Central Bank Strategy, Credibility, and Independence: Theory and Evidence', Cambridge, MA: The MIT Press. Beechey, M. J., B. K. Johannsen, and A. T. Levin (2008), 'Are Long-Run Inflation Expectations Anchored More Firmly in the Euro Area Than in the United States?', *Federal Reserve Board*, DP 2008-23. Bernanke, Ben (2009), 'The Federal Reserve's Balance Sheet: An Update', speech delivered at *Federal Reserve Board Conference on Key Developments in Monetary Policy*, Washington, 8 October.

[51] Lastra, R., (1996), 'Central Banking and Banking Regulation', London, UK: Financial Markets Group, London School of Economics. Taylor, M. and Fleming, A. (1999), 'Integrated Financial Supervision: Lessons of Scandinavian Experience', in *Finance and Development*, December 1999, IMF, pp.42- 45. Quintyn, M. and M.W.Taylor (2002): 'Regulatory and Supervisory Independence and Financial stability', *IMF Working Paper No. WP/02/46).*

stability what CBI is to monetary stability. Unfortunately the academic literature on regulation has been almost exclusively focused on CBI, to the virtual neglect of RSI.

The neglect of RSI assumes importance when one considers the fact that almost all episodes of financial distress have been associated with a weak RSI (See De Krivoy, 2000, for the Venezuelan experience of the mid-1990s, Lindgren et al., 1999 for the East Asian experience, Hartcher, 1998 for Japan, etc.)[52]. In India the financial regulatory and supervisory functions are distributed between the RBI (banks and NBFCs), state governments (for co-operative financial institutions jointly with RBI) and NABARD (for RRBs). For the purpose of this discussion, let us confine ourselves to the regulation and supervision of the banking sector and the NBFCs. The RBI discharges this function under the guidance of the Board for Financial Supervision (BFS), which comprises four directors from the RBI's central board, the RBI governor (as chairman) and four deputy governors.

In so far as independence from the government on the regulatory and supervisor fronts is concerned, this is ensured to a large extent by the fact that the RBI (acting under the guidance of the BFS) is authorised to issue directives in all areas of regulation and supervision. However, this realisation has to be tempered by the fact that an element of indirect control of the government does exist by virtue of the fact that the RBI directors (from whom four of the BFS members are drawn) are appointed by the central government. Incidentally, the CFSR's recommendation to set up the financial development council under the chairmanship of the finance minister 'for macro-economic assessment and development issues' (Proposal 26), if implemented, will strongly limit the existing independence of the regulators and supervisors, as it will provide a legitimate platform for the finance ministry to intervene in these matters, and further exacerbate the co-ordination problems between the RBI and the finance ministry.

But the other major dimension of RSI, viz., independence from markets, is equally important but has not received the attention it deserves. In the words of a very famous US central banker '...it is just as important for a central bank to be independent of markets as it is to be independent of politics' (see Blinder,1997).[53] Independence from markets is more difficult to ensure than independence from politicians, since the forces operating here are extremely subtle. This can occur primarily through two channels, both of which have been operating in the Indian context. First, an overrepresentation of financial sector and corporate representatives in high-level official committees and bodies, concerned with the designing of regulatory and supervisory frameworks. This usually takes place at the instance of a government strongly committed to reforms, and is usually done with the ostensible purpose

[52] De Krivoy, R. (2000), 'Collapse: The Venezuelan Banking Crisis of 1994', *Group of Thirty,* Washington, DC. Lindgren, C.T. Balino, C. Enoch, A. Gulde, M. Quintyn and L. Teo (1999), 'Financial Sector Crisis and Restructuring: Lessons from Asia', Washington, DC: IMF. Hartcher, P. (1998), 'The Ministry: How Japan's Most Powerful Institution Endangers World Markets', *Harvard Business School Press,* Boston: MA.

[53] Blinder, A.S. (1997), 'What Central Bankers Could Learn From Academics – And Vice Versa', *Journal of Economic Perspectives,* vol. 11 (2), p.3-19.

of taking on board the 'financial industry's' point of view.[54] Second, most media outlets are under corporate ownership with editorial/broadcasting functions not sufficiently independent of proprietary control. As a result, large sections of the media are strongly aligned with corporate sector interests and are usually successful in setting up a *grading system* in which supervisors and regulators are routinely rated publicly on how friendly they are to markets. Inherent in such an arrangement is the danger of ultimately having a regulatory authority overtly sensitive to financial market demands to the relative neglect of prudential considerations of financial stability.

VI. Conclusion

While there is no denying of the fact that financial system development is an integral component of overall development, there are important caveats to this general statement. The current financial crisis has exposed some clear fault lines in unchecked financial innovation and deregulation. In particular, opinion seems to be swinging away from the pristine view of free markets evident in classical laissez faire, to the more nuanced view of Keynes' *General Theory*. This shift in thinking has challenged several established orthodoxies and, as economists grapple to resolve their controversies, policymakers are struggling to find solutions to hitherto unencountered problems. Robert Posner's recent article[55] is an honest admission of the profession's confusion, wherein he says: 'We have learned since September that the present generation of economists has not figured out how the economy works. The vast majority of them were blindsided by the housing bubble and the ensuing banking crisis; and misjudged the gravity of the economic downturn that resulted….By now a majority of economists are in general agreement with the Obama administration's exceedingly Keynesian strategy for digging the economy out of its deep hole.'

But as the global economy is slowly emerging from the crisis, certain things are becoming clear -- in particular the inconsistencies in regulatory systems across countries and clear conflicts of interests between regulators across borders as well as between regulators and financial markets. A new era of global financial coordination to deal with global systemic risks seems to be dawining. But this will have to contend with four formidable and fundamental issues, viz.,

[54] As a matter of fact, if this were the sole purpose, it could be easily accommodated by calling in such representatives as observers or witnesses and recording their testimonies. As a notable but by no means isolated example of this tendency, we may mention a recently appointed high-level committee for 'Promoting Financial Inclusion', with the Reliance Industries head, Bharti head, ICICI Bank MD and CEO, HDFC chairman, Infosys chief mentor, chairman emeritus RPG Group and Bajaj Group and Motors Proprietor as members and the finance secretary as member secretary. Note that the committee does not include a single professional economist!

[55] A. Posner, 'How I Became a Keynesian', *The New Republic*, (23 September 2009), http://www.tnr.com/print/article/how-i-became-keynesian. Accessed on 21 March 2011.

i. *the coordination of regulations;*
ii. *coordination of resolution tools;*
iii. *coordination in depositor and investor protection;* and
iv. *enhanced information sharing*.

The global co-ordination process would essentially involve four main partners, viz.,

i. national regulatory and supervisory authorities;
ii. IMF;
iii. financial stability board (FSB) and other international standard setting bodies – Basel Committee On Banking Supervision (BCBS), International Organization Of Securities Commissions (IOSCO), etc.;
iv. influential groups like G-20.

The success of the global co-ordination process would depend upon how sincerely these four main partners execute their respective mandates.

In line with the post-crisis shift in global thinking on the regulation of financial markets, there was a realisation of issues on regulation, supervision and market discipline in the EME context, too. As a matter of fact (see Table 2 above), the South Asian regulatory and supervisory system measures up fairly well against the benchmark norms recommended by the G-20 in March 2009. Nevertheless, there are three major unresolved issues on the regulatory and supervisory front. The first of these pertains to the principles versus rules-based regulation controversy. We have tried to establish the general point that whatever the merits of a principles-based system in the long run (and even these are doubtful), any transition to such a system in the medium term could pose severe strains on the legal and regulatory resources of countries in the South Asian region. A more promising and safer course of action would be to make the existing (rules-based) system more flexible and dynamic.

The second issue pertains to the role that market discipline can play in a newly deregulated financial system. Market discipline is generally regarded as a useful and even necessary supplement to official regulation, though of course not a substitute for it. Unfortunately, in many EMEs (including India) the ability of shareholders and bondholders to respond appropriately to changes in bank fundamentals is seriously constrained by the relatively shallow and underdeveloped nature of financial markets. This leaves depositors as perhaps the sole source of market discipline. Even though a few studies in the Indian context do find an important role for depositors in disciplining banks, the ability is limited by the prevailing system of a flat rate deposit insurance premium. From the point of view of strengthening market discipline in general, as a minimal step, it may be worthwhile switching over to a risk-based premium deposit insurance system. Such a move, however, would require some political will, in a typically South Asian context, in which the cooperative bank network is extensively influenced by local political organisations and subject to the ‘dual control’ of the central bank and state governments.

Finally, we discuss the crucial issue of independence of regulators and supervisors from official (government) interference and market ‘noise’, in executing their mandate of financial stability. While both aspects of independence need special attention in almost all countries, the need for such independence becomes paramount in the South Asian context, in which the links between governments and industry have been very close, especially as the so-called *market friendly reforms* have often tended to be more *pro-business* than *pro-markets* (see Kohli (2006)[56] and in which consequently the lobbying efforts of large industrial groups could easily result in *captive* regulatory systems.

The future success of financial reforms in South Asia will be crucially contingent upon how successfully the regulatory architecture adapts to the twin dictates of financial development and financial stability, the extent to which market discipline can be usefully deployed as a pillar to support this architecture and the degree to which regulatory and supervisory independence is not comprimised.

……

[56] Kohli, A. (2006), ‘Politics of Economic Growth in India, 1980-2005: I & II’, *Economic and Political Weekly*, 1st and 8th April.

ISAS Working Paper

No. 132 – 6 September 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Recruitment of Labour Migrants for the Gulf States: The Bangladeshi Case

Md Mizanur Rahman[1]

Abstract

Recruitment constitutes an important part of the process of temporary labour migration in Asia. Existing literature explicitly suggests that the rapid development of recruiting agencies and migrant networks has accelerated the growth of labour migration in Asia. However, most existing literature tends to focus on either the role of agencies or the role of networks in the recruitment process, not both simultaneously. Likewise, the economics of recruitment is almost inseparable from labour recruitment in Asia but it remains an area of peripheral interest in existing literature. This study argues that a holistic approach, meaningfully combining migrant networks and recruitment agencies, to highlight both the operational and economic aspect of recruitment, is needed to better understand the complexity of migrant recruitment dynamics in Asia. Focusing on the recruitment experiences of Bangladeshi migrants in the GCC states, this study examines the operational as well as economic aspects of recruitment. This paper reveals how migrant networks and recruitment agencies adapt to the changing practices of recruitment to funnel migrant workers to the GCC countries. Further, it explains how constellations of interests at different points in the system create the conflicts and contradictions throughout the recruitment process.

[1] Dr Md Mizanur Rahman is Research fellow at the Institute of South Asian Studies (ISAS) in the National University of Singapore (NUS). The author can be reached at isasrmm@nus.edu.sg. The views expressed are those of the author and do not necessarily reflect those of the institute.

Introduction

Throughout history, demand for foreign labour has been met in a variety of ways such as enslavement, bond and, later, recruitment. Following the abolition of both slavery and the indentured servitude system, it is the recruitment process which is now widely practised for obtaining supplies of labour internationally (Prothero, 1990). Recruitment constitutes an important part of the processes of Asian labour migration (Arnold and Shah, 1986; Eelens and Speckmann, 1990; Shah, 1994a). It is dominated by private recruiting agencies and migrant networks which act as intermediaries between prospective workers and foreign employers (Skeldon, 1997; Shah and Menon, 1999; Martin, 2005). Whether it is an authorised or unauthorised form of labour migration, the role of recruitment is vital in channelling migrant workers across international borders. In particular, recruitment has made it possible to sustain the circulation of millions of migrants in the Gulf Cooperation Council (GCC) states in the last four decades as well as surface the GCC countries as one of the largest regions utilising labour migrants globally in the 21st century (Kuptsch, 2006; Eelens and Speckmann, 1990; Shah, 2010; Esim and Smith, 2004).

In the six member countries of the GCC (Bahrain, Kuwait, Qatar, Oman, Saudi Arabia and the United Arab Emirates), migrant workers outstripped the local workforce in the 1980s (Suter, 2005: 28). The number of migrant workers increased from 9 million in 1990 to an estimated 13 million in 2005 (Dito, 2008: 6). Migrants constituted a majority of the labour force in all the GCC countries, with the average for the year 2004 being close to 70 per cent (Kapiszewski, 2006:4) and for the year 2008 being close to 77 per cent[2] (Winckler, 2010:12; Baldwin-Edwards, 2011:9). In general, international migrants are invited under a specific labour migration programme called *Kafala* system in the Gulf states. The *kafala* system restricts family reunification for unskilled migrants, ties them to a single employer, disallows them from marrying locals, and enforces other restrictions on rights and movements so that the migrants stay as transient workers in the Gulf countries (see for details, Dib, 1988; Longva, 1999; Shah 1994b, 2008; Esim and Smith, 2004; IOM, 2004).

Existing literature explicitly suggests that recruitment agencies and migrant networks play a critical role in recruiting transient labour in the GCC countries (Arnald and Shah, 1986; Eelens and Speckmann, 1990; Eelens et al 1991; Shah and Menon, 1999; Gamburd, 2000; Zachariah, et al., 2001; IOM, 2004). However, these studies concentrate on other communities and the Bangladeshi migrant community is often neglected. Bangladeshis have played a role in the Gulf labour markets since the mid-1970s. Since then, Bangladesh has emerged as one of the major labour-contributing countries from Asia. According to the Bureau of Manpower, Employment & Training (BMET), around 5.3 million Bangladeshi

[2] Calculated from data provided by Winckler, 2010:12 and Baldwin-Edwards, 2011:9.

migrants were employed in the GCC states between 1976 and 2010.[3] Despite being a major labour-contributing country for the GCC states, such recruitment in Bangladesh has, thus far, received inadequate attention from the scholarly community. This study attempts to fill that gap.

On the theoretical and conceptual level, most existing literature on labour recruitment tends to focus either on migrant networks or on recruiting agencies in the GCC countries, offering an inadequate analysis of the overall recruitment procedures. Apart from this, the largest part of existing studies also tend to highlight either operational or economic aspects of recruitment and provide small, village-level survey data to support the economics of recruitment at the national level. Instead of studying the role of recruiting agencies and migrant networks separately, this study takes an innovative approach by reflecting on both recruiting agencies and migrant networks in the recruitment process. The roles of recruiting agencies and migrant networks are compared and contrasted to offer further insights into variations within the operational dimension of recruitment. Drawing upon national level migrant household data, the study provides the economic cost of recruitment and distribution of recruitment costs across different actors within the system. In doing so, this study attempts to provide a holistic understanding of Bangladeshi labour recruitment in the GCC countries.

This study is broadly divided into two parts: operational and economic aspects of recruitment. In the operational dimension of recruitment, the study covers a wide range of issues such as recruitment structure, licensed manpower recruiting agencies and their recruitment methods, and migrant networks and their respective methods. In the economics of recruitment, the study explains methods of payment for recruitment cost and provides the economic cost of recruitment to the Gulf counties. Before addressing the broader recruitment issues, the next section offers theoretical and conceptual issues, describes data sources with information about socio-demographic features of studied migrants which is followed by a description of Bangladeshi migration to the Gulf countries and an elaboration of *Kafala* system.

Theoretical and Conceptual Issues

In temporary migration of labour in Asia, several institutions come to assist prospective migrants to move intra-regionally for work: employers who recruit prospective migrants directly, public employment services working to match local workers with foreign jobs, migrant networks with access to foreign labour markets and private fee-charging agents (Martin, 2005; Martin, 2006; Kuptsch, 2006). They together form a recruitment structure that facilitates this overseas migration. Migrants may consult with and use the services of any of these labour intermediaries and, in some cases, more than one. However, over time the roles

[3] Bureau of Manpower, Employment and Training, Bangladesh (BMET) is responsible for record-keeping and granting permission to overseas job seekers. BMET posts vital migration statistics online www.bmet.org.bd. Accessed on 24 July 2011.

of a direct employer and public employment services have substantially declined and the roles of networks and private agents have increased globally (Martin, 2005: XII). In Asia, the role of direct employment and public employment services for low-skilled migrant workers has almost disappeared because of the rising number and increased diversity of migrants, and efficiency in recruitment of labour through networks and private agencies (Ullah and Rahman, forthcoming).

Network analyses have generated enormous literature, explaining how it facilitates and sustains labour migration across international borders (Massey et al, 1987; Boyd, 1989; Faist, 2000). Existing studies demonstrate that non-migrants, migrants and returnees are linked to one another through ‘social and symbolic ties’ that offer the social bedrock for sustained migration flows across international borders (MacDonald and MacDonald, 1974; Gurak and Caces, 1992; Shah, 1995; Shah and Menon, 1999; Rahman, 2009). Social ties are often defined as a continuing series of interpersonal transactions to which participants attach shared interests, obligations, expectations and norms such as family and kinship ties, while symbolic ties are a perceived bond to which participants attach shared meanings, memories and future expectations such as regional, national, ethnic, religious and lingual ties (for details, see Faist, 2000). The content of social and symbolic ties that Thomas Faist identifies as obligations, reciprocity and solidarity contribute to the evolution of migrant networks and the sustenance of the migration flows across international borders (Faist, 2000). In networked migration, basic human relationships adapt to play new roles in the migration process. In short, many migrants move because others with whom they are connected had previously migrated.

In social network literature, social reward and social debt are usually seen behind the working of network-assisted migration (Boyd 1989; Faist, 2000). However, there have been some changes in the modalities of contemporary labour recruitment, especially low level migrant worker recruitment in Asia. The rising and disturbing trend in labour recruitment is the emergence of ‘visa trading’ in various Gulf countries (Shah, 2008; De Bel Air, 2011). Due to the great supply of foreign workers and the intense competition between recruiting agencies, recruiting agents and migrant brokers need to pay *kafeel* to procure work visas for migrant workers. This development of visa-trade has transformed the modality and scale of transactions for intermediaries of both migrant networks and recruiting agencies alike. Forced by market pressures, actors of migrant networks are now required to charge fees for Gulf visas, leading to the commercialisation of network-assisted recruitment. Currently, network-assisted recruitment is increasingly run for both non-material and material rewards, if not solely non-material reward.

The other key intermediary of labour recruitment is private recruiting agencies that become formally involved in serving prospective migrants for a fee. Recruitment agencies act as private gatekeepers, managing the modalities that condition access for individuals seeking overseas employment (Goss and Lindquist, 1995). A recruiting agency is a national level contact point for a foreign recruiting agency or foreign employers. Recruiting agencies usually have control over information that allows them to negotiate with prospective migrants and their potential employers. They introduce prospective migrants to foreign partners (employers and other recruiters). There may be as many as several thousand recruiting agencies in each major source country in Asia if both licensed and unlicensed recruiting agencies are counted (Martin, 2006; Baruah, 2006; Lian and Rahman, 2006). Considering their role in the recruitment process, some scholars refer to networks as the ‘engines of migration’ (Phillips and Massey, 2000) and other scholars refer to recruiting agencies as the ‘other engines of migration’ (Hernandez-Leon, 2005:2). Some set rules and regulations control the behaviour of the recruiting agency while traditional social control mechanisms ensure the conduct of migrant network members.

To explain the recent changes in recruitment practices, scholars offer some mid-level concepts such as ‘migration institution,’ ‘migration industry’ and ‘merchants of labour’ (Castles and Miller, 2008; Goss and Lindquist, 1995; Kuptsch, 2006). For instance, Jon Goss and Bruce Lindquist present the concept of ‘migrant institution’ which is drawn on Anthony Giddens’ structuration theory (Goss and Lindquist, 1995). Migrant institution is conceived as ‘a complex institution consisting of knowledgeable individuals and agents of organisations (from migrant associations to multinational corporations) and other institutions from kinship to the state’ (Goss and Lindquist, 1995: 336). The argument is that the institution operates to facilitate overseas migration because brokers profit from the price and potential migrants are willing to pay, whether in terms of material payment or social debt. These organisations, such as recruiting agencies, benefit from fees charged in advance.

An International Labor Organization (ILO) study on migrant workers and facilitators of migration develop the concept of ‘merchants of labour’ to refer to public and private agents who move workers over national borders for economic rewards (Kuptsch, 2006). These merchants of labour include relatives who finance a migrant’s trip, provide housing and arrange for a job abroad, as well as public employment services and private recruitment agencies. Literally, it includes all intermediaries who make profit out of migrant workers. Another concept which has been in use for quite a while is ‘migration industry’ and it embraces a wide range of people who earn their livelihood by organising migratory movements (Castles and Miller, 2008:201). Such individuals include travel agents, labour recruiters, brokers, interpreters, housing agents, immigration lawyers, human smugglers and all others who extract fees from potential migrants for their services. One thing that is common for merchants of labour and actors in the migration institution and industry is the service fees that they charge to the prospective migrants.

The terms ‘recruitment fees’ and ‘economic cost of recruitment’ demand a conceptual clarification. They can be interchangeable when used in areas of expenses such as airfares, government fees, insurance, medical checkups, passport fees, short-term training, agency fees (official and unofficial) and other potentially required expenses. However, they differ in methods of payment.

For instance, in some sending countries, prospective migrants do not need to pay any amount of cash for recruitment upfront. All expenses associated with recruitment mentioned above are paid initially by the recruiting agencies. Later, recruiting agencies may deduct the paid expenses from the first several months of wages of the migrant worker. For instance, an Indonesian domestic worker typically pays around six to 10 months of her wages to the recruitment agency operators for working in Singapore, Hong Kong and Malaysia (Rahman, 2008). This method of repayment is commonly found among Asian female domestic workers (Wee and Sim, 2004; Jones and Pardthaisong, 1998). However, South Asian male migrants usually enjoy the privileges of active expenses in the recruitment process, by choosing service providers themselves and paying them upfront. The quality of choosing the service providers and paying the incurred expenses upfront justifies calling it 'economic cost of recruitment' rather than the seemingly binding 'recruitment fees'. This study is advanced in the context of this economic aspect of recruitment.

Data Sources

This research draws from qualitative data from both Bangladesh and a number of receiving countries in the GCC states and quantitative data from a national level migrant household survey conducted in Bangladesh. For the qualitative data, the author interviewed Bangladeshi migrant workers and migrant brokers in the UAE and Qatar, and Bangladeshi returnees, subagents and agents in Bangladesh between 2008 and 2010. A national level survey entitled 'Bangladesh Household Remittance Survey,' which was performed by the International Organisation for Migration in Dhaka with the financial support from Department for International Development – the United Kingdom (DFID-UK) in 2009, is the source for this study's quantitative data.

The survey interviewed households across the country through a nationally representative sample of migrant households from all six administrative divisions of Bangladesh. A 'migrant household' was defined as a household that had at least one of its members currently living/working abroad during 2009. In total, the number of migrants accounted for in the survey was 12,893. Of these 12,893 represented migrants, approximately three-quarters of the surveyed migrants (n=9292) were working in the GCC countries.

Of the 9,292 Gulf migrants in the sample, 98.5 per cent were males and 1.5 per cent females. Approximately 48 per cent of the migrants were working in Saudi Arabia, 34 per cent in the UAE, 8 per cent in Kuwait, 5 per cent in Oman, 3 per cent in Qatar and 2 per cent in Bahrain. Overall, nearly three-fourths of the migrants were in their 20s and 30s with the average age being 32. Although Bangladeshi migrants to the GCC countries were predominantly males migrating alone, they were not necessarily unmarried. Approximately 63 per cent of migrants were married with wives remaining in Bangladesh. Of these married migrants, 87 per cent had children. Wives left behind were primarily homemakers, taking care of children and in-law families. For most of these families, remittances were the only source of income for these households.

The major categories of occupations that these migrants were engaged in in the GCC countries were construction, janitor, driving, factor work, restaurant or hotel work (cleaners, waiters), general labour and gardening. The educational attainments of the surveyed migrants were low. Approximately 30 per cent of migrants received only one to five years of schooling while 50 per cent completed six to 10 years. Of the remaining 20 per cent migrants, half had no formal education while the other half attained secondary and other vocational certificates. Approximately 34 per cent of migrants were living between one and two years, 22 per cent between three and five years, and 23 per cent between six and 10 years. The remaining one-fifth of those surveyed had been working abroad for a period of 11 years to 21 years (in some cases more). On average, the duration of stay of migrants was 6.27 years. Given the average duration of stay, it is probably safe to note that Bangladeshi migration to the GCC countries has been matured over time to give birth to complex recruitment procedures supported by both recruiting agencies and migrant networks.

Bangladeshi Labour Migration to the GCC Countries

The 1973 oil boom and the subsequent undertaking of an unprecedented number of development projects led to an extremely rapid increase in the demand for foreign labour in the Gulf countries (Arnald and Shah, 1986; Birks et al. 1988; Winckler, 2010). The growth of foreigners in the GCC countries has progressively increased since 1975. Foreigners were estimated to be nearly one million (10 per cent) of total Gulf population in 1975, around eight million (37 per cent) in 1990 and around 17 million (43 per cent) in 2010 (Fargues, 2011:11). Obviously, all migrant workers are foreigners; however, all foreigners are not necessarily migrant workers as the GCC countries offer family visas (for spouses and children) for skilled and professional foreign talent.

Among Arab countries, there was considerable labour mobility in the pre-1973 era (Humphrey, 1991; IOM, 2010). However, the introduction of Asian labour migrants in the post-1973 period marked a shift from predominance of Arab labour migration to Asian labour migration in the oil-rich Gulf states (Arnold and Shah, 1986; Humphrey, 1991; Winckler, 2010). Since 1975 Asian workers have gained an increasing share of the migrant labour market; between 1976 and 1981 annual labour migration flows of Asian workers increased sevenfold, from 146,000 to more than a million with Asian countries representing the majority of sending countries to the Gulf (Humphrey, 1991: 47). Asian labour sending countries accounted for more than 63 per cent of the migrant worker stock in the Gulf states in 1985 (Birks et al., 1988: 268). Currently, Asia is the major human resource-contributing region for the GCC states.

The first official recording of labour migration flows to the GCC countries was initiated by the Bureau of Manpower, Employment & Training (BMET) in 1976. According to BMET, the formal recruitment of Bangladeshi labour to the GCC countries started in the mid-1970s and by 1980, nearly 80,000 migrants had gone to the GCC countries for work. The number of migrants reached nearly 1 million between 1981 and 1990, around 1.9 million between 1991 and 2000, and approximately 2.4 million between 2001 and 2010[4]. Almost half of the total migrants joined the labour market of Saudi Arabia. The other countries are the UAE, Kuwait, Oman, Qatar and Bahrain. The majority of Bangladeshis are unskilled male migrants. A small number of Bangladeshi women have also joined in the labour markets of the Middle East, Southeast and South Asia (Maldives); the rate of female migration, according to a recent BMET[5] report, is from 3 to 5 per cent at the national level.[6]

Labour Recruitment in the Gulf – *Kafala* System

The Gulf countries have developed a sophisticated migration management system that shares two common stances on international migration: protectionism and the absence of any project for integrating immigrants into society (Fargues, 2006:18). Philippe Fargues suggests that the Gulf migration policy is protectionist in two different ways: by making the entry of foreign workers more difficult and by giving priority to the employment of nationals commonly known as 'emiratisation, Saudisation, Qatarisation, Kuwaitisation, Bahrainisation and Omanisation' initiatives (Fargues, 2006). There is almost a general consensus that these policies have not fully achieved their goals (Toledo, 2006; Dito, 2008). The Gulf countries see migrants as transient workers and, therefore, are unwilling to integrate migrants into the mainstream Gulf society.

Labour recruitment in the GCC countries takes place in a system, popularly called *kafala* or sponsorship (Longva, 1999; Colton, 2010; Shah, 1994b; Baldwin-Edwards, 2011; De Bel-Air, 2011). In a *kafala* system, a migrant is sponsored by an employer who is a GCC citizen and who assumes full economic and legal responsibility for the employee during the contract period. Kafeel may be an individual, a placement agency, or a company/institution. The *kafeel* (sponsor-employer) signs a form whereby he or she declares that the foreigner works for him or her, undertakes to inform the immigration department of any change in the labour contract such as expiry, renewal or cancellation, and pledges to repatriate the employee upon termination of the contract (for details, see Longva, 1999). The migrant worker thereby is tied to his or her *kafeel*. The system works such that the migrant worker can work only for him or her for a specific period. *Kafeels* often hold their employees' passports and other travel

4 BMET statistics, www.bmet.org.bd. Accessed on 23 June 2011.
5 BMET, Bureau of Manpower, Employment and Training, is a government body and in charge of monitoring outflows of migrant workers.
6 http://www.randstad.com/the-world-of-work/increase-reported-in-bangladeshi-female-migrants.html?c=3053. Accessed on 12 December 2009.

documents and sometime exploit them by denying proper wages and conditions of employment to them (Colton, 2010).

Recently, Françoise De Bel-Air offers a two-fold classification of *kafeels*: small or occasional *kafeels* and big *kafeels* (De Bel-Air, 2011:3). 'Small' *kafeels* operate within small-scale, person-to-person frameworks such as employment of domestic workers. However, 'big' *kafeels* usually set up national level networks and possess adequate means and recourses to lobby for 'work visas'. Many big *kafeels* are believed to be involved in visa trading (De Bel-Air, 2011:3). Since visa trading generates kick-back fees for *kafeels,* it has become a multi-million dollar industry in the Gulf (Shah, 2008). In the UAE, for instance, a work visa for an Indian is sold for around US$2,000 (or AED7,500) (Shah, 2008:9) and for a Pakistani around US$2,700 to US$3,000 (AED10,000 to AED12,000)[7] (Gulf News, April 13, 2004). The scale of visa trading is massive. The Saudi Minister of Labour reported that 70 per cent of the visas issued by the government are sold on the black market and the government has been determined to crack down on this particular trade (Arab News- Saudi Arabia, 29 April 2004; cited in Shah, 2008:9).

In the *kafala* system, a change of *kafeel* is not impossible but entails hurdling bureaucratic procedures. Once the employment relationship is broken, foreign workers become illegal residents. Foreign workers are not allowed to marry or be involved in sexual relationships; domestic workers' physical bodies are under medical surveillance to detect sexual activity. The overall emphasis in the *kafala* system is on control and 'flexibility' in response to local labour market fluctuations.

The *kafala* system has been met with much criticism over the years. For instance, it is accused of encouraging corruption, visa trafficking, as well as import of workers widely outpacing labour market needs (*Migration News*, November 2001 cited in De Bel-Air, 2011:10). The system ensures additional lucrative incomes for local sponsors and, despite some genuine interests, governments in the Gulf countries have not introduced a meaningful change in the visa-trading system, largely because of pressure from business elites and clan members (De Bel-Air, 2011; Shah, 2008).

It is worth mentioning that the sponsorship system is not unique in the GCC countries. This approach to temporary migration management with some parallel purposes and control mechanisms can also be found in East Asia and Southeast Asia (Chan and Abdullah, 1999; Ruhs, 2002; Piper, 2004; Asis and Piper, 2008). Temporary migration programmes are, in essence, a demand-driven system that serves the interests of both parties – employers and migrants (Rahman, 2008). On the one hand, it is efficient in satisfying the needs of employers and therefore is capable of generating higher benefits for the host country. On the other hand, it is economically beneficial for migrants and their home countries because it spawns

7 Gulf News, 'Illegal visa trade still flourishes'. 13 April 2004.

remittance that directly goes to the migrants' families who genuinely require it. More importantly, it opens up the opportunity for millions of unemployed individuals from developing economies to earn wages and relevant working experiences overseas and employ these benefits upon return.

The Operational Aspects of Recruitment

Recruitment Structure

In the recruitment process, prospective migrants in Bangladesh use the services of four public and private institutions -- BMET, Bangladesh Overseas Employment Services Limited (BOESL), recruiting agencies and migrant networks -- and together they form a semi-coherent system of governance that facilitates smooth flows of labour overseas. The Bangladeshi government's most prominent structure regulating migration is known as BMET, established in 1976. The BMET issues and renews the licences of recruiting agencies, grants permission to agencies to recruit, provides immigration clearances after verifying visa papers and employment contracts, looks after the welfare of Bangladeshi workers abroad and manages many other functions related to training of workers and promotion of migration overseas. Currently, BMET is under the administrative control of the newly established Ministry of Expatriates' Welfare and Overseas Employment.

While the BMET supervises and controls recruitment, actual recruitment takes place through three other channels: a government-run organisation called BOESL, private recruiting agencies and migrant networks. The government-run organisation for overseas employment, BOESL, established in 1984, is mainly involved in migration of high-skilled professionals overseas. The role of BOESL in skilled and professional migration is not necessarily significant. Out of 179,910 professional migrants who took up overseas placement between 1976 and 2008[8], only 14,811 professional migrants found jobs through BOESL. The agency coordinates with Bangladeshi missions abroad in assessing the needs of labour and puts up advertisements in newspapers for recruitment. BOESL is seen as a model institution in the manpower sector to work in healthy competition with private agencies.

Private recruiting agencies have emerged in response to the growing demand for labour overseas in the late 1970s. There are around 700 licensed private recruiting agents in Bangladesh.[9] The government regulates recruiting agencies through a combination of economic leverage and bureaucratic requirements. Recruiting agencies assisted nearly 37 per cent (2.33 million) of a total stock of 6.26 million overseas job placements between 1976 and

[8] This is based on BMET data, http://www.bmet.org.bd/Reports/Overseas_Statistics.htm. Accessed on 24 July 2011.
[9] BAIRA website, http://www.hrexport-baira.org/index2.htm. Accessed on 12 August 2011.

2008.[10] Recruiting agencies have a guild known as the Bangladesh Association International Recruiting Agencies (BAIRA), formed in 1984 with a view to catering for the needs of licensed recruiting agencies. BAIRA is also involved in welfare of migrants overseas. They have launched two insurance schemes: one is for workers before their departure and the other is for their families left behind, through BAIRA Life Insurance Company Limited. BAIRA is also setting up a modern Medical Testing Centre with elaborate facilities for migrants who need to undergo medical tests before leaving the country.

Personal connections form a crucial avenue for overseas placement in Bangladesh. Personal connections assisted 62 per cent (3.88 million) of a total of 6.26 million overseas job placements between 1976 and 2008.[11] The growth of migration through personal connections is cumulative. More and more migrants have started taking the services of personal networks over the years, for instance 524 migrants took the services of personal networks in 1976, which escalated to 16,585 in 1980, 63,121 in 1990, 130,686 in 2000 and 665,092 in 2008. As per the survey data, nearly 58 per cent of the surveyed migrants (9,292) took the services of personal networks to migrate to the GCC countries. Recruiting agencies served the remaining 42 per cent.

Recruiting Agencies: Work Visa

Migration for work though a recruiting agency proceeds as follows (see Figure 1): A recruiting agency in a Gulf country places a 'demand letter' to their counterpart in Bangladesh, asking for a certain number of migrants for certain occupations. A recruiting agency in Bangladesh approaches the BMET for initial clearance. Once the agency receives the clearance, it searches out prospective migrants and asks them to submit passports, pictures, biographic information, working experiences (including relevant certificates) and a partial payment to begin the recruitment process. At this juncture, the Bangladeshi recruiting agency contacts its counterpart in the Gulf for visa processing. The potential sponsor-employer will then secure the visas from the relevant authority and pass the visas to the recruiting agency in the receiving country. This foreign recruiting agency then sends the visas to the recruiting agency in Bangladesh. From the time the potential migrant gives his passport to the agency to the time he or she flies out can be as short as a few weeks or as long as several months.

Although a general overview of how recruiting agencies work may seem simple, the actual recruitment procedures are much more complex and multi-layered. Along with formal recruiting agents, some informal agents located in different points throughout the system come to assist the recruitment procedures. Generally, most prospective migrants hail from

10 This is based on BMET data, http://www.bmet.org.bd/Reports/Overseas_Statistics.htm. Accessed on 24 July 2011.

11 http://www.bmet.org.bd/Reports/Overseas_Statistics.htm. Accessed on 24 July 2011.

villages in Bangladesh, but recruiting agencies based in the capital city of Dhaka encounter difficulty in locating prospective migrants who might be suitable for particular jobs and ready to pay the required fees. As a result, the recruiting agents rely overwhelmingly on a group of middlemen called sub-agents, who act as mediators between a prospective migrant and a licensed recruiting agent. For an extra fee, these sub-agents help prospective migrants find jobs and help agencies find prospective workers in a more timely fashion. Although the position of sub-agents in the official structure is nominal, they play a critical role in matching the demand for specific labour and the supply of such labour.

The sub-agents approach prospective migrants and convince them to take up the particular offer in the GCC countries. The true hurdle of this job is the sub-agents' ability to earn the trust of prospective migrants. Given the fact that migration can be a few-thousand-dollar project, a prospective migrant from a village prefers to deal with someone who embodies trust such as rural religious, economic and political elites so that they have a local contact to approach in cases of fraud and exploitation. Sub-agents are generally based in small cities or villages and have good contacts with these elites, if they themselves are not already elites themselves. Sub-agents assist prospective migrants with a wide range of activities such as paperwork, passports, bank accounts, medical checkups and transportation to the airport. In addition to facilitating the actual migration process, they sometimes vouch to the traditional moneylenders that their potential clients have already secured jobs in the Gulf and therefore are eligible for credit. They can even act as guarantors for some potential migrants who otherwise could not secure loans for migration, transgressing (wrong, suggest surpassing) the role of sub-agents beyond simple matching task.

Personal Connections: *Urro* or Flying (Work) Visa

As migration matures, many potential migrants learn more about the process of migration and the way to seek alternative services for jobs in the GCC countries. Instead of finding jobs with agencies, many potential migrants seek jobs arranged with sponsor-employers in the Gulf countries through some migrant brokers already connected by social and symbolic ties. Migrant brokers or what Bangladeshi migrants call '*dalal'* (broker) or '*adam babshahi'* (human-trader) are usually former migrant workers living in the Gulf countries for a considerable length of time and have greater access to local recruitment structure and visas.

A working visa arranged through personal networks is called '*urro'* or a flying (work) visa' as it flies directly from a migrant broker in the Gulf countries to a prospective migrant in Bangladesh, bypassing local recruiting agencies and their sub-agents. This is different from getting a visa through a recruiting agency. In the recruiting agency-operated recruitment, a sponsor-employer passes the visa to a foreign recruiting agency, which later goes to the Bangladeshi recruiting agency and finally to the prospective migrant.

Arranging a 'flying visa' usually proceeds as follows (see Figure 1): A migrant broker finds a job for a friend or relative with usually his *kafeel* or *kafeel's* network of friends and relatives. After successfully identifying a potential *kafeel*, the migrant broker arranges a photocopy of a passport, a portrait photograph and other relevant papers depending on the profile of employee (skilled or unskilled) to pass to the potential *kafeel* (sponsor-employer) for a work visa. Once a work visa is procured, the migrant broker sends it to the potential migrant in Bangladesh and asks to finish all local procedures such as medical check-up and BMET clearance before flying to the particular Gulf country within a stipulated period (usually less than three months). The flying visa benefits the mediating contact as he charges a commission to the potential receiver and the *kafeel* as he saves agency fees in his country of origin, in addition to kickback fees in most cases.

More importantly, the strategy of procuring a working visa through personal connections shows an individual migrant's ability to circumvent bureaucratic procedures and rising costs of Gulf migration. Since procurement of a 'flying visa' does not involve local mediators in Bangladesh, especially the sub-agents and agents, the 'flying visa' benefits the potential migrant who receives it. Depending on the nature of ties (social or symbolic ties) between a prospective migrant and migrant broker, the amount of the fees for and timing of payment can vary considerably. The direct benefit of a 'flying visa' is that the recipients usually pay part of the set fees out of the wages of the first several months in the destination country, forestalling indebtedness to moneylenders in Bangladesh. Although the ever-increasing costs of recruitment have made it difficult for many poor potential migrants to secure jobs in the Gulf countries, a thriving trade in 'flying visas' has opened the door of affordable employment for a growing number of Bangladeshis in the GCC countries.

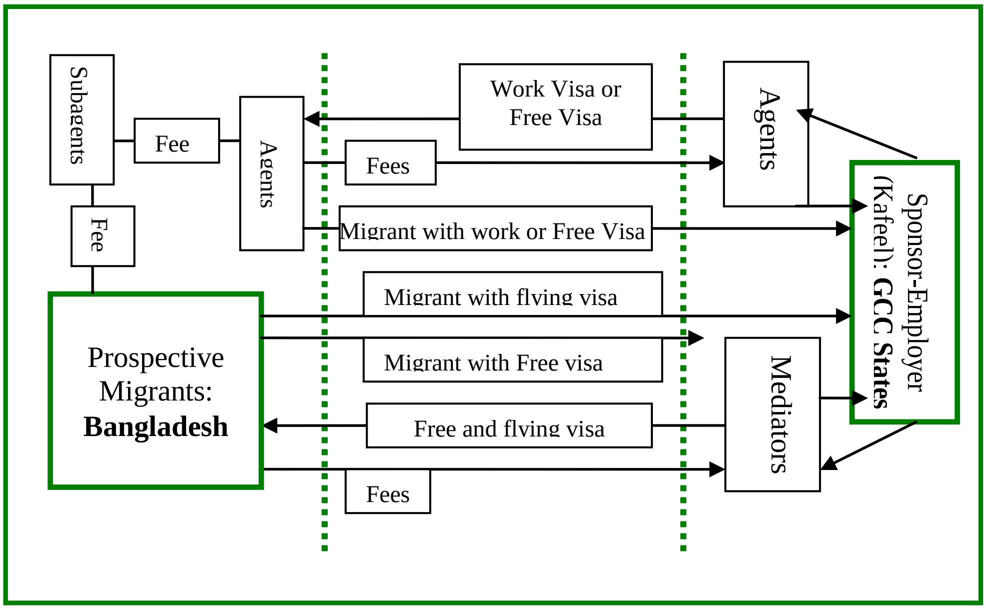
It is important to note that the Bangladeshi migration to the Gulf countries is deeply rooted in the social process organised through networks and forged through everyday interpersonal connections (Rahman 2010). It is founded on a social organisation infrastructure that includes common bonds of kinship and friendship, which are adopted and transformed through the reciprocity of mass migration. A landless villager in Bangladesh may be poor in financial capital but is often rich in social resources (social capital) inherent in such close knit connections. The beauty of social capital is that it is convertible into other forms of capital such as financial capital or access to overseas employment. The actual merit of personal connections is that it increases affordability of Gulf migration for those in the social stratum who may not otherwise envision undertaking such a costly venture.

From Flying Visa to Free Visa

Apart from 'flying visa', there is another type of visa, popular among potential Bangladeshi migrants in the Gulf countries, called a 'free visa'. This type of visa is an invention of migrant brokers in the Gulf countries involved in the trade of work-visas. Although there is no official category of visas called 'free visas' in the Gulf countries, the term is widely used among migrant communities. Pakistanis and some Indian Muslim migrants call it '*azad*' (free) visa. This unofficial category of visas allows a potential migrant to enter a GCC country for work under the *kafala* system, but the sponsor-employer (*kafeel*) who officially sponsors the migrant does not offer paid work. A migrant on 'free visa' is free to find his own job in any sector of the economy although it is illegal to work in other sectors or with a sponsor-employer other than one's own[12] (Shah, 2008:7). In other words, a 'free visa' is legal but, paradoxically, when a free-visa holder starts working for others, he becomes illegal by law and vulnerable to deportation.

A 'free visa' is also obtained through similar procedures described for the personal networks and recruiting agencies earlier. Both migrant brokers and recruiting agents are involved in the trade of 'free visas' in Bangladesh. As there is no legal job available for a 'free visa' holder, a 'free visa' is cheaper than a 'flying visa'. Many migrant brokers do not recommend 'free visas' to their close relatives for fear that they may lose social credibility and respect in their communities of origin in case the 'free-visa' holders do not find gainful employment and encounter deportation. Being for-profit organisations, recruitment agencies dominate the 'free visa' market. Like many 'work visas' and 'flying visas', 'free visas' also generate kick-back fees for sponsors/*kafeels* and this has perhaps given birth to such a dubious category of visas in the Gulf. The benefit of a 'free visa' is that the holder can bargain with his labour and get a good deal. However, the trade-off is that if the free visa holder is caught during working hours by the law-enforcement authority, the holder is exposed to deportation. Several Gulf countries have pledged to tackle the issue of 'free visas' and have taken action against people who have abused the system to bring in thousands of foreigners and enabled them to stay for a monthly monetary sum (Pakkiasamy, 2004).

Figure 1: Conceptualising Recruitment of Bangladeshi Labour to the Gulf States



[12] *Gulf News*, 'Kuwaitis speak out against crimes related to "'free visa" ', 2 January 2011.

The Economic Aspects of Recruitment

In the case of Asian migration to the Gulf countries, wages have fallen and agency recruitment costs have risen. To explain this situation in the Gulf countries, Gamburd has attributed changing international economic dynamics to a shift in agency fees and wages (Gamburd, 2000: 63). The benefits of Gulf migration dwindled in the 1980s when employer-sponsors lowered commissions paid to recruiting agencies in the Gulf countries (Gamburd, 2000). Since the Gulf countries opened the door for migrant labour from the Maghreb, Mashreq and Asian regions, there has been a high demand for the limited number of jobs in the Gulf, creating a competition among labour-source countries and among recruiting agencies in these source countries.

With an apparently endless supply of surplus labour in source countries across the regions hoping to work in the Gulf states even with reduced benefits, agencies of these countries have often bargained away workers' benefits in order to secure jobs and stay in business. Agencies in sending countries have to charge higher fees from potential migrants often in order to pay competitive commissions to Gulf recruiters. From the early 1970s until the mid-1980s, most sponsor-employers paid airfare, passport and medical costs for prospective overseas migrants. However, by the late 1980s, in addition to recruitment fees most Asian migrants had to handle these charges for employment in the Gulf, causing the rise of recruitment costs over time.

As mentioned earlier, prospective migrants are required to make some form of upfront payment regardless of the channel of recruitment. A set fee (official and unofficial fees for visa procurement) and other expenses such as passport fees, medical check-ups, government fees (for clearance), insurance, airfare and other transportation costs are some of the major areas of expenses although there are some exceptions. For instance, close relatives (such as brothers or cousins) in network-assisted migration sometimes pay the set fees from their first few months of wages. However, in recruiting agency-assisted migration, a prospective migrant is typically required to pay a full amount of set fees before departure for a destination country.

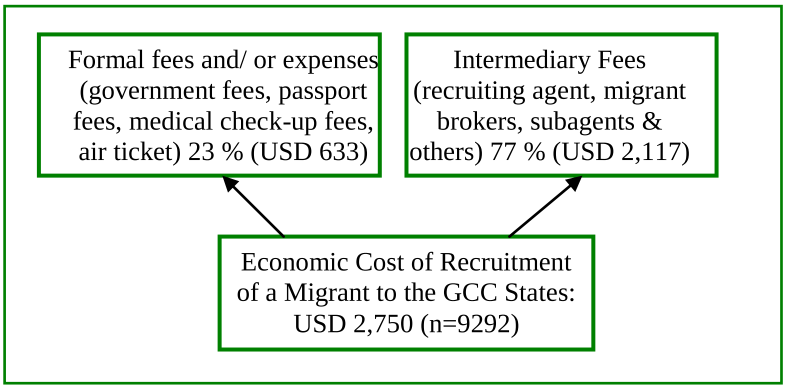
The economic cost of recruitment for a Bangladeshi migrant who seeks employment in the GCC countries is on average BDT195,237 (US$2,750, exchange rate as of 2010). The highest average cost is BDT221,683 (US$3,132) for Bahrain and the lowest is BDT174,021 (US$2,458) for Kuwait. This average cost of migration is higher than the cost set by Bangladesh government. The Bangladesh Government sets BDT84,000 (US$1,230) as a maximum recruiting charge for migrants going to the Gulf states (Martin, 2010:12). Given the average cost of migration, it is obvious that recruiting agencies largely ignore this maximum.

Given the high cost of migration, this study delves into distribution of recruitment expenses. For the convenience of understanding, the study divides the economic cost of recruitment into formal fees and intermediary fees. Formal fees include government fees, passport fees, air tickets, wage earners' contribution, and other relevant mandatory service fees in Bangladesh. Intermediary fees include both recruiting agency and migrant broker fees and other facilitators' fees such as sub-agents and network members who link a prospective migrant with the recruiting agency or migrant broker overseas. On average recruitment cost of US$2,750 for each migrant, formal fees represent around 23 per cent (US$633) of the economic cost of recruitment while the intermediary fees are nearly 77 per cent (US$2,117).

The fee for intermediaries is excessively high as a kickback regardless of channels of recruitment. Some Bangladeshi recruiting agents and migrant brokers reported the kickback fee of between US$1,500 and US$1,800 for each work visa. However, the kickback fee varies depending on the sector of economy. The kickback fees for work in construction sector is reported to be the lowest as it is more demanding and less rewarding, and the service sector is the highest as it is less demanding but more rewarding. The practice of kickback fee is widely reported in the Gulf news media and academic work[13] (see also, De Bel-Air, 2011; Ruhs, 2002; Shah, 2008). The kickback fee, intermediary fee, and sub-agent fee are charged unofficially without receipts, leaving no trace for documentary proof and legal recourse.

When the rising cost of migration was discussed with the actors at different levels, they often turned their discussion of unethical behaviour towards other actors in the institutional structure. While sub-agents blamed recruiting agencies for corruption, recruiting agencies condemned sub-agents for charging extra commissions and giving false promises, thereby inflating the recruitment cost. Bangladeshi recruiting agents also condemned Gulf recruiting agents for skimming off a great deal of the recruitment costs and vice versa. These different perspectives reveal conflicts and contradictions within the recruitment structure in the Bangladesh-Gulf migration corridor.

Figure 2: Distribution of Economic Cost of Recruitment



[13] *Gulf News*, 'Illegal visa trade still flourishes', 13 April 2004; Gulf News Call for tougher rules to curb visa trade, 12 October 2003

Conclusion

This paper has argued that development of the recruitment industry has made it possible to hire millions of foreign workers in the GCC countries over the years. This study has shown how recruitment of labour takes place across international borders by scrutinising both the operational and economic aspects of recruitment through the example of Bangladeshi labour recruitment in the GCC states. In doing so, it illustrates the role of both institutional and network players in the recruitment process. It continues to elaborate on the *kafala* system that forms the legal basis for labour recruitment in the GCC countries. The study notes that the basic principles of the *kafala* system such as tying migrants with a single employer, forbidding them from marrying locals, restricting family reunification, offering renewable work visas, and viewing migrants as disposable and transient are also seen in other migrant-receiving countries in Southeast and East Asia. The policies of entries and exits for migrant labour are mostly dictated by the economic imperative and informed by the principle of minimal social disruptions in the host countries.

This study has explained how the recruitment structure of Bangladesh has evolved over time and facilitated the channelling of more than five million migrants to the Gulf countries between 1976 and 2010. The study has identified four major players -- BMET, BOESL, recruiting agencies and migrant networks – in a semi-coherent system that governs and facilitates migration of labour from Bangladesh to the GCC countries.

However, it has also been shown that recruiting agencies and migrant networks are the actual players in labour recruitment representing nearly 38 per cent and 62 per cent, respectively. Recruitment agencies and migrant brokers have different but complementary role in the overall recruitment process. Recruiting agencies work in collaboration with their counterparts in the Gulf countries and use sub-agents to reach potential migrants. They are formal profit-making organisations helping prospective migrants to find jobs in the Gulf labour markets.

In recruitment through networks, a migrant broker in a Gulf country secures a work visa, known as a ‘flying visa’, for a prospective migrant in Bangladesh. Prospective migrants and migrant brokers are often connected by social and symbolic ties. A migrant broker charges fees for services but full down payment is not always required depending on the level and strength of ties; a prospective migrant may pay off a part of the set fee after working in the destination country for the first few months. Migrant brokers have also invented other type of visas, called ‘free visa’. to meet the ever-increasing requests from relatives and community members in the origin society. A ‘free-visa’ sponsor is not morally liable to offer paid jobs to the ‘free-visa’ holder; the holder is free to find his own employment. ‘Free visa’ holders can bargain their labour costs but take the risk of premature deportation. Both migrant brokers and recruiting agencies are involved in ‘free visa’ trade.

The economics of recruitment have shown the cost of recruitment in the Gulf countries and the financial benefits it generates for different actors in the recruitment process. The average cost of migration was US$2,750. With regard to areas of expenses for recruitment, 23 per cent of the recruitment cost was spent on government fees, agency fees, passport fees, airfares and other related expenses while the remaining 77 per cent was appropriated by intermediaries such as recruitment agents, migrant brokers, sub-agents and other facilitators. The study has pointed out that intermediary fees also contain kickback fees which are inherent in the recruitment cost in the Gulf countries regardless of the channels of recruitment. Nearly two-thirds of the intermediary fees could be the kickback fee that a prospective migrant shoulders in order to secure a job in the Gulf.

This study has attempted to provide valuable insights into the recruitment of Bangladeshi migrants in the GCC countries, especially the operational and economic aspects of recruitment. However, it cannot shed adequate light on some other aspects of recruitment such as political economy of international labour recruitment, visa trade, or their constellations of interests at different points in the system. Indeed, more research is required to understand the conflicts and contradictions surrounding labour recruitment for the Gulf countries.

. . . . .

BIBILIOGRAPHY

Asis, Maruja M.B. and Nicola Piper
2008 'Researching International Labour Migration in Asia', *The Sociological Quarterly*, 49: 423-444

Arnold, Fred and Nasra M Shah (Eds)
1986 *Asian Labor Migration: Pipeline to the Middle East,* West view: London.

Baldwin-Edwards, Martin
2011 Labor immigration and Labor markets in the GCC countries: national patterns and trends, LSE Global Governance, Number 15 (March)

Baruah, Nilim
2006 '"The regulation of recruitment agencies: experience and good practices in countries of origin in Asia', in Christiane Kuptsch (ed) *Merchants of Labour*, International Organization for Migration: Geneva

Birks, J.S., I.J. Seccombe and C.A. Sinclair
1988 ‘Labour Migration in the Arab Gulf States: Patterns, trends and prospects’, *International Migration*, 26 (3) 267-286

Boyd, Monica
1989 ‘Family and Personal Networks in International Migration: Recent Developments and New Agendas’, *International Migration Review*, Vol. 23, No.3, pp 638-70

Castles, S and Miller M. J
2008 *The Age of Migration: International population movements in the modern world*, Fourth Edition, Guilford Press: New York

Chan, Raymond K.H. and Moha Asri Abdullah
1999 *Foreign Labor in Asia: Issues and Challenges*, Commack, NY: Nova Science Publishers.

Colton, Nora Ann
2010 ‘The International Political Economy of Gulf Migration, Migration and the Gulf, the Middle East Institute’, Washington, DC

De Bel-Air, Françoise
2011 ‘Reforming the Sponsorship (Kafala) in the GCC Countries: what socio-political stakes? The Case of Saudi Arabia’, Conference Paper, presented Workshop 12, Migration in the Gulf, Gulf Research Meeting 6-9 July, Cambridge

Dib, George
1988 ‘Laws governing migration in some Arab countries’ in Reginald T Appleyard (ed.), International Migration Today, I: Trends and Prospects, University of Western Australia for the United Nations Educational, Scientific and Cultural Organization, Perth: 168-179

Dito, Mohammed Ebrahim
2008 ‘GCC Labour Migration Governance’, UN Meeting on International Migration and Development in Asia and Pacific, Bangkok, 20-21 September

Eelens, Frank and J.D. Speckmann
1990 ‘Recruitment of Labor Migrants for the Middle East: the Sri Lankan Case’, *International Migration Review*, 24:297-322

Eelens, Frank, T. Schampers and J.D. Speckmann
1991 *Labor Migration to the Middle East: From Sri Lanka to the Gulf*, Kegan Paul: London

Esim, Simel and Monica Smith
2004 ‘Gender and Migration in Arab States: the Case of Domestic Workers’, ILO: Geneva

Faist, Thomas
2000 *The Volume and Dynamics of International Migration and Transnational Social Space* (Oxford, Clarendon Press).

Fargues, Philippe
2006 ‘International Migration in the Arab region: trends and policies’, UN Expert group meeting on international migration and development in the Arab region, UN/POP/EGM/2006/09/Rev, Beirut, 15-17 May 2006

2011 ‘Immigration without inclusion: non-nationals in Gulf state nation building’, Conference paper, the 2011 Gulf Research meeting, July 6-9, University of Cambridge, UK pp1-16

Gamburd, Michele Ruth
2000 *Transnationalism and Sri Lanka’s Migrant Households: The Kitchen Spoon’s Handle*, Vistaar Publications, New Delhi

Goss, Jon and B. Lindquist
1995 Conceptualizing International Labor Migration: A Structuration Perspective, *International Migration Review*, 29 (2)

Gunatilleke, G. (ed.)
1992 *The Impact of Labor Migration on Households: A Comparative Study in Seven Asian countries*, Tokyo: UNU Press

Gurak, Douglas T. and Fe Caces
1992 ‘Migration networks and the shaping of migration system’, in Mary Kritz, Lin Lean Lim, and Hania Zlotnick (eds.), *International Migration Systems: A Global Approach*, Clarendon Press, Oxford: 150-76

Hernandez-Leon, Ruben
2005 ‘The migration industry in the Mexico-U.S. migratory system’, Working Paper CCPR 049 (2005), California Center for Population Research, University of California, Los Angeles.

Humphrey, Michael
1991 ‘The Changing role of Asian Labour Migration in the Middle East’, Des Migrations Internationales, Volume 7, No. 1, pp 45-63

International Organization for Migration (IOM)

2004 *Arab Migration in a Globalized World*, Geneva: International Organization for Migration

2010 *Intra-regional labour mobility in the Arab World*, IOM: Geneva

Jones, Huw and Teing Pardthaisong

1998 'The commodification of international migration: Findings from Thailand', *Tijdschrift voor Economische en Sociale Geografie*, vol. 90, No. 1, pp. 32-46.

Kapiszewski, A.

2006 'Arab Versus Asian Migrant Workers in the GCC countries', UN/POP/EGM/2006/2 Department of Economic and Social Affairs, Beirut, 15-17 May

Kuptsch, Christiane (ed)

2006 *Merchants of Labour*, International Organization for Migration: Geneva

Lian, Kwen Fee and Md Mizanur Rahman

2006 'International labor recruitment: channelling Bangladeshi migrants to East and South-East Asia', *Asia-Pacific Population Journal*, 21(1): 85-107.

Longva, A. N.

1999 'Keeping Migrant Workers in Check: The Kafala System in the Gulf', *Middle East Report*, 211. pp. 20-22

MacDonald, John S. and Leatrice D. MacDonald

1974 'Chain Migration, Ethnic Neighborhood Formation, and Social Networks', In Charles Tilly (ed.), *An Urban World*, Little, Brown & Co., Boston: 226-36.

Martin, Philip

2005 'Merchants of labor: Agents of the evolving migration infrastructure', ILO discussion paper, DP/158/2005, ILO: Geneva

2006 'Regulating private recruiters: the core issues' in Christiane Kuptsch (ed) *Merchants of Labour*, International Organization for Migration: Geneva

2010 'The Future of Labour Migration Cost', in *World Migration Report 2010*, International Organization for Migration: Geneva

Massey, Douglas S., Rafael Alarcon, Jorge Durand, and Humberto Gonzalez

1987 *Return to Aztlan: The Social Process of International Migration from Western Mexico*, University of California Press.

Pakkiasamy, D

2004 ‘Saudi Arabia’s Plan for Changing its Workforce’, Migration Policy Institute, November 1

Piper, Nicola

2004 ‘Rights of foreign workers and the politics of migration in South-East and East Asia’, *International Migration*, vol. 42, No. 5, pp.71-95

Phillips, Julie and Douglas S. Massey

2000 ‘Engines of immigration: Stocks of human and social capital in Mexico’, *Social Science Quarterly*, vol. 81, pp. 33-48.

Prothero, R. Mansell

1990 ‘Labour Recruiting organizations in the developing World: Introduction’, *International Migration Review*, 24 (2): 221-228

Ruhs, Martin

2002 *Temporary Foreign Worker Programmes: Policies, Adverse Consequences, and the Need to Make them Work*, Working Paper No. 56, June, 2002, The Center for Comparative Immigration Studies, University of California-San Diego.

Rahman, Md Mizanur

2008 *Gender Dimensions of Remittances: Indonesian Domestic Workers in Singapore, Malaysia and Indonesia*, UNIFEM-East and Southeast Asia, Research Report, 2008, pp 52, Available online, http://unifem-eseasia.org/docs/2008_Gender_dimension_of_Remittances.pdf

2008 ‘Management of Foreign Manpower in Singapore’, in Lian Kwen Fee and Tong Chee Kiong (eds.), *Social Policy in Post-Industrial Singapore*, Brill Academic Publishers, 2008, pp145-172

2009 *In Quest of Golden Deer: Bangladeshi Transient Migrants Overseas*, VDM Verlag: Germany

Shah, M Nasra

1994a ‘An Overview of Present and Future emigration dynamics in South Asia’, *International Migration*, 32 (2) 217-268

1994b ‘Arab Labour Migration: A Review of Trends and Issues’, *International Migration*, 32 (1) 3-27

2005 ‘Restrictive Labour Immigration Policies in the Oil-Rich Gulf: Implications for sending Asian countries’, Conference paper, International Population Conference, Tours, France, 18-23 July,

1996 The role of social networks in migration to Kuwait among South Asian males, IOM/UNFPA workshop on Emigration Dynamics in South Asia

2008 ‘Recent Labour Immigration Policies in the Oil-Rich Gulf: How Effective are they likely to be?’ ILO Asian Regional Programme on Governance of Labour Migration Working Paper No 3, ILO: Thailand

2010 ‘Building State capacities for managing contract worker mobility: the Asia-GCC context’, in *World Migration Report 2010*, IOM: Geneva

Shah, M Nasra and Indu Menon

1999 ‘Chain Migration through the social network: experience of labour migrants in Kuwait’, *International Migration*, Vol. 37 (2) pp 361-382

Silvey, R.

2006 ‘Consuming the transnational family: Indonesian migrant domestic workers in Saudi Arabia’, *Global Networks*, 6:1, pp 23-40

Skeldon, Ronald

1997 *Migration and Development: A Global Perspective*, Harlow, Uk: Addison Wesely Longman

Sobieszczyk, Teresa

2000 ‘Pathways abroad: Gender and international migration recruitment choices in northern Thailand’, *Asian and Pacific Migration Journal*, vol. 9, No. 4, pp.391-428.

Suter, Brigitte

2005 Labour Migration in the United Arab Emirates: Field Study on regular and irregular migration in Dubai, IMER, Malmo University, Sweden

Toledo, H.

2006 ‘The Problems and Prospects of Emiratization: Immigration in and Imperfect Labor market’, Working Paper, Department of Economics, The American University of Sharjah, UAEAbella, Manolo

Winckler, Onn

2010 ‘Labour migration to the GCC states: patterns, scale, and policies’, in Middle East Institute, *Migration and the Gulf*, Washington D.C.: Middle East Institute pp 9-12

Wee, Vivienne and Amy Sim (2004). ‘Transnational networks in female labour migration’ in Aris Ananta and Evi Nurvidya Arifin, eds., *International Migration in South-East Asia*, Institute of South-East Asian Studies: Singapore.

Zachariah, K.C. E.T. Mathew, and S. Irudaya Rajan
2001 ‘Social, Economic and Demographic Consequences of Migration on Kerala’, International Migration, Vol. 39 (2) 43-71

ISAS Working Paper

No. 133 – 15 September 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

An Approach to Forecasting Market Demand in India: A Case Study of Steel

S Narayan[1], Sarin Paraparakath, Asha Abraham & Deepa Karthykeyan[2]

Abstract

One of the characteristics of growth in emerging economies is the sharp growth in steel consumption resulting from public investment outlays in infrastructure, coupled with outlays in construction as the economy expands. The last decade's healthy growth of the Indian economy has led to steep rises in the consumption of steel. This paper is an attempt to econometrically analyse the growth in market demand for steel in India using aggregate sectoral demand patterns. It seeks to project demand-supply gaps up to 2014 – 2015. The results would be of interest to academics and for business.

I. Demand Planning and Forecasting

Demand forecasting is an integral exercise in the planning efforts of an enterprise. The choice of forecasting model is conventionally preceded by a formulation of the problem/objective and an initial assessment of the available data. Along with these, factors such as complexity of the relationship to be determined, and the desired level of forecasting accuracy sought from the modelling exercise help to decide on the nature and application of the forecasting model.

---

1 S Narayan is Head of Research and Visiting Senior Research Fellow, Institute of South Asian Studies (ISAS), an autonomous institute in the National University of Singapore (NUS). The author can be reached at isassn@nus.edu.sg. The views expressed are those of the author and do not necessarily reflect those of the institute.

2 Research Consultants, Athena Infonomics.

Forecasting literature is replete with several models for adoption. The commonly used forecasting methods of demand estimation may be broadly categorised as:

i. Judgemental Methods
ii. Econometric Methods
iii. Other Methods

i. Judgemental Forecasts

This method makes predictions on the basis of intuition and opinions and is highly subjective in nature. This category consists of a number of techniques including the simple survey method, Delphi method (an interactive forecasting method which relies on a panel of experts), analogy method (utilises analogies between the phenomenon to be forecast and some historical event, or popular physical or biological process) and scenario-building methods (a process of analysing possible future events by considering alternative possible outcomes).

ii. Econometric Forecasts

Econometric methods of forecasting primarily include two types: time series forecasting and causal/structural forecasting. Time series methods are often considered as being *atheoretical* in nature as future predictions are made entirely on the basis of historical knowledge/data. The contrary causal/structural forecasting methods enforce *a priori* assumptions or restrictions on the theoretical linkages between the variables.

iii. Other Methods

Other methods include artificial neural networks (essentially simple mathematical models associated with a particular learning algorithm or learning rule), simulation, probabilistic forecasting (a technique conventionally used for weather forecasting which relies on different methods to establish probability of an event occurrence/ magnitude), reference class forecasting (predicts the outcome of a planned action based on actual outcomes in a reference class of similar actions to that being forecast) and SVM (support vector machines, a set of related supervised learning methods that analyse data and recognise patterns).

Among these categories, econometric forecasting methods are conventionally applied to predict shifts in demand and supply patterns. These include a number of methods such as moving average, linear extrapolation or trend estimation, exponential smoothening, autoregressive integrated moving average (ARIMA) models, ARIMAX (ARIMA including explanatory variables) and vector autoregressive (VAR) methods. The relevance and accuracy of these models to estimate demand varies with the nature of the variable that one is forecasting.

In this paper, an attempt has been made to evolve a methodology to predict the supply of and demand for steel in India. Steel is a very important primary metal whose demand movements are often seen to be closely linked to the economic growth of a nation. In fact the quantity of steel consumed is often considered a proxy for the stage of a nation's industrial development. Therefore the need to evolve a robust methodology to forecast steel demand is a national imperative.

Steel Industry in India

The period starting from 2007 till 2010 had witnessed the stabilisation of the steel industry in India at a higher equilibrium of approximately 60 million tonnes (MT) and presents itself as an interesting period of inflection. The dampening of global supply of steel coupled with rising domestic consumption has placed the Indian market, along with that of China's at the heart of the global steel industry.

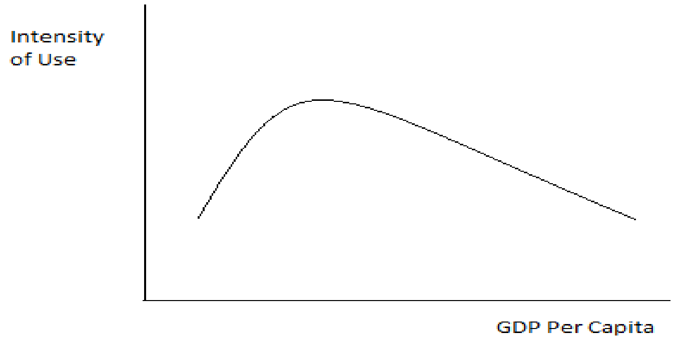
Riding on the back of robust growth rates and healthy domestic demand, India has risen from being the seventh largest producer of steel in the world in 2005 to the third largest in 2009. The advent of new production technologies and a conducive policy environment, together with firm-level efforts at capacity expansion and increased capacity utilisation, have led to a noticeable transition in the structure and potential of the Indian steel industry. However, despite the promising rise of the steel industry in India, there exists some apprehension on the capability of Indian steel suppliers to meet the expectations arising from a changing demand scenario. This apprehension has reinforced our need to evolve a robust method to analyse the potential gap through the estimation of both the supply for and demand of steel for the future.

Summary of Past Approaches to Estimate Steel Consumption

Several approaches have been used to forecast steel demand in India and abroad. In developed economies, the demand for steel is conventionally estimated through the establishment of an empirical relationship between GDP per capita and metal intensity of use. This was developed by Malenbaum in 1973. Here, a simple relationship is assumed between population and GDP growth and the metal intensity of industrial output. According to Malenbaum, a typical (steel) consumption to GDP ratio will show a rapid increase in use with rising per capita GDP and then a slow reduction.[3]

[3] Crompton Paul, 'Forecasting Steel Consumption in South-East Asia', *Resources Policy,* Vol. 25, (1999), pp.111-123

Figure 1: Steel Consumption Ratio



The two other popular techniques used to estimate steel is the partial equilibrium and vector autoregression (VAR) approach. In the partial equilibrium approach developed by Labson et al (1997)[4] a dynamic, non-spatial, partial-equilibrium trade model is used to forecast crude steel consumption. Under this approach, crude steel consumption is forecast for each region using a single linear econometric equation, which explains variations in consumption using an index of steel prices, industrial production and a time trend. On the other hand, through the vector autoregression technique, the historical correlations between variables in a system of dynamic, linear equations are analysed to extrapolate future values of all variables involved. Chen et al. use this approach to forecast crude steel consumption in China.[5]

In India, the most traditional approach to estimating steel demand consists of using econometric equations in which the demand for steel is modelled as a broad function of economic variables such as index of industrial production (IIP), gross domestic product (GDP), gross capital formation (GCF) and public expenditure, among others. However, this method is beset with a number of problems. The most important among them is the presence of weak and unclear transmission mechanisms between macro-variables and steel consumption. In fact, the over ambitious targets often set by governments are described as being a 'crisis in forecasting' by an UNIDO/ICIS report published in 1975.[6]

The Model

Given the aforementioned difficulty with forecasting the demand for steel, in this paper an attempt has been made to overcome some of the pertinent problems associated with data through the construction of 'tailor-made' approaches to estimate steel consumption within all major industries/sectors. As an *end-use method*, this model is based on the premise that to determine the demand for steel one must determine the demand of various commodities and activities that consume steel. Here, the output estimates for all final products or services

5 Labson B. Stephen, 'Changing patterns of trade in the world iron ore and steel market: An econometric analysis, *Journal of Policy Modeling*, Vol 19 (3), (1997), pp-237-251.

6 Chen D et al, 'Forecasting steel demand in China', *Resources Policy*, Vol 17 (3), (1991), pp. 196–210.

consuming steel within each sector is estimated and the changing patterns in growth are captured. The sectors for which demand is estimated include construction, machinery/equipment, automobiles, railways, power, consumer durables, fasteners and shipbuilding.

Once the output patterns of each industry/ sector are captured, the model attempts to capture the material composition of product (MCO) (where applicable) to identify the amount of steel used in the creation of a product. This approach helps us overcome concerns over the presence of weak and unclear transmission mechanisms between macro-economic indicators like GDP and IIP and steel consumption. Further, by disaggregating the model in this manner, we are capable of estimating finished steel consumption in each industry and identifying those industries that are expected to remain drivers of domestic demand for steel.

Limitations

This model however makes two important assumptions:

- First, we assume that the input-output technical coefficients that guide steel use remain constant over the period for which steel demand is being estimated. This is based on the assumption that there will be no substantial shift in the manufacturing processes and product design over the period for which steel is being estimated.
- Second, the model does not entirely capture the price effect of steel and assumes that consumption patterns are relatively inelastic and non-responsive to changing prices in the short run.

Outside the limitations imposed by the model, the findings of the study are also restricted in its scope to select sectors on account of lack of access to or non-availability of data.

Scope and Methodology

The model restricts itself in scope to the estimation of demand for and supply of finished steel for the fiscal year 2015-16. A combination of primary and secondary data was used to estimate steel consumption patterns within each sector. Primary data collection involved holding direct interviews with industry experts and bureaucrats. Secondary information was compiled from a number of sources such as the annual survey of industry, Ministry of Statistics and programme implementation (MOSPI), Reserve Bank of India publications, Society of Automobile Manufacturers (SIAM), Construction Industry Development Council (CIDC), Planning Commission, Cement Manufacturers Association (CMA), Indian Electrical and Electronics Manufacturers Association (IEEEMA), World Steel Association and Steel Scenario yearbooks among others.

The paper primarily used time-series tools to forecast steel consumption. A combination of auto regressive integrated moving average (ARIMA) and the vector autoregression (VAR) technique was used (wherever applicable) to forecast the demand for steel across sectors.

Outline

The model is used to predict the movement in the supply and demand patterns of 'finished steel' for the period starting from 2010-11 till 2015-16. Section II of the paper describes the methodology that was used to arrive at supply estimates for steel for the year 2015-16. Section III describes the approach used to establish demand for steel in each sector and the aggregate demand estimate. Section IV evaluates the validity of the model by comparing the demand and supply estimates with alternative studies that were conducted. Section V makes a broad set of observations and conclusions based on the established supply and demand estimates.

II. Supply

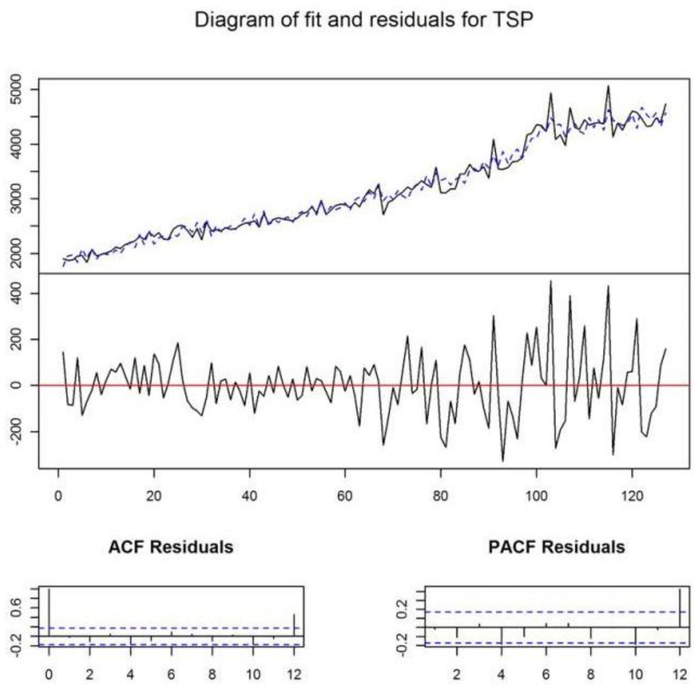
Domestic steel in India is produced in a highly fragmented industry with major integrated producers contributing to merely 50 per cent of the total supply. The remainder comes from a large number of mini steel mills and re-rollers. Further, these small secondary producers contribute 70 per cent of the country's steel exports. As of 2009-10, the total steel production in the country was estimated to be 60 million tonnes. Conventionally targets set by major and secondary steel producers are taken to be the estimates of steel production by the Ministry of Steel. However, targets often have a tendency to possess strong upward bias. For example, the steel production target for the year 2011-12 was estimated to be 124 million tonnes by the Ministry of Steel. But the likely addition may not exceed 75 million tonnes, which is 49 million tonnes short of the Ministry of Steel estimates.

Thus, in order to make a realistic estimate on domestic steel production in 2015-16, we undertook a new approach. We began by establishing for ourselves the potential range within which supply would lie. Here, the total steel supplied in a 'business as usual' scenario, in which one assumes that the past growth patterns and trends continue, was deemed to be the lower limit of the range, while the ambitious targets set by the Ministry of Steel was used as the upper limit.

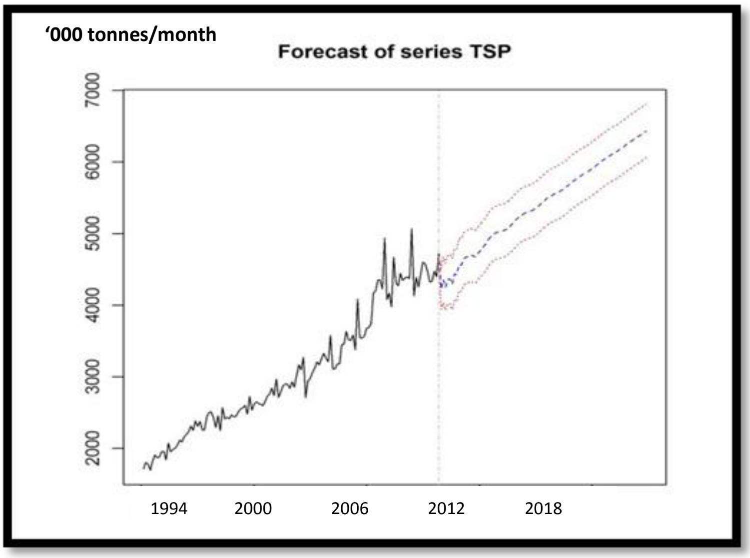
In order to estimate the production of steel in a 'business as usual' scenario, the study used a VAR model in which future growth was estimated based on the historical correlation between steel supply and certain endogenous and exogenous variables through the construction of a system of dynamic linear equations. The VAR model was chosen on account of the flexibility that it offered and its proven capability to describe the dynamic behaviour of multiple economic time series and forecasting. However, no theoretical or structural restrictions were imposed in the current model. In this model GDP was considered to be an endogenous variable, while the iron and steel price index (ISPI) and coke price index (CoPR) weree introduced as exogenous variables. The lag order was taken to be five.

$$TSP = \alpha TSPt - 1 + \alpha 1GDPt - 1 + \alpha 2TSPt - 2 + \alpha 3GDPt - 2 + \alpha 4TSPt - 3 + \alpha 5GDPt - 3 + \alpha 6TSPt - 4 + \alpha 7GDPt - 4 + \alpha 8TSPt - 5 + \alpha 9GDPt - 5 + Const + Trend + ISPI + CoPr +$$

<u>Figure 2</u>: Diagram of Fit and Residuals for TSP



<u>Figure 3</u>: Total Finished Steel Production - Forecast



The VAR model gave us an estimate which formed the lower limit. The estimates as established by the Ministry of Steel were given to be 150 million tonnes, which were used as the upper limit.

Now, in order to identify a point estimate, a critical analysis of firm-level capacity expansions was performed on all major steel producers and secondary players. The steel producers considered for the analysis were SAIL, RINL, TATA Steel, Esssar, JSW, JSPL, Ispat (now known as JSW Ispat Steel Ltd), Bhushan Power and Steel, Bhushan Steel and other secondary producers. Data on capacity expansion plans were gathered from the websites, annual reports of the various companies and through direct interviews with members in these industries.

Only Brownfield and Greenfield projects that will be commissioned by 2015-16 were included in the estimate. An assessment of all independent Brownfield and Greenfield expansions that might be carried out by producers gave us a very large estimate. However, discussions with various experts and an assessment of the clearance risk associated with Greenfield projects made it clear that not all of this would materialise. Thus, an optimistic assessment of firm-level expansions was made by speaking to independent producers on a realistic estimate of production before 2015-16. This estimate was based on various parameters such as average time taken for a Greenfield /Brownfield expansion to actually begin operations, the risk of obtaining clearances and other contingencies that a Greenfield expansion may encounter.

This brought down the figure to just around 118 million tonnes of crude steel on 2015-16. However, this figure is the expected capacity that may be created assuming a 100 per cent capacity utilisation. However, most steel producers in India continue to operate at around 90 per cent capacity utilisation. Further, not all crude steel is converted into finished steel as a percentage of crude steel produced by integrated steel plants like Tata steel and SAIL is directly sold as billets and blooms.

Also, secondary steel plants are seen to have functioned at lower capacity utilisation of merely 85 per cent because of the poor quality of the raw material. Thus, after carrying out all the above deductions, total finished steel production was estimated to be 100.7 million tonnes.

III. DEMAND

By virtue of steel being an important intermediate good, the demand for it is always derived from the demand for and production of products or services using steel. The sectors whose demand for steel is estimated include construction, machinery/equipment, automobiles, railways, power, consumer durables, fasteners and shipbuilding. The other sectors such as home appliances, defence, auto components were not taken into account because of non-availability of data and a model to accommodate the steel consumed by these sectors. Also, the steel used for replacement and maintenance has not been entirely accounted for.

Construction

Construction is a very broad term that encompasses within its realm a large number of very different sectors. In India, construction is the second largest economic activity after agriculture. It accounts for nearly 65 per cent of the total investment in infrastructure and is expected to be the biggest beneficiary of the surge in infrastructure investment over the next five years. By virtue of its size and nature construction continues to remain the largest consumer of steel in the country.

However, construction as a sector is not very well regulated and falls almost entirely into the unorganised sector. Further, the heterogeneity in steel consumption within various categories including residential, commercial and industrial made the task of estimating future steel consumption very difficult.

The only source of information on the construction industry was derived from estimates provided by the Construction Industry Development Council (CIDC) established by the Planning Commission of India.

Method

In this report, the scope of what constitutes construction has been narrowed down to construction activities within general infrastructure and construction activities in real estate. Within infrastructure, the sectors considered are roads and bridges, airports, sea ports, water and sanitation, and telecommunication. Demand for steel through construction activities taking place in the railway and power sectors (which are technically an integral part of the country's infrastructure) have been separately accounted for as part of the steel consumption of these sectors respectively. Real estate, a big consumer of steel, is analysed independently of infrastructure. Investments in real estate are primarily categorised into residential, commercial and industrial.

In order to estimate the consumption of steel in the real estate sector, a 'steel intensity ratio' was built. It is the ratio of the price of steel consumed per sq foot to the price of construction per sq foot in a standard residential, commercial or industrial building. The definition of what constitutes a standard residential, commercial or industrial building and the cost of construction per square foot in each of these categories was borrowed from data provided by the Construction Industry Development Council (CIDC).

Table 1: **Unit Construction Cost (INR/sq ft)**

	Residential (terrace) **		Residential (high rise)		Commercial office		Industrial	
	Standard	Luxurious	Standard	Luxurious	Standard	Prestige	Light	Heavy
1997	825	1,100	650	1,100	625	950	600	800
1998	870	1,200	650	1,100	625	950	600	850
1999	890	1,300	650	1,100	625	950	600	850
2000	865	1,350	640	1,150	610	1,050	600	870
2001	875	1,370	685	1,225	640	1,225	615	890
2002	918	1,430	719	1,286	672	1,286	646	934
2003	964	1,502	755	1,350	705	1,350	678	981
2004	1,012	1,577	793	1,417	740	1,417	712	1,030
2005	1,050	1,600	805	1,500	760	1,500	750	1,080
2006	1,123	1,712	861	1,065	813	1,606	802	1,155
2007	1,202	1,830	920	1,717	870	1,717	858	1,236
2008	1,286	1,960	986	1,837	931	1,837	918	1,323
2009	1,376	2,097	1,055	1,966	996	1,966	983	1,415
2010(Oct)	1,470	2,244	1,130	2,103	1,065	2,103	1,051	1,514

Source: **Construction Industry Development Council (CIDC), Planning Commission**

The amount of steel consumed per square foot of construction was derived through direct interviews with a number of civil engineers and construction contractors. The cost of steel was estimated by taking the average of price of channels, sections, joists, TMT bars, etc., and was estimated to be an average of R32 a kilogram. The steel intensity ratio gives us that percentage of the investment on real estate construction that is spent on the consumption of steel. Annual investments, both public and private in the residential sector, were also obtained from CIDC and projections were made on expected investments by fitting a trend on the past values of investment in these sectors.[7]

Similarly, under infrastructure, expected steel consumption in bridges and roads, telecommunication, irrigation, water and sanitation, seaports and airports and storage sectors were analysed using a common strategy. As mentioned earlier, railways and power, two of the largest consumers of steel within the infrastructure sector were analysed separately and in greater detail. In order to estimate steel consumption in infrastructure construction (excluding railways and power), we used the steel utilisation norms provided by the Planning Commission and a research report by ICICI titled 'Steel Sector' published in May, 2009. The steel utilisation norms used were:

[7] The ARIMA Technique was not used to forecast future investments on account of inadequate number of data points.

Figure 4: Investment in Construction

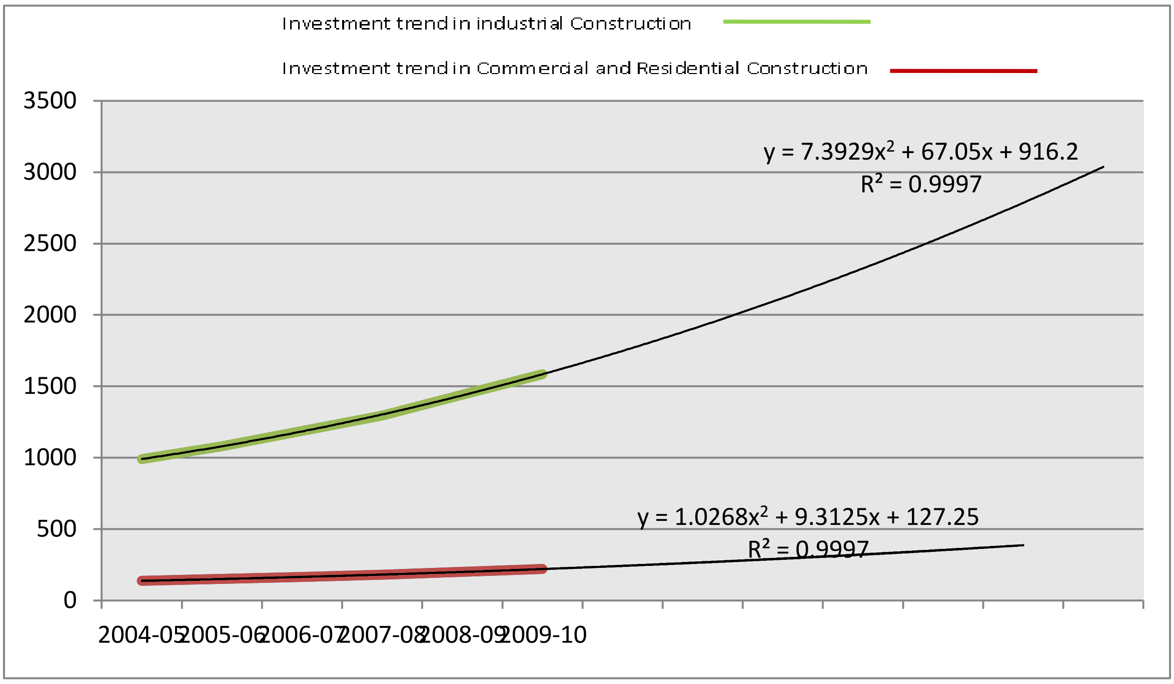


Table 2: Steel Utilisation Norms

Sector	Roads and Bridges	Telecom	Irrigation	Water and Sanitation	Airports	Storage	Oil & Gas Pipelines	Ports
Civil Construction (% of Investment)	100	15	50	60	40	75	35	70
Steel Component (% of Construction)	14	20	15	18	25	24	43	25

Source: ICICI Direct Research Report on Steel and Planning Commission

These steel utilisation norms were used to estimate the growth of steel consumption in infrastructure construction. An aggregate of steel consumption in real estate and infrastructure was used to give us the total steel consumed in construction. Steel consumption in the construction industry is expected to grow at an average rate of 10 per cent till 2015-16.

Railways

Indian Railways has a symbiotic relationship with the country's industry and economy. The railway's share in the country's GDP has been more or less constant at a level of 1.18 from 2003-04 till 2007-08.

Conventionally, steel consumption of the railways is captured through proxies such as the growth in railways as a percentage of GDP and public expenditure. However, in the current study an attempt has been made to break down the railway sector into various steel-consuming sub-segments to arrive at a more accurate estimation of steel use.

Method

To calculate the steel requirement for the railways, major areas where steel is predominantly used was taken into account. These primarily includes rolling stock (which comprises the locomotives, wagons and coaches), rail track material, concrete sleepers, clips to hold rails to sleepers, posts to carry overhead traction lines and construction in the railways.

With respect to the rolling stock, the number of units produced by the year 2020 was derived from the *Vision 2020* report published by the Ministry of Railways. The weight of steel in each unit was derived through direct interviews with design engineers and coach/locomotive manufacturers. The average weight of a locomotive was established to be 120 tonnes, wagons around 20 tonnes while coaches around 50 tonnes. The steel weight to total weight ratio was taken as 1.00, 0.8 and 0.75 for wagons, locomotives and coaches, respectively. The product of these weights with the expected number of units was estimated to be the total steel consumed by rolling stock.

In the case of track material, all the possible areas of use including new lines, gauge conversion, doubling and track renewal by the railways was estimated and the total consumption of steel was established. The amount of steel used in railway sleepers was calculated by multiplying the steel used in one concrete sleeper with the number of sleepers estimated to be used in the laying of new tracks. Similarly, the steel used in clips was calculated by taking the product of the number of clips used in a sleeper with the length of the new tracks.

In the case of traction posts, the weight of each traction post was estimated to be one tonne and the total amount of steel consumed was calculated by taking the product of route length electrified with the number of such posts in a kilometre of electrified track.

The amount of steel used for other construction purposes in the railways such as bridges, over/under bridges, stations, etc., was calculated using the amount spent on steel per rupee of investment in each of these sectors using the steel utilisation norms laid down by the planning commission. The aggregate of all these individual steel consuming sub-segments was taken to estimate the total consumption of steel by the railway industry.

Power

Power like the railways is an important consumer of steel. The growth in the power sector and the steel consumption norms are well documented by the Central Electricity Authority.

Method

Estimation of steel demand in the power sector was divided into generation and transmission sectors. Generation is further divided into hydro, thermal and nuclear power plants.

Generation

The amount of steel required, i.e., tonnes/MW in the case of a hydro, thermal or a nuclear plant has been formulated by NHPC (National Hydro Power Corporation) and BHEL (Bharat Heavy Electricals Limited). This formula is based upon the amount of steel that is required for electrical and mechanical packages (generators and turbines) and civil work. The table below gives the set norms in the case of hydro, thermal, gas and nuclear power projects.

Table 3: Steel Utilisation Norms – Hydro Power Plant

Steel Type	Steel Required (Tonnes/MW)
Structural Steel	34
Reinforcement Steel	93
Total	**127**

Source: Central Electricity Authority (CEA)

Table 4: Steel Utilisation Norms for Thermal, Gas and Nuclear Power Plants

Type	Imported Steel (Tonnes/ MW)	Indigenous Steel (Tonnes /MW)	Total
Thermal	18.89	111.707	**130.597**
Gas Powered	6.36847	44.53545	**50.90392**
Nuclear	19.14	111.67	**130.83**

Source: Central Electricity Authority (CEA)

In India, on an average it takes five years to build a hydro power plant. Therefore, the consumption of steel will start five years before the date of commissioning of a hydro plant. Similarly, on an average it takes a minimum of three years to construct a thermal/nuclear project or a gas-based power plant. Thus, steel consumption by hydro power plants is assumed to be distributed over the previous five years in the ratio 10:10:20:30:30 while steel consumption by thermal, nuclear and gas plants is distributed in the ratio 20:30:50. The capacity additions in the power sector for the past 10 years are given in the table below.

<u>Table 5:</u> Capacity Additions in the Power Sector

Year	Installed Capacity (MW)	Capacity Addition (MW)
2000-01	97,885	3.741
2001-02	101,626	3.420
2002-03	105,046	2.831
2003-04	107,877	4.807
2004-05	112,684	5.742
2005-06	118,426	5.861
2006-07	124,287	8.042
2007-08	132,329	10.732
2008-09	143,061	13,694
2009-10	156,755	10,523

<u>Source:</u> CEA

Assuming 80 per cent of the targets set by the 12^{th} Five Year Plan is achieved, the hydro sector is expected to add 24,000 MW in 2017, the thermal sector is expected to add 44,500 MW and the nuclear sector is expected to add 1,200 MW. The potential capacity that might be added by 2020 was estimated from the data given in the above table using the auto regressive moving average (ARIMA) technique. The results are given in the table below.

<u>Table 6</u>: Capacity Additions till 2020

Year	Hydro	Thermal	Nuclear	Capacity Addition
2011-12*	2,282	9,654	1,050	12,986
2012-13*	2,701	4,006	1,080	7,787
2013-14*	3,360	4,984	1,344	9,688
2014-15*	4,073	6,041	1,629	11,743
2015-16*	4,939	7,327	1,976	14,242
2016-17*	5,927	8,792	2,371	17,090
2017-18 *	7,063	10,477	2,825	20,365
2018-19 *	8,459	12,548	3,384	24,391
2019-20 *	10,171	15,086	4,068	29,325

**Estimates based on ARIMA*

These capacity additions together with the steel utilisation norms were used to estimate the amount of steel that may be consumed till 2015-16.

<u>Transmission</u>

A detailed assessment has been made to calculate steel requirement for towers, power transformers, sub-stations, conductors and earth wires. Different norms have been set according to the design of different transmission voltage levels. The amount of steel consumed in metric tonnes per circuit km for each of the above voltage lines is given below along with the steel requirement during the 12th Five Year Plan.

Table 7: Steel Utilisation Norms for Transmission Lines

Line Voltage (kV)	Norms for weight of steel for transmission lines MT/Km	(12th Plan)		2012-13		2013-14		2014-15		2015-16	
		ckt Km	Total Weight of steel for transmission lines (MT)	ckt. Km	Total Weight of steel for transmission lines (MT)	ckt. Km	Total Weight of steel for transmission lines (MT)	ckt. Km	Total Weight of steel for transmission lines (MT)	ckt. Km	Total Weight of steel for transmission lines (MT)
500 HVDC	4.64	5,400	14,848	1,061	4,925	1,193	5,538	1,240	5,756	843	3,913
765	3.5	3,200	18,900	629	2,201	707	2,475	735	2,573	500	1,749
400	4.53	44,440	201,313	8,735	39,568	9,822	44,492	10,209	46,245	6,941	31,441
220	1.79	23,000	41,170	4,521	8,092	5,083	9,099	5,283	9,457	3,592	6,430
TOTAL			**276,231**		**54,786**		**61,604**		**64,031**		**43,534**

Source: CEA

Special Steel-CRGO[8] Requirement for Power Transformers

Based on statistics of the Central Electricity Authority, an assessment has been made using the norms to calculate the steel requirement of power transformers in terms of metric tonnes per million volt amperes.

Table 8: Steel Utilisation Norms for Power Transformers

Line Voltage (kV)	CRGO Requirement (MT/MVA)	(11th Plan)		2012-13		2013-14		2014-15		2015-16	
		Total MVA Capacity	CRGO Weight (MT)	Total MVA Capacity	CRGO Weight (MT)	Total MVA Capacity	CRGO Weight (MT)	Total MVA Capacity	CRGO Weight (MT)	Total MVA Capacity	CRGO Weight (MT)
500 kV	0.8	12,500	10,000	3,031	2,425	2,316	1,853	2,091	1,673	1,830	1,464
765 kV	0.4	44,310	17,724	10,744	4,298	8,211	3,284	7,412	2,965	6,486	2,594
400 kV	0.4	73,700	29,480	17,871	7,148	13,657	5,463	12,328	4,931	10,788	4,315
220kV	0.5	52,000	26,000	12,609	6,305	9,636	4,818	8,698	4,349	7,611	3,806
Total			**83,204**		**20,175**	**33,820**	**15,418**	**30,530**	**13,918**	**26,714**	**12,179**

Source: CEA

[8] Cold-rolled grain oriented silicon steel

Total steel used in transmission and distribution systems was aggregated to understand steel consumption by the power sector.

Machinery

Production of heavy engineering equipment and machinery is closely interrelated with the growth and development of other capital goods-intensive industries. The machinery/general engineering sector emerges as the second largest consumer of steel after construction and is an excellent proxy for a nation's industrial growth. In India, demand is greatest for building machinery and plastic-moulding machines as well as machine tools and textile machinery. Makers of building machinery are benefiting from the large-scale infrastructure projects planned by the Indian government, while machine-tool makers are being buoyed by the upturn in the automobile and auto- parts industries.

To estimate steel consumption norms for a sector as heterogeneous and complex as the machinery and heavy engineering equipment sector is a very difficult task. The machinery sector constitutes a large number of sub-sectors varying from industrial, textile, printing and office machinery to heavy construction and agricultural equipment such as agricultural implements, tractors, dumpers, cranes, etc.

Method

Thus, in order to estimate steel consumption patterns by the machinery sector we had to entirely depend on growth proxies. In the current study the machinery sector was broadly classified into electrical, non-electrical and electronic.

In order to estimate total steel consumption within the machinery sector, a sample of equipment was chosen in both the electrical and the non-electrical category. The electronic equipment category was ignored on account of the negligible amount of steel consumed by this sector.

The sample equipments chosen in the non-electrical category included:

- Dumper
- Ball and roller bearings
- Gear boxes
- Lifts
- Material handling equipment
- Cutting tools
- Machine tools
- Valves
- Diesel engines

The sample equipment included in the electrical category included:

- Electric generators (including alternators)
- Power and distribution transformers
- Electric motors
- Turbines

Independent ARIMAs were carried out on each of these sample equipment items to forecast their production value/number in 2015-16. After having forecast output for each sample component, the average growth rate in the production of these components was calculated for the year 2015-16.

Table 9: Average Growth Rates of Machinery Components

Year	Growth Rate* (%)
2010-11	4.57
2011-12	6.63
2012-13	4.97
2013-14	4.39
2014-15	4.06
2015-16	3.81

**Growth rates calculated on the basis of ARIMA estimates*

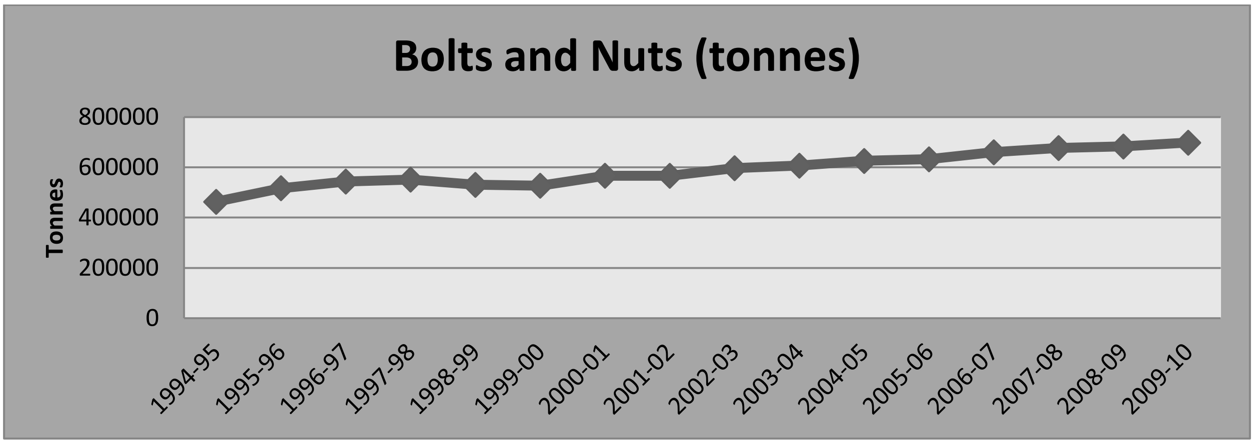
Finally, a weighted average of the various growth rates was taken to assess the overall growth in the machinery sector. The weights were assigned on the basis of intensity of steel consumption. Here, a 1:1 relationship has been assumed between growth in the number of units produced and steel consumption. Steel consumption is 14.1 million tonnes in 2009-10 and was expected to grow at the same rate as the various component machinery sub-sectors in 2015-16.

Fasteners

Method

Steel consumed in the fastener and hardware industry was calculated by using the production of bolts and nuts as a proxy. The ARIMA technique was applied on the production of bolts and nuts for the last 14 years and production forecasts and growth rates were obtained for the next five years. The industry was established to be growing at an average rate of 2 per cent per annum. Current consumption of steel by the fastener and hardware industry is 575,000 tonnes. An average yearly appreciation of 2 per cent was considered to derive estimates for 2015-16.

Figure 5:



Source: **Annual Survey of Industries, Ministry of Statistics and Programme Implementation.**

Consumer Durables

Method

A similar strategy was adopted to estimate steel consumption in the consumer durable industry. A sample consisting of time series data on the production of washing machines, refrigerators and air conditioners was taken up. Three independent ARIMAs were performed on the three sample components to get their future growth rates. The weighted average growth rate of the three products was used as proxy for the growth of the consumer durable industry. This was estimated at 11 per cent. In 2009-10, the industry was estimated to have consumed 0.78 million tonnes of steel[9]. Thus, if the industry grows at an average rate of 11 per cent, steel consumption is expected to go up to 1.40 million tonnes of steel by 2015-16.

Automobiles

The automobile sector is a boom sector that is expected to evolve as a major consumer of steel in the future.

Method

In order to predict the total de**m**and for steel in this industry, the sector was divided into six components as specified in the National Industrial Classification Code by the Reserve Bank of India. The six components consists of: 1) commercial vehicles, 2) passenger cars, 3) jeep vehicles, 4) auto rickshaws, 5) motorcycles, and 6) scooters. The production of automobile units in each of these categories was forecast using a VAR technique.

---

[9] Steel Scenario Yearbook - 2010

Table 10: Automobile VAR Estimates (units)

Year	Commercial Vehicles (CV)	Passenger Cars (PC)	Jeeps (JV)	Auto rickshaws (AR)	Motorcycles (MC)	Scooters (SC)
2010-11	711,526.7	2,465,030	482,197.7	735,141	9,975,379	2,687,804
2011-12	620,057	3,209,073	477,410	741,683	9,885,139	3,050,828
2012-13	664,148	4,230,439	504,204.4	772,955	10,101,656	3,541,613
2013-14	737,652	5,707,772	536,609	816,164	10,845,150	4,090,454
2014-15	779,217	7,863,533	569,261	863,196	11,687,243	4,698,302
2015-16	821,862	11,027,611	601,651	910,781	12,352,594	5,366,356

Figure 6: Production of Auto Rickshaws
(units/month)

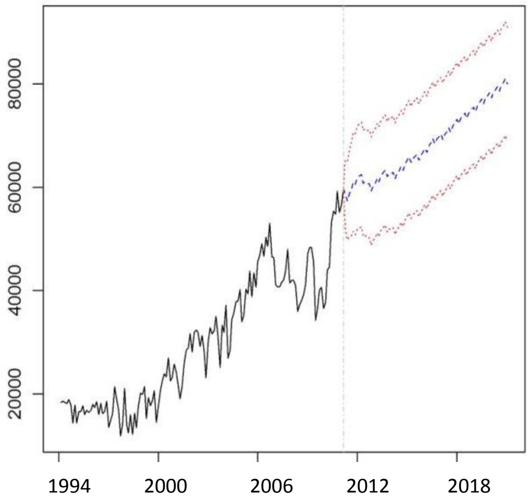


Figure 7: Production of Commercial Vehicles
(units/month)

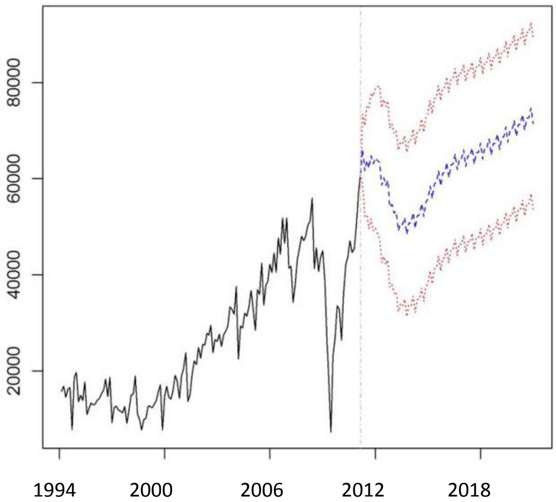


Figure 8: Production of Motorcycles (units/month)

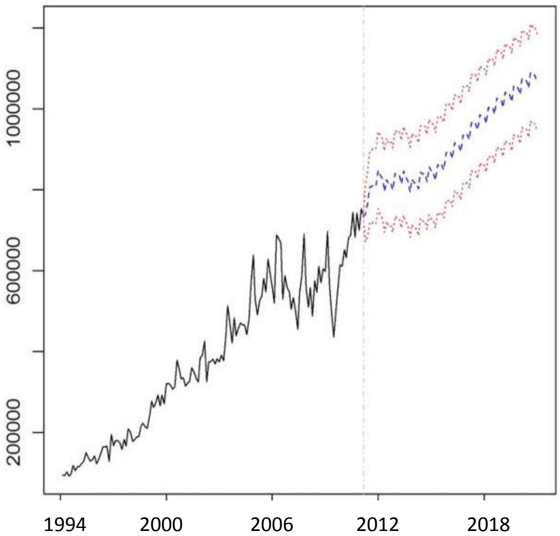


Figure 9: Production of Passenger Cars (units/month)

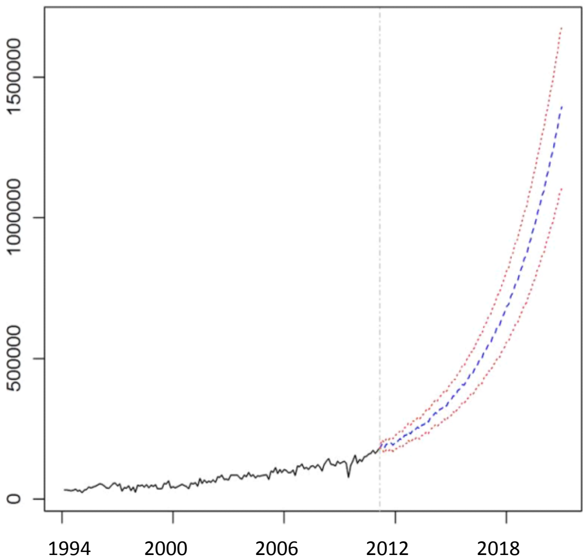


Figure 10: **Production of Scooters ('000 units/month)**

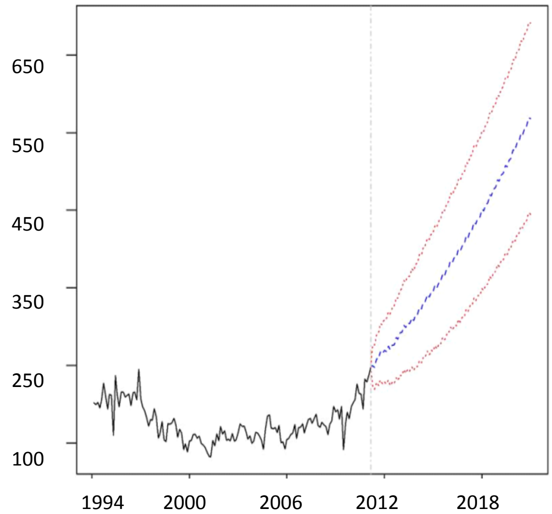
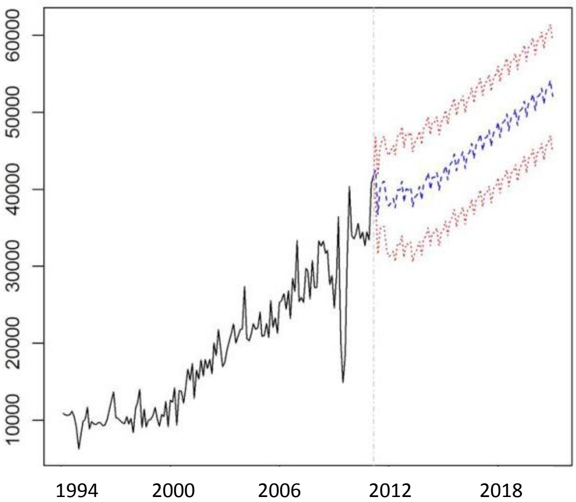


Figure11: Production of Jeeps (units/month)



The steel weight of each component was derived from various experts and the steel weight of the total number of units produced was estimated for each category. The average steel weight in each category of automobile gave us the average steel consumed to produce one unit. This was then multiplied by the number of units to be produced to arrive at the total steel consumption of various segments in the industry.

Shipbuilding and Containers

With the opening up of trade in India, the shipping sector is assuming renewed significance in the transport industry of the Indian economy. India has one of the largest merchant shipping fleets among developing countries and approximately 95 per cent of the country's export-import merchandise trade by volume (70 per cent in terms of value) is transported by sea. Given the aforementioned context, the role of the shipbuilding sector in the future of the Indian economy seems very bright.

Method

In order to calculate the total consumption of steel by the shipbuilding sector, the major types and number of ships currently being built in India (based on tonnage and DwT) was compiled from the order books of all the major shipbuilding yards. These ships were then categorised into four weight groups namely small (<1,000 tonnes), medium (1,000-40,000 tonnes), large (40,000-100,000 tonnes) and ultra large (>100,000 tonnes). A review of naval literature and expert opinions from naval architects were used to identify the self-weight of ships (weight of an empty ship) and the time taken to complete building ships in each of these categories.

Table 11: **Details of Shipping Industry**

Type of ship	Deadweight Tonne (DwT)	Self Weight as a percentage of DwT	Project Completion Time (Minimum)
Small	<1,000 T	35%	6 months
Medium	1,000-40,000 T	25%	6 months -1 year
Large	40,000-100,000 T	15%	2 years
Ultra Large	>100,000 T	12-15%	>3 years

Source: **Athena Infonomics**

Problems of heterogeneity in the customer base of the shipbuilding yards, differing delivery timelines and a poor track record of delivery on time makes the estimation of annual consumption of steel very vague and ambiguous. Thus, the shipbuilding sector suffers from an obvious time error. It is thus at this stage quite difficult to establish time series data on steel consumption in shipbuilding. However, assuming that the current pattern in the order book will be sustained, an average of 0.46 million tonnes will be consumed by the shipping sector in 2015-16. Further, in order to account for the steel consumed in ship repair and maintenance, a margin of 10 per cent of total steel used in shipbuilding was added.

In addition to shipbuilding, container manufacturing is another large steel consuming sector. The total number of containers being manufactured in the country was compiled from the Annual Survey of Industries data. The ARIMA technique was applied to forecast output. The total output in tonnes was considered a proxy for steel consumption. Total consumption of steel by the container industry is estimated to be around 1.16 million tonnes.

IV. EVALUATION OF THE MODEL

In order to test the validity of our model and the degree of inclusiveness of our forecast, we applied our demand estimation methodology to the year 2009-10. The actual demand for the year is stated to be 60 million tonnes. The demand for steel as estimated by our methodology for 2009-10 was estimated at 56.42 million tonnes. The sectoral divisions are given in the table below.

Table 12: **Sectoral Steel Consumption (2009-10)**

Sector	**Demand (MT)**
Real estate	**25.4**
Infra	**6.8**
Machinery	**13.4**
Fasteners	**0.69**
Consumer durables	**0.7**
Auto	**4.83**
Power	**1.4**
Railways	**2.1**
Containers	**1.1**
TOTAL	**56.42**

This gives us a forecast error of 6 per cent. The sectors that have been considered under the current model are only 94 per cent inclusive. Thus, an additional 6 per cent margin has been added to the 2015-16 estimates in order to make our demand estimation model more inclusive.

V. OBSERVATIONS

While this approach continues to be fraught with forecast errors and general approximations, the merits of such a 'bottom-up' approach far outweighs its disadvantages. The use of macro-economic parameters to estimate the consumption of steel has a tendency to exaggerate the demand for steel. Similarly, the use of apparent steel consumption (production+imports-exports) as a proxy for steel demand is inadequate as the formula used to calculate apparent steel consumption excludes change in stock (ΔS).

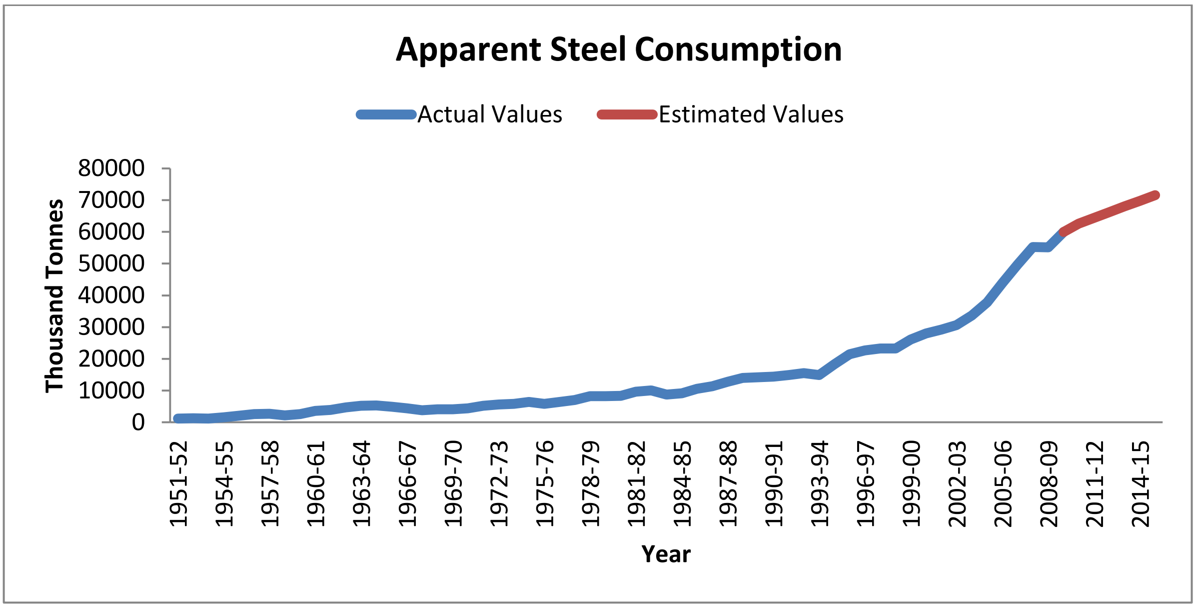
In order to test the validity of using apparent steel consumption as a proxy for demand we forecast future apparent steel consumption and compared the estimates thus derived with the estimates that were obtained from the end-use estimation method used in this study.

On running an ARIMA on apparent steel consumption we obtained the following estimates.

Table 13: **ARIMA Estimates**

Year	**Estimated Values**	**SE**	**+SE**	**-SE**	+2SE	-2SE
2010-11	62,550.343	886.628	63,436.97	61,663.72	64,323.6	60,777.09
2011-12	64,405.817	997.4792	65,403.3	63,408.34	66,400.78	62,410.86
2012-13	66,229.022	1,009.182	67,238.2	65,219.84	68,247.39	64,210.66
2013-14	68,021.071	1,019.971	69,041.04	67,001.1	70,061.01	65,981.13
2014-15	69,783.04	1,029.926	70,812.97	68,753.11	71,842.89	67,723.19
2015-16	71,515.967	1,039.12	72,555.09	70,476.85	73,594.21	69,437.73

<u>Figure 12:</u> Apparent Steel Consumption



<u>Source:</u> Steel Scenario Yearbook, 2010 and Athena Infonomics.

The apparent consumption of steel hovers around 71 million tonnes while the steel demand as estimated by the 'bottom-up' approach is close to 111 million tonnes of steel. This is a fairly large margin of error as it does not take into account the growth of various sectors and the consequent rise in steel consumption.

Alternatively the Bayesian vector autoregression equation can be used, in which certain proxy variables are introduced as an endogenous variable along with apparent steel consumption to capture the growth of independent sectors on total steel consumption. Again, we discovered this model was less efficient than methods used above on account of the poor quality of the proxies used to represent the different sectors.

In a world with the infinity of time, nothing is ever complete.[10] Thus any attempt to forecast market demand for steel in India is a continuous and dynamic process that will have to evolve with the industry.

.....

10 Prof. Shackle, *Epistemics & Economics*, Cambridge University Press, (1972) pp. 25-27.

ISAS Working Paper

No. 134 – 13 September 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Manmohan in Bangladesh: The Visit Revisited

Iftekhar Ahmed Chowdhury[1] and M. Shahidul Islam[2]

Abstract

The visit by Indian Prime Minister Manmohan Singh to Bangladesh in September 2011 was billed as his most important foreign policy initiative of the year. It was to have been a paradigm for resolving intractable relations between neighbours, a model to be emulated in other similar situations. Instead, it fell a victim to the complexities and idiosyncrasies of India's domestic politics, and became what many saw as much ado about little. Some key agreements were not signed, despite public expectations rendering this important event one of more protocol than substance. The article analyses the reasons why. The essay points to some structural issues of centre-state relations in India that will require to be addressed with regard to foreign policy questions, particularly in terms of relations with other nations in the region. It examines how perceived national self-interests can often override even the closest of personal rapport as between Prime Ministers of Bangladesh and India. One simple but profound lesson learnt from this episode is that one must not undertake major initiatives with regard to inter-State relations, even between the best of friends, without the most thorough preparations. Nonetheless, the authors give the visit a mixed grade, and argue that if an appropriate follow-up mechanism is put in place even now, there would be potentials for advance on whatever had been achieved, which while little now, can grow into much over time.

---

[1] Dr Iftekhar Ahmed Chowdhury is Senior Research Fellow at ISAS. He was the (Foreign Advisor) Foreign Minister of Bangladesh from 2007-2009. He can be contacted at isasiac@nus.edu.sg. The views expressed are those of the author and do not necessarily reflect those of the institute.

[2] Mr Mohd Shahidul Islam is Research Associate at ISAS. He can be contacted at isasmsi@nus.edu.sg. The views expressed are those of the author and do not necessarily reflect those of the institute.

Introduction

The long awaited visit of Manmohan Singh to Bangladesh (6-7 September 2011) is now over. It will get mixed grades. Without a doubt, there have been forward movements in terms of bilateral relations. At the same time it is widely believed that it has fallen short of expectations.

An important achievement was the Framework Agreement that the two Prime Ministers signed. It should set the tone for future relations. There were also several others inked. But significant were the ones that were *not* signed, though they were expected to have been. These relate to water-sharing and transit. There was an element of tit-for-tat in this.[3] When India went back on the former due to the lack of endorsement from West Bengal's (or now Paschimbangla's) maverick Chief Minister Mamata Banerjee, Bangladesh followed suit on the latter. There does not appear to have been any lack of commitment on the part of Bangladesh's Sheikh Hasina. She had indeed succeeded in evolving some kind of consensus that it was important now to settle issues with India, despite many differences within Bangladesh as to details. Unfortunately Singh was unable to get his act together, partly due to his government's weaknesses and the idiosyncrasies of Indian domestic politics. Unlike the situation in the Trojan Wars when Laocoon (Trojan priest) warned, which went unheeded, that he feared the Greeks even when they come bearing gifts, here was a matter of Greeks coming bearing no gifts at all!

Earlier Singh had sought to placate Bangladesh by making some dietary accommodation. Despite being a vegetarian, he agreed to partake in the *hilsa*, Bangladesh's favourite fish dish. Unfortunately it turned out that this was perhaps the only accommodation he could make. His experts had drawn up an agreement to share the water of the Teesta River, which seemed to have been endorsed by Bangladesh, and which would have removed an important apple of discord between the two countries.

The problem was the Teesta waters were to be shared with Bangladesh by the Indian state of Paschimbangla, now governed by a volatile Banerjee, who though an ally of Singh in the Center, was obviously not under his control. She was to have been one of five State Chief Ministers accompanying Singh to Dhaka.

Popular in Bangladesh as yet another lady politician in charge, like many in that country, Banerjee was unwilling to risk trading her domestic votes with foreign popularity, and balked at the last minute both at the treaty and at being in the delegation.

[3] 'Dhaka Seeks Explanation for Postponing Teesta Deal', *Daily Star* (6 October 2011).

The Bangladeshis were not amused. This meant no deal signed on Teesta, and also no transit for India from Bangladesh. In Dhaka, memories of historical negative behaviour by the Calcutta *bhadrolok* were revived, even though this time round it was now a *bhadramahila*.[4] So instead of actually signing the deals, the leaders of both countries, in the 65-point joint statement at visits end, had to remain satisfied by making promises and pledges. But these in the context of South Asian inter-State politics, are notoriously more brittle than a lover's oaths.

Agreements Signed

The two major documents signed in the course of the visit involved the Framework Agreement, and another that related to the enclaves and land boundaries. A number of Memorandas of Understanding was also inked. These included the offer of duty free access to 46 Bangladeshi textile products, designed to reduce the ballooning trade gap (It is noteworthy that Bangladeshi experts forcefully argued that the impediments to trade lie not so much on the formal tariff wall, but on non-trade barriers or NTBs.)

(A) Framework Agreement

The framework agreement on cooperation for development was a tone setter. It recalled the two shared bonds of history, culture and values. It contained 12 points providing the template for future bilateral cooperation on a wide range of areas. These included, among others, water sharing, trade facilitation and connectivity, sub-regional cooperation, environment protection, information sharing, and security issues.[5]

This was an important document. It sought to create the necessary positive atmospherics for more detailed understandings. It recorded the political *will* between the two parties to forge cooperation. As everyone knows, the *will* is a prerequisite for *ways* that would follow.

---

4 The *bhadralok* literally meaning 'gentlemen' were a largely Weberian status-group, drawn from the Hindu community, influenced by Protestant Anglo-Saxon values, who dominated the socio-political life in 19th and early 20th century Bengal, generally criticised by liberal sociological analysts collaborating with the British Raj. For a detailed study, see J.H. Broomfield, *Elite Conflict in Plural Society: Twentieth Century Bengal (*Berkeley: University of California Press, 1968). The important point that irked Muslim Bengalis, mainly from East Bengal, now Bangladesh, is that the *bhadralok* tended to look down upon them, or so they perceived. The *bhadramahila* is the female counterpart.

5 For details see the *Ministry of External Affairs website*, *India*, available at http://www.mea.gov.in/my start.php?id=501018197&flg=1.

(B) A Protocol On Land Boundary

The two foreign Ministers signed a protocol (Protocol to the 1974 Mujib-Indira Land Boundary Agreement) concerning the demarcation of the land boundaries between the two countries, adversely possessed land and enclaves.[6] This landmark agreement aimed at resolving a long-standing dispute that had been souring relations between the two countries for decades. Each country through a quirk of irrational border-demarcations earlier, owns bits and pieces of land inside the other's territory. These number 162 in total. Thus India 'adversely' occupies 551.8 acres of Bangladeshi land and the latter 'adversely' occupies 226.81 acres of the former's.[7] The protocol included the settlement of the demarcation of the land boundary and transfer of adversely possessed land in the border.

Moreover, the residents in two of the more significant Bangladesh enclaves[8], *Dahagram* and *Angarpota*, can now enjoy 24-hour 'unfettered access' to their mainland through the Tin Bigha Corridor (a strip of land formerly belonging to India on the West Bengal-Bangladesh border). An estimated 34,000 people live in the 111 Indian enclaves located in four districts of Bangladesh and 17,000 people reside in 51 Bangladeshi enclaves inside the Indian district of Cooch Behar. These enclaves would be exchanged between the two countries under the Mujib-Indira land boundary agreement on ratification of the protocol.

The disputes over boundary and enclaves originally aroused out of the anomalies in the Radcliffe Award in 1947. Over a decade after the division of British India in view of the problems arising out of boundary demarcation and enclaves, both India and Pakistan reached an agreement (known as the Nehru-Noon agreement) in 1958 that provided for 'exchange of enclaves on the basis of enclaves for enclaves without any consideration of territorial loss or gain.'[9] Bangladesh inherited the problem after its independence in 1971. The Indira-Mujib agreement of 1974 laid the groundwork for demarcating the unidentified part of their border and the issues relating enclaves. However, being hostage to other problems of Indo-Bangla relations, the issues were not settled for such a long time.

Cutting the Gordian Knot of this difficult and complex issue must be considered a forward movement. This has been featuring on bilateral negotiations for over 35 years, and at one

6 For details see *the Ministry of External Affairs website*, *India*, available at http://www.mea.gov.in/meaxpsite/declarestatement/2011/09/06js12.pdf.

7 Bibek Debroy, 'India Needs to Show Magnanimity to Resolve Outstanding Issues', *Weekly Holiday* (12 August 2011).

8 In Bengali, these are called *chitmohol,* signifying a chit of paper. These *chitmohol* are pieces of land that the Maharaja of Cooch Behar and Rangpur won or lost in gambling centuries ago.

9 Living With a Border in the Backyard, *The Telegraph* (1 September 2011). Also see, http://coochbehar.nic.in/htmfiles/tinbigha_contd.html

stage in the early 1990s, one of the authors was deeply involved in the negotiating process.[10] The proof of the pudding will lie in the eating and both sides must ensure the requisite exchanges are affected within a given time-line. Any follow-up mechanism set up to implement the various outcomes of the visit must be mandated to ensure that.

(C) Memorandas of Understanding (MoUs)

A large number of Memorandas of Understanding (MoUs)[11] were signed in course of the visit. These were on renewable energy, facilitating Overland Transit Traffic between Bangladesh and Nepal, conservation of the Sunderbans as also of the Royal Bengal tigers, cooperation in the field of fisheries, educational cooperation between the Jawaharlal Nehru University and the Dhaka University, academic cooperation between National Institute of Fashion Technology, India and BGMEA Institute of Fashion and Technology, Bangladesh, and cooperation between Doordarshan and Bangladesh Television (the state televisions of the respective countries). Individually each may not be significant in itself, but collectively they did manage to convey a predilection to agree on details, thus creating an overall positive ambience.

Agreement Not Signed: Teesta and Transit

Unfortunately the ambience did not succeed in achieving what was to have been the crowning glory of the visit, the agreement on the Teesta waters and another on transit.

Given the high expectations from the Singh visit, it was hoped that the two landmark treaties - Teesta water sharing agreement and Transit - would also be inked in Dhaka. The Teesta pact was indeed viewed as a crucial component of Singh's visit. However, the officials in Dhaka were informed by their Indian counterpart at the eleventh hour that the agreement would not be signed. By this time the Indian Prime Minster and his entourage had already arrived Dhaka, and the visit had commenced.

India’s last minute U-turn to sign the Teesta treaty had subdued the fanfare in Dhaka markedly. In understandable retaliation, Bangladesh blocked the deal on sharing the Feni River waters and signing a ‘letter of exchange’ containing Dhaka's approval letting India use Chittagong and Mongla ports. This was a difficult decision for Hasina, but according to

[10] Dr. Iftekhar Ahmed Chowdhury, who in 1993, then as Director General for India at the Bangladesh Foreign Ministry, headed a negotiating team to India on this specific subject.

[11] For details see the *Ministry of External Affairs website, India*, available at http://meaindia.nic.in/my start.php?id=501018158

received wisdom, the right one. An investigative reporting has published a blow-by-blow account of how this came about.[12]

Originating in *So Lomo lake* in Sikkim, the Teesta flows through northern Paschimbanga of India before entering Bangladesh. An arrangement is already in place (under a 1983 agreement) that allows India and Bangladesh to share 75 per cent of its waters with the former using 39 per cent and the latter 36 per cent. However, there is need for a consensus between Delhi and Dhaka on the remaining (unallocated) 25 per cent.[13]This was to have been the crux of the pact due to be signed in Dhaka.

Ostensibly the reason for Mamata's stiff opposition to the Teesta deal was that the negotiated agreement was detrimental for the farmers in North Bengal districts.[14] While no official data or account is available, it is reported that Mamata had objected to giving Bangladesh 50,000 cusecs of water, as mentioned in the final draft of the interim treaty for Teesta water-sharing instead of 33,000 cusecs as in the initial draft.[15] However, the Indian central government, including the Prime Minister, claimed that she had been consulted regularly on the issue and she agreed to visit Dhaka with other four Chief Ministers. After the visit of Singh, the Bangladesh Prime Minister also confirmed this when she said that 'New Delhi and Dhaka had reached an understanding on water-sharing in the Teesta and Feni rivers'. [16]

While Bangladesh had much stake in the proposed water sharing agreement on Teesta (and other common rivers for that matter[17]) given that it is a lower riparian country with many more numbers dependent on it, India also stood to gain enormously had the deal on Transit was signed in Dhaka, which would have been the case if the agreement on Teesta had gone through. India's North-eastern states are 'Bangladesh-locked'. For seamless connectivity between NEI and the Mainland India, between India and Bangladesh as well as with rest of Asia the transit deal was a categorical imperative, at least as far as India was concerned. The implications for NEI are discussed later in the piece.

While Mamata had been blamed for the less than hoped-for outcome in Dhaka, it seems that both parties were not thorough with regard to their preparations. There is no denying that

---

12 *New Age* (10 September 2011).

13 Islam M. Fakrul and Higano Yoshiro, 'Equitable Sharing of International Waters: A Proposal for Optimal Utilisation of The Teesta River', Bangladesh Development Initiative, available at http://www.bdiusa.org/Publications/JBS/Volumes/Volume2/jbs2.2-4.pdf.

14 Manmohan Says Mamata Assented to Teesta Deal, *The Hindu* (9 September 2011).

15 Reasons for U-turn, *Daily Star* (6 September 2011).

16 On his way back on board his special flight to Delhi the Indian Prime Minister himself told the media that 'the West Bengal government assented to a strategic water-sharing agreement with Bangladesh before backing out of it over the weekend'. See, Manmohan Says Mamata Assented to Teesta Deal, *The Hindu* (9 September 2011).

17 Bangladesh is criss-crossed by over 300 rivers. Out of its 57 trans-boundary rivers, 54 are common with India and the rest with Myanmar.

Sheikh Hasina's government took a political risk by stating readiness to sign a transit deal with India.

The issue is an intensely politically sensitive one in Bangladesh given the security concerns and the political polarisation in that country. However, a palpable shift in public opinion in recent years has shifted in favour of having a wider economic cooperation with India, including providing some kind of transit facilities to New Delhi (though modalities were and are being fiercely debated) and increasing wider connectivity in that region. The immediate past Caretaker Government of Dr Fakhruddin Ahmed was also persuaded of it and indeed took some steps in that direction.[18] Thereafter Hasina's heavy investment, and indeed stake, in the relationship became a major driver of Indo-Bangladesh relationship, buttressed by Bangladesh's own by now rather widely perceived needs, shared by the common citizenry that acknowledge that a 'rising' India offers many economic opportunities. Nonetheless there was some criticism of the lack of transparency in the preparatory process. The delay now provides a window of opportunity for this to be corrected.

Various analysis and estimations indicate that transit would be beneficial for both stakeholders provided the users' fees and charges are settled on in line with international best practices.[19] However, the Bangladesh government was apparently, according to some analysts, not adequately prepared at least in conveying how it was dealing with the issue and the rapidly evolving situation.[20] Experts believe that the emphasis by Dhaka on personal relationships and linkages tended to minimise the role of institutions, thereby eroding both their capacities and effectiveness.[21]

There is no doubt that the lion's share of the blame for the failure to sign agreements that were key rested on India's shoulders, while not necessarily on that of its Prime Minister, though, Mamata notwithstanding, it is indeed with Singh where the buck stops. It was a remarkable event between two friendly powers that the envoy of one was summoned to the Foreign Ministry of another to explain itself just three hours before its Prime Minister was about to land to a red-carpet welcome in the latter country with all the pomp and panoply

[18] See, Sreeradha Dutta, *Caretaking Democracy: Political Process in Bangladesh 2006-2008* (New Delhi, Institute for Defence Studies and Analyses, 2009). Dutta writes: 'Free from partisan politics, the Caretaker Government was able to initiate and respond positively towards India. It was free from any anti-Indian pressures that undermine the ability of a government in Bangladesh to respond positively to various Indian overtures', p.108. She adds that 'under the Caretaker Government, Indo-Bangladesh relations improved considerably', p.86, while also referring to the assertion of Dr. Iftekhar Ahmed Chowdhury, one of the authors who was then Foreign Advisor (Foreign Minister) of Bangladesh that his country would never 'agree to any arrangement that would be contrary to our sovereign national interest', p.106.

[19] 'The Big Bargain?', *The Star Magazine*, Volume 10, Issue 19, 20 May 2011.

[20] See, Mishandling of State Affairs Causes Pain for the Nation, *Weekly Holiday* (9 September 2011).

[21] For an interesting study in this regard, 'Lessons from Dhaka Summit', *Daily Star* (8 September 2011), 'Ball is Now in India's Court', *Daily Star* (8 September 2011).

that protocol could muster.[22] The warmth of Singh's reception was undeniable with his counterpart receiving him in the airport, a ritual once common but now relegated to being a thing of the past in the post-modern functional age.

Trade, Connectivity and Wider Cooperation between North-East India and Bangladesh

Despite the media, and also governmental furore (on both sides) created by Mamata's absence, Singh's entourage contained four Chief Ministers from North-east India (NEI). They were Manik Sarkar of Tripura, Tarun Gogoi of Assam, Mukul Sangma of Meghalaya and Pu Lalthanhawla of Mizoram. NEI is geographically, historically, linguistically and culturally more intimate with Bangladesh than mainland India.[23] For large swathes of Bangladesh, including the districts of the Sylhet and parts of Chittagong Divisions of Bangladesh, these Indian States are key.

While the caretaker government of Bangladesh (2007-09) had taken an initiative to normalise Indo-Bangla relations in 2007, as has been pointed out earlier, it was the Sheikh Awami League-led government of Hasina, installed in office in January 2009, that helped turn them around even further by satisfying New Delhi's assertions that the North-eastern insurgents should not find safe haven in Bangladesh. This had also fulfilled the first precondition for initiating long-term economic and infrastructure projects in NEI. New Delhi's apparent consensus with Dhaka on the *de facto* 'Teesta for Transit' trade-off aimed at greater economic development in its backward region. A transit deal with Bangladesh would naturally benefit India's landlocked region enormously. As a result, while the trip has been a setback for both India and Bangladesh, for NEI it is more so. NEI's connectivity with Mainland India, in particular, and the region, in general, largely depends on Bangladesh.

One key issue that needs further investigation is that of India's uncoordinated and unbalanced state-centre relations. While the Teesta is certainly a case to test the hypothesis, the Chief Ministers from the North-east region made it clear at a business gathering on the second day of the visit that if Bangladesh can win the heart of Indian central government through

---

[22] 'Dhaka Seeks Explanation for Postponing Teesta Deal', *Daily Star* (6 September 2011).

[23] Bangladesh is geographically surrounded mostly by West Bengal and North-eastern states of India except for a small border with Myanmar to the far South-east and the Bay of Bengal to the South. Bangladesh shares a long border with West Bengal (2,216.7 km), Assam (263 km), Meghalaya (443 km), Tripura (856 km) and Mizoram (318 km). North-east India's outlays to the sea are through Chittagong port in Bangladesh and via Bangladesh's rivers to Calcutta port. The region ships tea and other exportable by inland water transports through the rivers of Bangladesh for overseas shipment from Calcutta. However, with the partition of India, the region was cut off from its hinterland, formerly East Bengal. See Sobhan, Rehman. 'Rediscovering the Southern Silk Route: Integrating Asia's Transport Infrastructure' The University Press Limited, Dhaka, 2000, and Islam, M. Shahidul, 'Bangladesh-China-Northeast India: Opportunities and Anxieties', ISAS Insights No. 36, (Singapore: Institute of Southeast Asian Studies, September 2008).

negotiations, there could be many opportunities to be seized upon.[24] This is not unique in the case of India's relations with its eastern states and Bangladesh. Similar differences persist between Tamil Nadu vis-à-vis Delhi when comes to India's relations with Sri Lanka.

The trade-off between electric power and connectivity is a case that offers some immediate benefits for NEI and Bangladesh. According to the Chief Minister of Tripura, he is ready to export electricity to Bangladesh if New Delhi agrees to the plan. The region, being blessed with huge hydroelectric resources, is in a position to sell electricity to Bangladesh that has huge shortage of power.[25]

Similarly, Bangladesh has much stake in its relationship with NEI given her export potential to the 'seven sister' states in the North-east. While trade between India and Bangladesh exceeded the US$5 billion mark in 2010-11, there is much greater room to further increase the numbers, particularly if Bangladeshi products are allowed to access to NEI.

The rise of trade is not due to any significant breakthrough between the two neighbours (in the form of bilateral FTA (Free Trade Arrangement), for instance, but largely due to increasing economic growth both in India and Bangladesh. Indeed, to feed her steady economic growth, Bangladesh's trade (particularly imports) with many Asian countries has increased markedly in recent years.

This is also reflected in the fact that China replaced India as Bangladesh's largest trading partner with the two-way trade exceeding US$7 billion in 2010-11. Similarly, China's investment in Bangladesh is also on the rise in line with the latter's increasingly better economic potentials.[26] In today's global economic matrix, all nations are in search of plural trading and investment partners, heeding the Nobel Laureate James Tobin's warning not to put 'all eggs into one basket'.[27]

Given the geographical proximity, many Bangladeshi products can be exported to the NEI market more cost-effectively benefiting the latter's consumers. For instance, most wealthier Non-Resident Bangladeshis, residing mostly in the United Kingdom, belong to the Sylhet Division bordering NEI, and would be eager to invest in manufacturing industries in their hometown provided there was a market for them in the 'Seven Sisters'. But this has not materialised due to India's non-tariff barriers and other similar hurdles. It is not only the businesses in Bangladesh that demand for greater access to the NEI market. The region itself

---

[24] Tripura Offers Power for Connectivity, *Daily Star* (8 September 2011).

[25] Tripura Offers Power for Connectivity, *Daily Star* (8 September 2011). Also see Islam M. Shahidul 'Energy Cooperation between India and Bangladesh: Economics and Geo-politics', in *The Geopolitics of Energy in South Asia*, edited by Marie-Carine Lall, Singapore: Institute of Southeast Asian Studies, 2009.

[26] For these details see, India- Bangladesh: Go East, Old Man, *Economist* (30 August, 2011).

[27] Willem H. Buiter, 'James Tobin An appreciation of his contribution to economics' available at http://www.nber.org/~wbuiter/tobin.pdf . Accessed on 10 September 2011.

is seeking New Delhi's help in this regard, ironically including Bangladesh government's intercession with New Delhi in this regard. While India offered some tariff concessions during Singh's Dhaka visit, it was the Chief Minister of Tripura who raised his voice calling on New Delhi to do more concerning the removal of non-tariff and para-tariff barriers to facilitate the market access of Bangladeshi products in India.[28]

There is a much room for two-way investments. The facilities that Bangladesh has lately offered to various Indian companies should be reciprocated. NEI is a virgin area into which large quantums of Bangladeshi investment can pour, if the appropriate incentives are offered. Progress in Bangladesh is creating greater capacity to invest abroad, and new Bangladeshi entrepreneurs, who by definition would be cautious and conservative, would prefer to invest closer to home than in faraway markets.

The enthusiasm and environment that have been created in NEI following the dramatic fall in insurgency, with assistance from Bangladesh, can only be sustained if both regions allow natural trade to develop, exploiting each other's complementarities. Increasing people to people connectivity, infrastructure development, cultural exchanges and free flow of information (including removing the hurdles to show the Bangladeshi TV channels) can help narrow the various gaps that have been created following the division of 1947 to an otherwise a century-old well-integrated region. Such a development will bring progress and prosperity to, Bangladesh of course, but also India's north-east, doing more perhaps to stem the insurgencies, present and future, than through those morally, emotionally and financially costly military operations. Due to the exigencies of modern-day international politics, what should have been natural trading and other links between Bangladesh and India's north-east, have become dependent upon, and subject to, the formalities, and to a certain extent the vagaries, of Dhaka-New Delhi relations. Just like the waters of the rivers in question, these relationships must also be allowed to flow naturally, in an unimpeded fashion, so that the accruing benefits can be shared by all. If the visit has contributed at all to this idea taking hold, it has scored a significantly positive point.

Some Extrapolations

It has been said, a saying usually connected with romance in literature but very apt in this political setting: 'Of all sad words of tongue and pen, the saddest are these: It might have

[28] The Chief Minister of Tripura remarked during the Dhaka trip that 'waiving of tariff on the export of 46 garment items is not everything. Both the governments should sit soon to simplify the process so that the 46 garment products could be exported smoothly.' See Tripura Offers Power for Connectivity,*The Daily Star* (8 September 2011).

been!'[29] This visit will be remembered for not what it actually achieved, but what it might have.

Both sides had hyped up its importance, but with a modicum of reason. Hasina had managed to seize the spirit of Bangladesh which was at equilibrium when an understanding with India would have gone down well with her people now focused more on external linkages for prosperity than on instinctive Indo-phobia.[30]

On the eve of the visit, a leading Indian newspaper spoke of it crafting 'a new paradigm in a complicated bilateral relationship'.[31] Sanjaya Baru, a well-known Indian analyst, noted that the trip could be the 'most important foreign policy initiative' of Singh this year. An influential Bangladeshi media editor, Mahfuz Anam, rhetorically asked: 'Will the Indian Prime Minister make or repeat history, implying the hope that he would make it.'[32] Alas what happened was a repeat of history, yet another failure to grasp the opportunities that an unique moment, one that in Nehruvian language 'comes but rarely' in nations' lives, with hope giving way, if not to despair, most certainly to a sense of resignation.

The historian E.H. Carr has elegantly argued that, the building of any idealistic superstructure among nations, such as one of peace, must await the digging of appropriate foundations.[33] This is sound logic. But the wait cannot be unending. The time to forge ahead is almost always never absolutely ripe. In this case, Hasina was able to ready Bangladesh as much as one possibly could, for with regard to India, there will always be the wary recalcitrants.

Singh, however, had sufficient time to dig his preparatory foundations, but was unable to do so. Was it because he was too weak, heading a government riddled with allegations of corruption and incompetence, shaken by the power of the people reflected in the Anna Hazare phenomenon, helpless in the face of the challenges of dissatisfied allies like Mamata? Is the central government in India so vulnerable to the vagaries of such politics? If that be so, there are deeper and more ominous concerns, about India, possessing the potentials to respond as one powerful unit, not just to the more placable Bangladesh, but to the more adversarial Pakistan or China.

India's greatest foreign policy challenge must be to design a single and coherent one that it is capable of executing as a central subject. If foreign entities begin to find it incumbent upon

29 The quote is from the poem 'Maud Muller', written in 1856, by the American Poet John Greenleaf Whittier (1807-1892).
30 For a general analysis of the shifting mood, see Iftekhar Ahmed Chowdhury, 'Come September, Manmohan Comes to Dhaka', ISAS Brief No. 214, 15 August 2011.
31 Editorial, *Hindu* (6 September 2011).
32 Commentary, *Daily Star* (6 September 2011).
33 This is made, with its tinge of Marxist thinking, in his classic work *The Twenty Years Crisis,1919-1939:An Introduction to the Study of International Relations* (London: Palgrave, Macmillan) Reprinted 2001.

them to deal with the units of the Indian federation separately, 'India, the emerging power', as Cohen described it, loses much of its meaning.[34] What one witnessed in Dhaka in the first week of September, was not an India that had, in (US President) Barack Obama's words 'already risen', but one struggling to find its own two feet.

The Way Forward

To his credit though it must be said where an individual role was called for, Singh acquitted himself with superb aplomb. In fact his erudite speech at the Dhaka University Senate House played a yeoman's role in calming the negative passions on other counts.

Some low-hanging fruits were indeed plucked. And the resolution of the enclaves issue that had been hanging fire for decades, was no mean achievement. The biggest disappointment was, of course, the failure to sign the Teesta waters deal. Once that had happened, Hasina was in no position to sign on the transit, and that was understood on the Indian side. A weakened Hasina would not have been of any benefit to India, and forcing a transit agreement would be a Pyrrhic victory that India could ill afford. A lesson learnt from this episode, a simple but profound one, that one must not attempt to undertake major initiatives in inter-State relations, even between the best of friends, without the most thorough preparations.

There is a political tradition in South Asia, as in many other parts of the world that major agreements are only signed at summit levels during bilateral visits. Unfortunately such occasions are rare in South Asia. Indo-Bangladesh Prime Ministers do not visit each other with relentless regularity.

The previous trip to Bangladesh by an Indian Prime Minister was a dozen years ago. Compare this with the frequency of interactions in each other's capitals, say of the leaders of Britain and France. Also for such favourable constellation of forces to exist, as they now do on both sides, could take years. Therefore, it would be wise and even fruitful to keep up the momentum, and work towards such understandings at the next opportune occasion which could be a visit to India by Hasina, who has been formally invited to do so.

To maintain and enhance the state of preparedness, the two governments could set up a joint task force, co-headed by senior Cabinet Ministers from both sides to monitor not just pacts agreed upon, but also make progress on those still pending. The teams should meet on regular intervals, for in this case, forward movement should not only happen, but also be seen to happen, just as in the case of justice, which must not only been done, but also seen to be done.

---

[34] Stephen Philip Cohen, *India: Emerging Power* (Washington D.C., Brookings Institution Press, 2001).

It will be more acceptable, for both sides, for the result of the Singh visit to be assessed like a glass half full, than like a full glass, half of whose contents were accidentally spilled in course of a trip that was much ado about little.

. . . . .

ISAS Working Paper

No. 135 – 20 September 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Does Labour Migration Bring about Economic Advantage? A Case of Bangladeshi Migrants in Saudi Arabia

Md Mizanur Rahman[1]

Abstract

This paper revisits the assumed economic advantage of temporary labour migration. The widely shared sentiment that temporary migration brings about economic advantage for migrants and their families often is a function of income differentials between two countries. This study argues that opportunity for temporary employment in a high income country does not necessarily translate into economic advantage for every individual migrant and his or her family in a low income country. This study addresses the undercurrent of risks in the international labour migration process and its implications on family economics. This study draws from the experiences of Bangladeshis in Saudi Arabia. It reports that migrants often undertake international migration at great costs of their own, incurring large debts, risking personal savings and family assets, and accentuating income risks and capital constraints, while the remittances are meagre in the repair of such family economics.

The 1973 oil boom and the subsequent undertaking of an unprecedented number of development projects in the Gulf Cooperation Council (GCC) countries led to an extremely

[1] Dr Md Mizanur Rahman is Research fellow at the Institute of South Asian Studies (ISAS) in the National University of Singapore (NUS). The author can be reached at isasrmm@nus.edu.sg. The views expressed are those of the author and do not necessarily reflect those of the institute.

rapid increase in the demand for foreign labour.[2] As a result, people from the Maghreb (Morocco, Tunisia, Libya, and Algeria), the Mashreq (Egypt, Jordon, Occupied Palestinian Territories, Lebanon, Syria, and Yemen) and Asian (South Asian and Southeast Asian countries) regions have started joining the labour markets of the GCC countries[3]. Over the decades, the GCC countries (Saudi Arabia, Qatar, Kuwait, Oman, Bahrain, and the UAE) have emerged as a relatively stable destination for migrant labour. The growth of migrant labour in the GCC countries has been so enormous that foreign population has even surpassed local population in some countries, such as Qatar, Kuwait and the UAE. In 2008, migrant workers were estimated to be nearly 77 per cent of total labour force in the GCC countries.[4]

Labour migration to the GCC countries is transient in character, although the migration phenomenon seems to be almost permanent in these societies. This is because temporary labour migration plays a key structural role in the region's economy.[5] Migrant workers in the GCC countries are offered work permits for a specific duration, so the states can maintain the foreign workforce phenomena as transient and migrants as disposable.[6] Additional measures – such as not permitting family reunion, forbidding marriages to locals, and not tolerating procreation out of wedlock – explains the transiency of migrant labour in the Gulf. All GCC countries follow the similar policies when it comes to hiring, retaining and deporting migrant workers. This common migration policy has forced migrant workers and their families (spouse, children and extended family members) to live under 'transnationally split'[7] conditions with a provision of visiting home countries during discretionary annual leave.

However, such a migration pattern has its own dynamics with the social relations that play a part where many migrants come and go usually at annual intervals or send for their extended

[2] Fred Arnold and N.M Shah (eds), *Asian Labor Migration: Pipeline to the Middle East* (London: West view, 1986), M.N. Shah and Indu Menon, 'Chain Migration through the social network: experience of labour migrants in Kuwait', *International Migration*, Vol.37, no.2 (1999), pp.361-82. Frank Eelens, T Schampers and J.D. Speckmann, *Labor Migration to the Middle East: From Sri Lanka to the Gulf* (London: Kegan Paul, 1991).

[3] N.M. Shaw, 'Arab Labour Migration: A Review of Trends and Issues', *International Migration,* Vol.32, no.1 (1994), pp.3-27. Simel Esim and Monica Smith, *Gender and Migration in Arab States: the Case of Domestic Workers* (Geneva: International Organisation for Migration, 2004).

[4] Onn Winckler, 'Labour migration to the GCC states: patterns, scale, and policies", in Middle East Institute, *Migration and the Gulf* (Washington D.C.: Middle East Institute, 2010), pp. 9-12. Martin Baldwin-Edwards, *Labor immigration and Labor markets in the GCC countries: national patterns and trends,* LSE Global Governance, Report no.15 (March 2011), p9.

[5] Maruja M.B. Asis and Nicola Piper, 'Researching International Labour Migration in Asia', *The Sociological Quarterly*, Vol.49 (2008), pp423-444.

[6] Philippe Fargues, 'International Migration in the Arab region: trends and policies', UN Expert group meeting on international migration and development in the Arab region, UN/POP/EGM/2006/09/Rev, Beirut, 15-17 May 2006, Christiane Kuptsch (ed), *Merchants of Labour,* (Geneva: International Organization for Migration: 2006). M.N. Shah, *Recent Labour Immigration Policies in the Oil-Rich Gulf: How Effective are they likely to be*?, ILO Asian Regional Programme on Governance of Labour Migration Working Paper no3 (2008).

[7] Brenda S.A. Yeoh, Elspeth Graham and Paul J. Boyle, 'Migrations and Family Relations in the Asia Pacific Region', *Asian and Pacific Migration Journal*, Vol.11, no.1 (2002).

family members to join the foreign labour market.[8] Since migrants and their families live under 'transnationally split' conditions, migrants identity themselves in terms of their communities of origin and retain strong emotional and financial relationships with remnant family members. As a result, temporary migration is seen more as a livelihood strategy, whereby, millions of left-behind families are maintaining better living standards in their home countries[9]. However, this description of temporary migration hides the subtle and complex considerations that provoke the provisional migration of labour and determine its courses in the process[10]. More specifically, this research revisits the assumed economic advantage of temporary migration for migrants and their families.

The widely shared sentiment that temporary migration brings about economic advantage for migrants and their families often links to income differentials between two countries. This study argues that the opportunity for temporary employment in a high income country does not necessarily translate into economic advantage for every individual migrant and his/her family in a low income country. This study draws from the experiences of Bangladeshis in Saudi Arabia. In particular, the study investigates the following research questions: How does recruitment take place in Saudi Arabia? What is the economic cost of migration? How much are they capable of earning, saving and remitting? Whom do they remit to? Who decides how to use remittances? What role do remittances play in family economic dynamics? In interpreting the data, this study highlights the nature of risk exposure for migrants and the economic implications of such risks on their families in the Bangladesh-Saudi Arabia migration corridor.

This study adopts a family perspective to understand the Bangladesh labour migration to Saudi Arabia because it is the family that decides about migration of its members. Family extends economic support to its members for migration and migrant member remits to family to compensate and contribute to family resources. This study attempts to make a conceptual contribution to the analysis of emigration and family economics under conditions of temporary labour migration. Saudi Arabia is chosen for this study because it is the largest destination for Bangladeshi migrants; nearly 2.58 million Bangladeshi migrants joined the Saudi Arabia labour market between 1976 and 2010.[11] Of around US$ 11 billion migrant remittances that Bangladesh received in 2010, Bangladeshi migrants working in Saudi Arabia

[8] Md Mizanur Rahman, 'Bangladeshi Migrant workers in the UAE: gender-differentiated patterns of migration experiences', *Middle Eastern Studies*, Vol.47, no.2 (2011), pp.395-412.

[9] Maruja M.B. Asis, 'Overseas Employment and Social Transformation in Source Communities: Findings from the Philippines', *Asian and Pacific Migration Journal*, Vol.4, no.2-3 (1995), pp.327-46. Graeme J. Hugo, 'Effects of International Migration on the Family in Indonesia', *Asian and Pacific Migration Journal*, Vol.11, no.1 (2002), pp13-46.

[10] Erind Pajo, International Migration, Social Demotion and Imagined Advancement: An Ethnography of Socioglobal Mobility (New York: Springer, 2008).

[11] Bureau of Manpower, Employment and Training, Bangladesh (BMET) is responsible for record-keeping and granting permission to overseas jobseekers. BMET posts vital migration statistics online www.bmet.org.bd accessed on 24 July 2011.

remitted nearly US$ 3.31 billion.[12] Despite the significant contribution, the experience of migrants in the Bangladesh-Saudi Arabia migration corridor is not adequately reported in the existing literature. This study attempts to fill the gap.

The following section provides the theoretical and conceptual issues relating to international labour migration followed by a brief discussion about data sources for this study. The next, offers trends and patterns of Bangladeshi migration to Saudi Arabia, with a summary of socio-demographic features of Bangladeshi migrants and their families who are in Saudi Arabia for work. Subsequent sections focus on recruitment of labour to Saudi Arabia, the economic cost of migration, implications of economic cost of migration on families, and finally remittances and family economics. The final section provides a summary of the findings of the study, with an emphasis on policy implications.

Theoretical and Conceptual Issues

International labour migration literature is often replete with economic causes and consequences of such migration for migrants, their families and communities in the sending countries.[13] For instance, the neoclassical microeconomic model of individual choice views international labour migration as a sum of individual cost-benefit decisions undertaken to maximise actual income or expected income through international movement.[14] However, in the developing countries it is not the individual but the families that mobilise resources for migration, and take charge of receiving and allocating remittances. Confronted by the inherent dilemma of who makes the decision in developing countries, new economic theory emerges with fresh insights to complement the neoclassical economic approach.

As per this new theoretical perspective called the 'new economics of migration', migration for work is a family decision and it is more than just a source of income or expected income. Migration is seen as a response to income risk and failures in a variety of local markets (for example, credit, crops and future markets) in the developing countries.[15] This new theoretical perspective sees individual migration as a broader family strategy.[16] Precisely, the 'new

---

[12] Calculate from Central Bank of Bangladesh (Bangladesh Bank) remittance data: http://www.bangladesh-bank.org/econdata/wagermidtl.php accessed on June 2011.

[13] Thomas Straubhaar, *On the Economics of International Labor Migration* (London: Verlag Paul Haupt Bern und Stuttgart, 1988). Oded Stark, *The Migration of Labor* (Oxford: Basil Blackwell, 1991). Douglas S. Massey et al., *Worlds in Motion- Understanding International Migration at the End of the Millennium* (Oxford: Clarendon Press, 1998). Demetrios G. Papademetriou and Philip L. Martin (ed.) *The Unsettled Relationship: Labor Migration and Economic Development* (London: Greenwood Press, 1991).

[14] Michael P Todaro, *Internal Migration in Developing Countries: A Review of Theory, Evidence, Methodology and Research Priorities (*Geneva: International Labor Office, 1976). George J. Borjas, 'Economic theory and international migration', *International Migration Review*, Vol.77 (1989), pp532-85.

[15] Oded Stark, *The Migration of Labor* (Oxford: Basil Blackwell, 1991).

[16] J. Lauby and O. Stark, 'Individual Migration as a Family Strategy: Young women in the Philippines', *Population Studies,* Vol.42 (1988), pp.473-486.

economics of migration' focuses on the family, rather than the individual, as the decision-making unit and paves the way for linking individual migrant behaviour with responsibility and expectations of family members left behind, a phenomenon that was previously treated separately in the migration literature.[17]

Financial remittances (hereafter remittances) are a much cited link that theorists of 'new economics of migration' always present as a case in point. The new economic model recognises that in the developing world, markets for capital, the future and insurance are often absent, imperfect, or inaccessible. In order to self-insure against risks to income, production and property, or to gain access to scarce investment capital, the family sends one or more members to foreign labour markets for gainful employment. In other words, international migration is seen as a strategy for risk-minimisation and capital accumulation[18]. Although the above discussion theoretically explains the rationale for migration from labour-abundant but capital-poor countries to labour-scarce but capital-rich countries, it does not account for the risks that migrants are exposed to in the migration process and its implications for family economics.

Potential migrants and their families are presented with the opportunity to engage in migration behaviour that can lead to a significant loss in individual and family economics. A migrant often commences his or her international trip for work incurring large debts, risking personal savings and valuable family assets that undermine the family incomes and aggravates the income risks and capital constraints. Sufficiently aware of the income risk and the market failures that provoke international migration of labour from developing countries, previous analysis has not adequately informed the risks that migrants assume in the migration process and its implications on migrants and their family economics. This is an overly neglected aspect of labour migration research, especially in the context of Middle Eastern countries.

This paper suggests the need to scrutinise Asian labour migration as a process with its all complexities so that the spheres of potential risks and its implications for migrants themselves and their families become apparent. This analysis will identify several such spheres of risks and elaborate on them to reflect the nature and extent of the risks and its profound implications for migrants and their families, in particular migration corridors. For instance, it highlights the spheres of recruitment, cost of migration and remittances; shedding light on how they produce risks for migrants and their families that undermine family economics. Such a holistic approach to temporary labour migration is expected to offer a

---

[17] Douglas S. Massey et al., 'Theories of International Migration: A Review and Appraisal', *Population and Development Review*, Vol.19, no.3 (September 1993), pp.431-466. Douglas S. Massey et al., 'An Evaluation of International Migration Theory: The North Mexican Case', *Population and Development Review*, Vol.20, no. 4 (December 1994), pp.699-751.

[18] Oded Stark, *The Migration of Labor* (Oxford: Basil Blackwell, 1991). Douglas S. Massey et al., *Worlds in Motion- Understanding International Migration at the End of the Millennium* (Oxford: Clarendon Press, 1998).

much needed insight into the complexity of Asian labour migration and generate policy recommendations for safer and economically rewarding migration.

Literature on migration and family is considerably wide. The existing studies on migration and family reveal some significant implications: moderate changes in headships and gender roles within families; a medium for upward social mobility; families adjust well in the absence of male or female migrants; improved education, health care, and the overall quality of life of migrant families; the women left behind take on the roles previously assumed by the men; left-behind children learned to be more independent in the migration process; and so on[19]. While these studies expand our understanding about broader implications of migration on family dynamics, this particular study deepens the insights into family economics. In doing so, it emphasises the impact of migration on the economic resources at the disposal of families.

Temporary migration affects family economics in at least two ways: one is the outflow of indispensable family resources to meet the expenses incurred in the migration process (referred to as the 'economic cost of migration') and the other is the transfer in cash (or kind) from migrants to their non-migrating families in the countries of origin, (referred to as the 'migrant remittances'[20]. Both economic cost of migration and migrant remittances affect family economics. In studying the economic implications of emigration on family dynamics, it is therefore imperative to shed light on both outflows of family financial and other economic resources and inflows of remittances to the family. This study advances the economic context of family wealth aggregation.

There is a growing body of literature that suggests that for overseas jobs, loans are taken which can only be repaid at great effort, land is sold, and family economics are risked[21].

---

[19] Maruja M.B. Asis, 'Overseas Employment and Social Transformation in Source Communities: Findings from the Philippines', *Asian and Pacific Migration Journal*, Vol.4, no.2-3 (1995), pp.327-46. Graeme J. Hugo, 'Effects of International Migration on the Family in Indonesia', *Asian and Pacific Migration Journal*, Vol.11, no.1 (2002), pp.13-46. Sandra Weinstein Bever, 'Migration and the Transformation of Gender Roles and Hierarchies in Yucatan', *Urban Anthropology*, Vol.31, no.2 (2002), pp.199-230. A Parrado Emilio, Flippen Chenoa and Chris McQuiston, 'Migration and Relationship Power among Mexican Women', *Demography*, Vol. 42, no.2 (May 2005), pp.347-372. G.Gunatilleke (ed.), *The Impact of Labor Migration on Households: A Comparative Study in Seven Asian countries* (Tokyo: UNU Press, 1992). Rhacel Salazar Parreñas, *Children of global migration: transnational families and gendered woes* **(**Stanford, Calif. : Stanford University Press, 2005). K.C. Zachariah, E.T. Mathew, and S. Irudaya Rajan, 'Social, Economic and Demographic Consequences of Migration on Kerala', International Migration, Vol.39, no.2 (2001), pp.43-71. Hania Zlotnik, 'Migration and the family: the Female Perspective', *Asian and Pacific Migration Journal*, Vol.4, No. 2-3 (1995), pp.253-271.

[20] Md Mizanur Rahman, *Debt and Migration: A Case of Bangladeshi migrants in the Gulf Countries,* International Organization for Migration Policy Paper (Geneva: International Organization for Migration, forthcoming).

[21] Michele Ruth Gamburd, 'Sri Lanka's "Army of Housemaids: Control of Remittances and Gender Transformations, *Anthropologica*, Vol.7, no.1 (1995), pp.49-88. M.R. Gamburd, *Transnationalism and Sri Lanka's Migrant Households: The Kitchen Spoon's Handle*, (New Delhi: Vistaar Publications, 2000). Daniéle Bélanger, and Tran Giang Linh, 'The Impact of transnational migration on gender and marriage in sending communities of Vietnam', *Current Sociology*, Vol. 59, no.1 (2011), pp.59-77. G.M. Arif, *Recruitment of Pakistani Workers for overseas employment: mechanism, exploitation and vulnerabilities*,

However, the findings are usually drawn from small-scale surveys (e.g. small migrant worker surveys or village case studies) that have inherent limitations to offer national level policy recommendations. However, when such a study draws additionally from representative data, it is more capable of illuminating the experiences of migrants at the national level and generating policy recommendations for harnessing the development potential of migration. This particular study draws from a representative survey.

Data Sources

This research draws from qualitative data and a national-level migrant household survey conducted in Bangladesh. For the qualitative data, the author interviewed Bangladeshi migrants, returnees, migrant brokers, sub-agents, and agents in Bangladesh between 2008 and 2010. A national-level survey entitled 'Bangladesh Household Remittance Survey,' which was performed by International Organisation for Migration in Dhaka with the financial support from Department for International Development – the United Kingdom (DFID-UK) in 2009, is the source for this study's quantitative data. The survey interviewed households across the country through a nationally representative sample of migrant households from all six administrative divisions of Bangladesh.

A 'migrant household' has been defined as a household that had at least one of its members living/working abroad for a minimum period of one year. In total, the number of migrants reported in the survey was 12,893. Of these 12,893 surveyed migrants, 4,427 migrants were working in Saudi Arabia. Therefore, this study represents the experiences of these 4,427 migrants and their families. As this study is primarily based on national level survey, it has few limitations that precluded more in-depth analysis of certain aspects of family economic dynamics. Apart from the sending end, the precautionary measures in the destination end have also disallowed such research to be administered and get a glimpse of the social world that migrants create in Saudi Arabia. As a result, the broad nature and vast spread of these migratory cultures in Saudi Arabia develop in differing and changing patterns creating impossibility to define an overall social dichotomy.

International Labour Organisation Working Paper Series 64, (2009), Geneva. Md Mizanur Rahman, *In Quest of Golden Deer: Bangladeshi Transient Migrants Overseas* (Germany: VDM Verlag, 2009). Hisaya Oda (ed.), *International Labor Migration from South Asia*, Institute of Developing Economies, JETRO, Japan, ASEDP 70 (2004), pp181-208. Hisaya Oda, "The Impact of labour migration on household well-being: evidence from villages in the Punjab, Pakistan' in Hiroshi Sato and Mayumi Murayama (eds), *Globalization, Employment and Mobility: the South Asian Experience*, (London: Palgrave and IDE-JETRO, 2008)

Bangladeshi Labour Migration to Saudi Arabia

Saudi Arabia, the sacred land of Islamic devotion to Muslims from all around the world, is also the largest temporary migrant-worker receiving country in the Middle East. Like other GCC countries, labour migration to Saudi Arabia started after the 1973 oil price hike. The growth of foreigners in Saudi Arabia was steady and remarkable: 4.63 million foreigners in 1992, 5.25 million in 2000, and 8.42 million in 2010.[22] Despite the presence of the highest number of foreigners, unlike other GCC countries, foreigners in Saudi Arabia have never surpassed the local population. Nevertheless, 31 per cent of the total population belonged to foreigners in Saudi Arabia in 2010.[23] Broadly, foreigners can be categorised as low-skilled, high-skilled, professional migrants. The majority of foreigners are low-skilled migrants, working in construction, manufacturing, service, agriculture, and domestic sectors. Low-skilled migrants are predominantly single male migrants, living in camps with other co-workers, mostly dormitories. The professional migrants enjoy greater benefits and privileges, including reunions with family, education and medical benefits for dependents and annual paid leave (often with return airfares).

Saudi Arabia is a popular destination for Bangladeshi migrants. The official record of labour migration flows to the GCC countries was initiated by the Bureau of Manpower, Employment and Training (BMET) in 1976. According to BMET, the formal recruitment of Bangladeshi labour to Saudi Arabia started in the mid-1970s and by 1980, nearly 20,000 migrants went to Saudi Arabia for work. The number of migrants reached nearly 300,000 between 1981 and 1990, around 1.18 million between 1991 and 2000, and approximately 1.14 million between 2001 and 2010[24] (Figure 1). In total 7.13 million Bangladeshi migrants sought overseas employment between 1976 and 2010 and of these migrants nearly 2.58 million or 36.18 per cent joined the labour market of Saudi Arabia.[25] Along with the largest destination for migrant labour, Saudi Arabia is also the largest source of migrant remittances for Bangladesh (Figure 2). Bangladeshi migrants from Saudi Arabia remitted nearly US$ 21.42 billion to their families between 2000 and 2011.[26]

---

[22] Philippe Fargues, 'Immigration without inclusion: non-nationals in Gulf state nation building', Conference paper, the 2011 Gulf Research meeting, University of Cambridge, July 6-9 (2011), p.12.

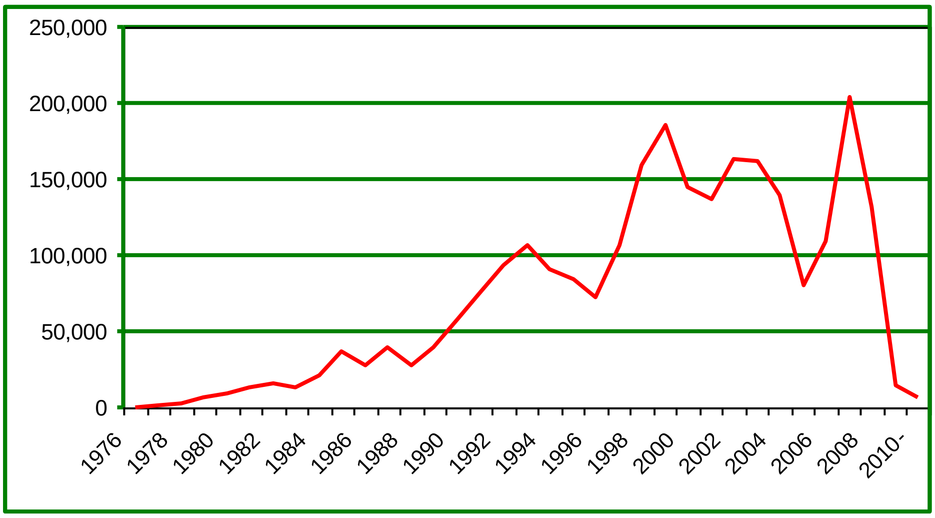
[23] *Ibid*., p.13.

[24] BMET statistics, www.bmet.org.bd accessed on 23 June 2011.

[25] BMET statistics, www.bmet.org.bd accessed on 23 June 2011.

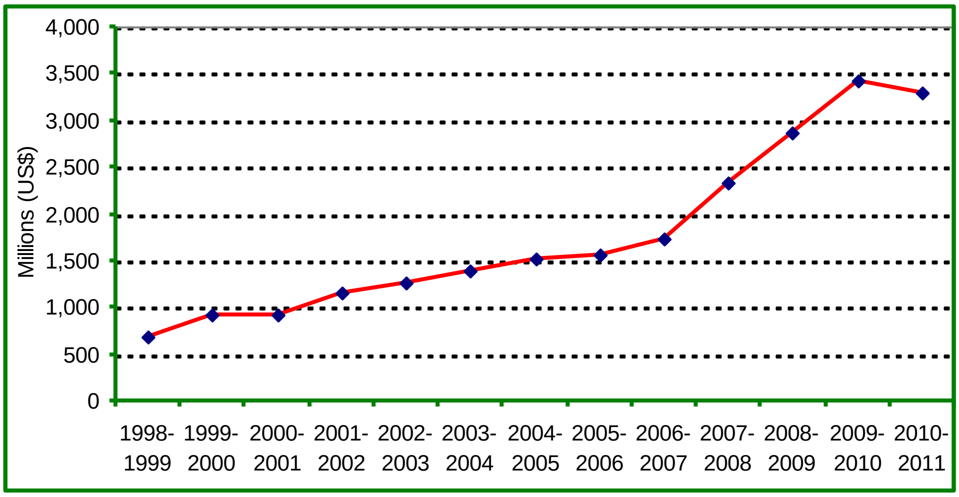
[26] http://www.bangladesh-bank.org/econdata/wagermidtl.php. Accessed on 15 August 2011.

<u>Figure 1:</u> Trends of Bangladeshi Migration to Saudi Arabia, 1976-2010



<u>Source:</u> Compiled from data found in Bangladesh Government website, www.bmet.org.bd.

<u>Figure 2</u>: Trends of Remittances from Saudi Arabia to Bangladesh, July 1998 – June 2011



<u>Source:</u> Compiled from data found in Bangladesh Government website, www.bmet.org.bd and Central Bank of Bangladesh (Bangladesh Bank), http://www.bangladesh-bank.org/econdata/wagermid tl.php

In the forthcoming paragraphs, a summary of the socio-demographic profiles of respondents is presented. This basic information on the respondents and their families is crucial to the interpretation of the study's findings. As mentioned earlier, this study is based on nationally representative migrant household survey in Bangladesh, 2009. As per the sample, 4,427 migrant workers were working in Saudi Arabia for at least one year and they remitted regularly to their families. Of these 4,427 Saudi migrants in the sample, 98.5 per cent were males and 1.5 per cent females. Although women's participation in various economic sectors has increased in the recent years in Bangladesh, their migration out of Bangladesh remains insignificant. Religious conservatism and restricted mobility has put pressure on women seeking employment overseas.[27]

Overall, nearly 39 per cent of the migrants were in their 20s, 35 per cent were in their 30s and around 26 per cent were in their 40s and above, with the average age being 33.3 years. As a comparison, the mean age for Bangladeshi migrants in Hong Kong and Malaysia is reported 34.1 years[28]. Bangladeshi migrants to Saudi Arabia were predominantly single (lone) male migrants. Nevertheless, they were not necessarily unmarried. Nearly 67 per cent of migrants were married with wives remaining in Bangladesh. Of these married migrants, nearly 87 per cent had children and average family having 2.36 children. Wives left behind were primarily homemakers, taking care of children and in-law families. Educational attainments of surveyed migrants were low. Approximately 30 per cent of migrants received only one to five years of schooling while 50 per cent completed six to 10 years. Of the remaining 20 per cent, half had no formal education while the other half attained secondary and/or other vocational certificates.

In terms of occupation, around 79 per cent were working before their migration to Saudi Arabia; they were mostly engaged in agriculture, small businesses, and urban informal economy. The major categories of occupations that these migrants were reported doing in Saudi Arabia were construction, maintenance, driving, factory work, restaurant or hotel work (cleaners and waiters), general labour, and gardening. Approximately 23 per cent of migrants worked and resided there between one to two years, 22 per cent between three to five years, and around 33 per cent between six to 10 years. The remaining nearly 20 per cent had been working abroad for a period of 11 to 21 years (in some cases more). On average, duration of stay of migrants was 7.03 years, which is likely to be sufficient to offer a clear indication of migration benefits for migrants and their households.

Recruitment of Bangladeshi Labour to Saudi Arabia

Labour recruitment in Saudi Arabia and other GCC countries takes place in a system popularly called *kafala* or sponsorship[29]. In a *kafala* system, a migrant is sponsored by an employer of GCC citizenship who assumes full economic and legal responsibility for the

[27] AKM Ahsan Ullah, *Rationalizing Migration Decisions: Labour Migrants in East and Southeast Asia* (London: Ashgate, 2010). Nana Oishi, *Women in motion : globalization, state policies, and labor migration in Asia* (Stanford: Stanford University Press, 2005).

[28] AKM Ahsan Ullah, *Rationalizing Migration Decisions: Labour Migrants in East and Southeast Asia* (London: Ashgate, 2010), p.68.

[29] I have explained elsewhere about Kafala system and recruitment in the GCC countries in general, please see Md Mizanur Rahman, Recruitment of labour in the Gulf Countries, ISAS Working Paper 130 (2011), Institute of South Asian Studies, National University of Singapore, Singapore. For details about Kafala system, also see, A.N. Longva, ‘Keeping Migrant Workers in Check: The Kafala System in the Gulf’, Middle East Report no.211 (1999), pp.20-22. Françoise De Bel-Air, ‘Reforming the Sponsorship (Kafala) in the GCC Countries: what socio-political stakes? The Case of Saudi Arabia’, Conference Paper, Workshop 12, Migration in the Gulf, Gulf Research Meeting at the University of Cambridge 6-9 July 2011.

employee during the contract period. A *kafeel* may be an individual, a placement agency, or a company/institution. The system works such that the migrant worker can only work for him or her *kafeel* for a specific period. Foreign workers are not allowed to marry or be involved in sexual relationships as a mechanism to separate them from permanence in the society. The overall emphasis in *kafala* system is on control and 'flexibility' in response to local labour market fluctuations.

The *kafala* system has given birth a new form of trade called 'visa trade' in which a *kafeel* charges fees to a potential buyer of visa (migrant worker) for each visa offered. Since the visa trading generates kickback fees for *kafeels,* it has been a multi-million dollar industry in the Gulf.[30] In the UAE, for instance, a work visa for an Indian is sold for around US$2,000 (or AED 7,500)[31] and for a Pakistani around US$2,700 to US$3,000 (AED 10,000 to 12,000)[32]. The scale of visa trading is so massive that the Saudi Minister of Labour reported that 70 per cent of the visas issued by the government were sold on the black market[33]. The *kafala* system has been met with much criticism over the years. For instance, it is accused of encouraging corruption, visa trafficking, as well as import of workers widely outpacing labour market needs.[34] Since the system generates additional lucrative incomes for local sponsors, governments in the Gulf have so far failed to stop visa trading, notwithstanding some genuine interests in part of the Gulf governments.

Recruitment is a key aspect of temporary labour migration. Recruiting agencies and migrant networks play a critical role in the recruitment process.[35] Recruitment of Bangladeshis to Saudi Arabia takes place through both recruiting agencies and migrant networks (see Figure 3). In the recruitment system assisted by recruiting agency, proceeds as follows: a recruiting agency in Saudi Arabia places a 'demand letter' to their counterpart in Bangladesh. Then a sister recruiting agency in Bangladesh searches out prospective migrants and asks them to submit a passport, pictures, biographic information and a partial payment to begin the recruitment process. At this juncture, the Bangladeshi recruiting agency contacts their counterpart in Saudi Arabia for visa processing. The recruiting agents rely overwhelmingly on a group of intermediaries called sub-agents, who act as mediators between a prospective

---

30 M.N. Shah, 'Recent Labour Immigration Policies in the Oil-Rich Gulf: How Effective are they likely to be?' ILO Asian Regional Programme on Governance of Labour Migration Working Paper No 3 (2008).

31 Ibid., p.9.

32 Gulf News, (13 April 2004) 'Illegal visa trade still flourishes'.

33 M.N. Shah, 'Recent Labour Immigration Policies in the Oil-Rich Gulf: How Effective are they likely to be?' ILO Asian Regional Programme on Governance of Labour Migration Working Paper No 3 (2008), p.9

34 Françoise De Bel-Air, 'Reforming the Sponsorship (Kafala) in the GCC Countries: what socio-political stakes? The Case of Saudi Arabia', Conference Paper, Workshop 12, Migration in the Gulf, Gulf Research Meeting at the University of Cambridge 6-9 (July 2011). M.N. Shah, 'Building State capacities for managing contract worker mobility: the Asia-GCC context', in *World Migration Report 2010* (Geneva: International Organization for Migration, 2010).

35 M.R. Gamburd, *Transnationalism and Sri Lanka's Migrant Households: The Kitchen Spoon's Handle*, (New Delhi: Vistaar Publications, 2000). M.N. Shah and Indu Menon, 'Chain Migration through the social network: experience of labour migrants in Kuwait', *International Migration*, Vol.37, no.2 (1999), pp.361-82.

migrant and a licensed recruiting agent. For an extra fee, these sub-agents help prospective migrants find jobs and help agencies find prospective workers in a more timely fashion.

As migration matures, many potential migrants learn more about the process of migration and the way to seek alternative services for jobs in Saudi Arabia. Instead of finding jobs with agencies, many potential migrants seek jobs arranged with sponsor-employers in Saudi Arabia through personal networks. Working visa arranged through personal networks is called in Bengali '*Urro'* or in English a 'flying (work) visa' as it flies directly from a migrant broker in Saudi Arabia to a prospective migrant in Bangladesh, bypassing local recruiting agencies and their sub-agents[36]. Arranging a 'flying visa' usually proceeds as follows (see Figure 3): a migrant broker finds a job for a friend or relative with usually his *kafeel* or *kafeels'* network of friends and relatives. Once a work visa is procured through *kafeel*, the migrant broker contacts the potential migrant in Bangladesh and ask them to fly within a stipulated time.

Apart from 'flying visa', there is another type of visa called a 'free visa'[37]. Although there is no official category of visas called 'free visas' in the Gulf countries, the term is widely used among migrant communities. Pakistani migrants call it in Urdu '*Azad*' (free) visa. This unofficial category of visas allows a potential migrant to enter a GCC country for work under *kafala* system, but the sponsor-employer (*kafeel*) who officially sponsors the migrant does not offer paid work. A migrant on 'free visa' is free to find his own job in any sector of economy, although it is illegal to work in another sector or with other sponsor-employers than one's own[38]. In other words, a 'free visa' is legal but, paradoxically, when a free-visa holder starts working for others, he becomes illegal by law and vulnerable to deportation.

Recruitment practices, therefore, raise the question about why migrants are brought in under such a visa category that does not guarantee work under a sponsor/*kafeel* as per law. As discussed earlier, recruitment entails the kickback fees inherent in the visa trading system in the Gulf. As a result, visa trading generates additional incomes for *kafeels* and this income-generating feature of *kafala* system drives the recruitment practice in Saudi Arabia whether it is under a general work visa, flying visa, or free visa. However, it is the free visa that exposes migrants more to uncertainty about work and risk of starvation[39] and deportation. The implication of such recruitment practice is that it denies migrant workers from their very basic right of work and the resulting means of earning overseas for which they originally

[36] Md Mizanur Rahman, Recruitment of Labour in the Gulf Countries, ISAS Working Paper no.130, Institute of South Asian Studies, National University of Singapore, Singapore.

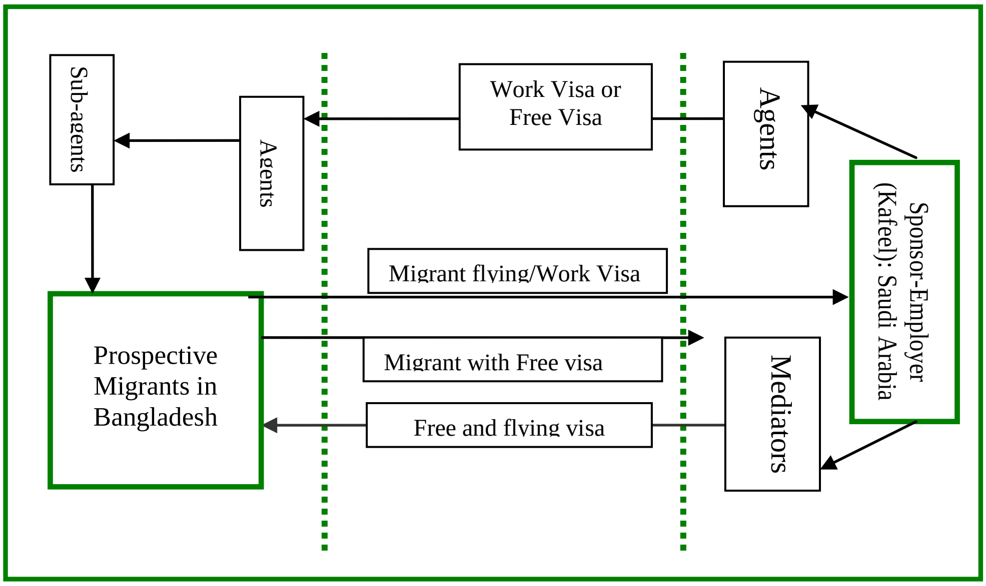
[37] Md Mizanur Rahman, Recruitment of Bangladeshi Labour in the Gulf Countries, ISAS Working Paper no. 130 (2011), Institute of South Asian Studies, National University of Singapore, Singapore.

[38] *Gulf News*, "Kuwaitis speak out against crimes related to 'free visa'", 2 January 2011. M.N. Shah, *Recent Labour Immigration Policies in the Oil-Rich Gulf: How Effective are they likely to be*? ILO Asian Regional Programme on Governance of Labour Migration Working Paper No.3 (2008), p.7.

[39] Since a *kafeel* does not take responsibility of offering work or providing food and accommodation to a migrant as a 'free visa' holder, a migrant is exposed to starvation if he does not get work for a few consecutive days.

migrate. Moreover, since overall recruitment practices is shaped by a grouping of interests at different points in the system, it increases the economic cost of migration and the resulting recuperating period, as we will see in the next section.

Figure 3: Conceptualising Recruitment of Labour to Saudi Arabia[40]



Economic Cost of Migration to Saudi Arabia

The economic cost of migration is an important aspect of labour migration that determines the potential outcomes of migration in the long run. By economic cost of migration, this study not only provides the actual financial cost of migration but also reveals the embedded costs, that is, the sources of arranging the financial cost of migration and its potential impact on family economics. However, before detailing the economic cost of migration for recruitment, a standard practice that often shapes the actual cost of migration requires clarification here. For migration to Saudi Arabia, a potential migrant is required to pay a part of the financial cost of migration, which is by and large from around one-fourth to half of the financial cost of migration, to the middlemen/sub-agents in advance. The remaining amount is usually paid in several instalments depending on the progress of visa application. However, all dues are payable before a prospective migrant flies to Saudi Arabia.

The waiting time between the first payment or instalment and the departure for Saudi Arabia should not be ideally more than three months. In practice, it often takes longer and therefore demands explanation. Of the surveyed migrants, around 57 per cent of migrants received the

[40] Adapted from Md Mizanur Rahman, *Recruitment of Bangladeshi Labour to The Gulf Countries*, ISAS Working Paper no.130 (2011), Institute of South Asian Studies, National University of Singapore, Singapore, p.14.

work visa and flew to Saudi Arabia within three months. However, 11 per cent waited between three and five months, while 32 per cent had to wait between six and 13 months, or even longer. On average, a migrant had to wait around 5.22 months to complete the recruitment procedures in Bangladesh. Some vested-interest groups manipulate the waiting time for recruitment and make profit out of migrants' initial investments here. Intermediaries are often suspected for delaying the recruitment procedures. They will collect a first payment from potential migrants well in advance on promise that they will be first recruited once they receive demand offers or requests from the Saudi Arabia-based recruiters. Sometimes, potential migrants are not even consulted about the status of demand letters and third parties still collect the first payment well in advance.

Since the demand for visas is higher than the supply of visas, potential migrants can hardly afford to refuse the payment. For intermediaries, this cash payment generates additional incomes, as they often invest the cash for some profit-making ventures. For migrants, advance payment and the delaying of recruitment increases the cost of migration as they often borrow from moneylenders with higher interest rates, putting pressure on their family income. Once prospective migrants initiate the recruitment procedure with the first instalment, they cannot cease the recruitment and would claim the repayment of the full amount. This exposes potential migrants to victimisation and exploitation, even in the country of their origin.

Figure 4 presents a conceptual schema for the economic cost of migration to Saudi Arabia from a family perspective. The figure maps out three important layers that constitute the economic cost of migration such as sources of securing funds to pay for financial cost of migration, contribution of multiple sources to the financial cost of migration, and disbursement of financial cost of migration as formal service fees and intermediary fees. The average cost of migration to Saudi Arabia was in BDT (Bangladeshi Taka) 206,058 or US$3,000[41] – virtually beyond the personal savings of all migrants. As a result, most migrants rely on multiple sources to accumulate the funds for migration. As per frequency, major sources of securing funds were: selling land (27 per cent), mortgaging land (23 per cent), taking loan (72 per cent), and other sources (19 per cent) such as selling of livestock, jewellery, and so on. Surprisingly, only nine per cent of migrants used personal savings to meet their migration expenses.

A relevant question is the percentage of contribution of the different sources to the total financial cost of migration (Figure 4 presents this information). Land paid off nearly 24 per cent of the cost. As mentioned earlier, loans from moneylenders accounted for 52 per cent. Other sources such as in-laws, dowry and the sale of family assets (livestock, jewellery, and so on) constituted nearly 20 per cent of financial cost. What is surprising about the contribution of different sources is that personal savings only constituted four per cent.

41 All Bangladeshi currency (BDT) figures were converted into USD in early 2010. The exchange rate was US$1= BDT 68.68.

Although personal savings alone hardly met the expenses for migration in Asian countries, the overwhelming dependence on sources other than personal savings is probably unique to the Bangladeshi situation[42]. This extreme dependence on other sources for fundraising is expected to affect the family incomes in the first few years, as we will see later in this section.

Considering the high cost of migration, this study further investigates the major areas of expenses in the recruitment process to offer a glimpse into the distribution of economic costs across different service providers. For the purpose of understanding, the study divides the economic cost of migration into the formal service fees that include government fees, passport fees, wage earners' contribution and other relevant mandatory service fees in Bangladesh and the mediators' fees that include fees charged by intermediaries and recruiting agencies for their services. A detailed report on expenses for migration reveals that formal fees represent on average of only 24 per cent of the financial cost of migration and the intermediaries' fees represent the remaining 76 per cent of cost of migration. In other words, 24 per cent of economic cost of migration (US$ 3,000) was spent on formal services and 77 per cent was appropriated by intermediaries linked to recruiting agencies and migrant brokers in Bangladesh and Saudi Arabia.

It is important to note that the intermediary fees also include kickback fees which are inherent in the financial cost of migration to Saudi Arabia regardless of the channels of recruitment – recruiting agencies or migrant networks. Some intermediaries in Bangladesh suggest that nearly two-thirds of the intermediary fees constitute kickback fees in the case of migration to Saudi Arabia. Although media reports constantly blame the recruiting agencies in Bangladesh for exorbitant fees, they are in fact making a tiny profit while the bulk of the profit goes to the other side of the recruitment end.

Emigration and Disruption of Family Economics

As explained earlier, it is obvious that financial cost of migration to Saudi Arabia is beyond individual migrants' personal savings, forcing them to use multiple sources for fundraising. This extremely disproportionate dependence on other sources for fundraising is not deliberate but a necessity to meet the cost of migration. To invest in their migration, migrants sell off those family assets that are also the source of income for families, borrow from moneylenders with interest rates that can only be repaid through external earnings, such as remittances, and emptying the savings of individuals and extended family members that they often require to minimise unpredicted risks (such as health risk, crop risk and so on). Migration, thus, undermines family economics in two ways. First, it hampers regular family incomes due to

[42] AKM Ahsan Ullah, *Rationalizing Migration Decisions: Labour Migrants in East and Southeast Asia* (London: Ashgate, 2010).

the dispossession of income-generating assets, such as land, livestock and so on. Second, the loans constraint family resource use. To ascertain extent to which migration impacts on family economics, this study examines the size of land-holding and the loan status at the post migration period.

Land is a crucial income contributor and status marker in Bangladeshi society, especially rural Bangladesh. It is also a source of cash for cash-strapped families. To finance the migration, nearly 50 per cent of surveyed migrant households sold out or mortgaged away land. In other words, 50 per cent of migrant households were deprived of regular incomes from land. The land-ownership pattern in Bangladesh is very polarised. Rapid population growth and inheritance law has caused fragmentation of land over time and the number of landless households in the country stood at 50 per cent[43]. As per the survey, nearly 42 per cent of households completely lacked arable land, that is, they were indeed members of a landless class. The remaining 58 per cent may be called marginal land-owning class, as they own only a certain amount of arable land. Yet, their arable land-ownership was on average approximately 181 decimal, which is indeed much lower than a rural household required for its subsistence level of income for a family of five members in Bangladesh[44]. The fallow land in these agrarian communities equate to the same status as landless, due to a lack of income from crop production. Thus, it is safe to conclude that most migrants who take up migration as a means of family strategy were apparently from the landless class or marginal land-owning class, who were struggling to earn their living locally.

Apart from landholdings, 72 per cent of migrants who took micro-credits from moneylenders (69.05 per cent) and NGOs (2.75 per cent) were affected by migration. At the post migration stage, nearly 61 per cent of migrants had outstanding loans to pay back; the average loan amounted to BDT 157,057 or US$2,286 (US$ 1=BDT68.68) or 76 per cent of mean financial costs for migration. Surprisingly, more than some 77 per cent of the migrants were working in Saudi Arabia for a period of three years or longer. This suggests that working in Saudi Arabia for a period of three years is not sufficient to get rid of migration-induced debt and the compounded debt that was still required paying after three years of repayment. The average size of the current debt signals the severity of indebtedness among the Bangladeshi households with members in Saudi Arabia. It is important to note that the interest rate for migration loans is different from other types of loans, such as those for agriculture, business, weddings, and festivals. As migration yields high returns, moneylenders charge up to seven to 10 per cent interest per month or roughly 100 per cent per year. If the interest is compounded, the debt will double in less than a year and triple in less than two years.

[43] Sadman Khaled Monsur, 'Landlessness and its impact on economic development' *Star Campus*, Vol.2 no.86 (14 September 2008).

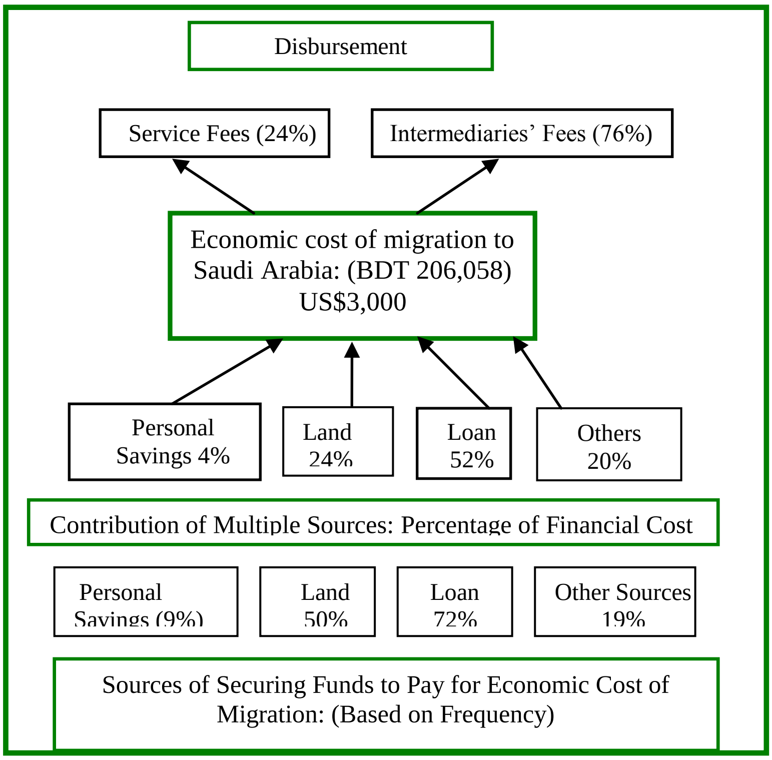
[44] Peter J.Bertocci, 'Community Structure and Social Rank in Two Villages in Bangladesh'. *Contributions to Indian Sociology*, VI: 19-52 (1972).

In the decision to seek overseas employment, there is indeed a trade off between the possibility of higher incomes and the destruction of existing family economics. Migrants, who choose the migration option over the possible collapse of existing family economics, do so with the hope of repairing and enhancing it through remittances. Whether the hope pinned on remittances has been realistic is discussed in the next section.

Remittances and Family Economics

We have so far seen the outflow of family resources and its implications on family development dynamics. Remittances are the most tangible benefit that labour migration generates for migrants and their families. Remittances are seen as an external resource for the debt-ridden migrant families. However, the size and frequency of remittances are important variables for the economic take off of migrant families. The size of the remittances is contingent on the monthly incomes of the migrants overseas. Therefore, this study investigates the monthly remuneration of migrants in Saudi Arabia. On average, the monthly remuneration of the migrants was BDT18,723 or US$ 273. While this amount is several times higher than a job in Bangladesh, if the monthly salary is estimated against the economic cost of migration, which was on average BDT 206,058 or US$ 3,000, a migrant requires roughly 11 months to recoup his financial cost of migration if other expenses are controlled.

Figure 4: Economic Cost of Migration: A Family Perspective[45]



[45] Adapted from Md Mizanur Rahman, *Debt and Migration: The Bangladeshi Migrants in the Gulf Countries*, International Organization for Migration Policy Paper (Geneva: International Organization for Migration, forthcoming).

Figure 5 presents a conceptual schema for remittances and family economics. First, the figure presents the average amount of remittances in each transfer and frequency of remittances in a year. Second, the study maps out major areas of use of remittances such as family expenses, repayment of loan, medical, education and income generation. Third and finally, the paper provides the implications of remittances on family in terms of food, education, and incomes. On average, migrants remitted approximately four times a year. The average amount of remittances was at a time was BDT 22,258 or US$ 324. If average remittances and frequency of remittances are calculated, a migrant household received around US$ 1,296 in a year. Given the annual flow of remittances to the migrant households, a migrant requires roughly 2.31 years to recover the actual financial cost of migration if other expenses are controlled. What happens is that debt and the deficit of family incomes in the migration process prolongs the recovery of economic investment in migration.

This study also explores to whom migrants usually remit, who control remittances, and who manages the remittances in the households. A migrant usually remitted to the head of the household in Bangladesh. On average, 31 per cent of the migrants remitted to their spouses with nearly 32 per cent of migrants were married in the sample. Remitting to wives rather than fathers was found to be extremely high among Bangladeshi migrants, even when the rural family authority structure in Bangladesh where fathers, when alive, assume the predominant role in managing household affairs. This is a possible area where an in-depth study is required. Interestingly, 55 per cent of migrants remitted to their father (67 per cent of migrants were unmarried in the sample). Thus, we infer that when migrants are married, they predominantly remit to their wives and when they are unmarried, they usually remit to their fathers. Other major recipients of remittances were siblings (seven per cent).

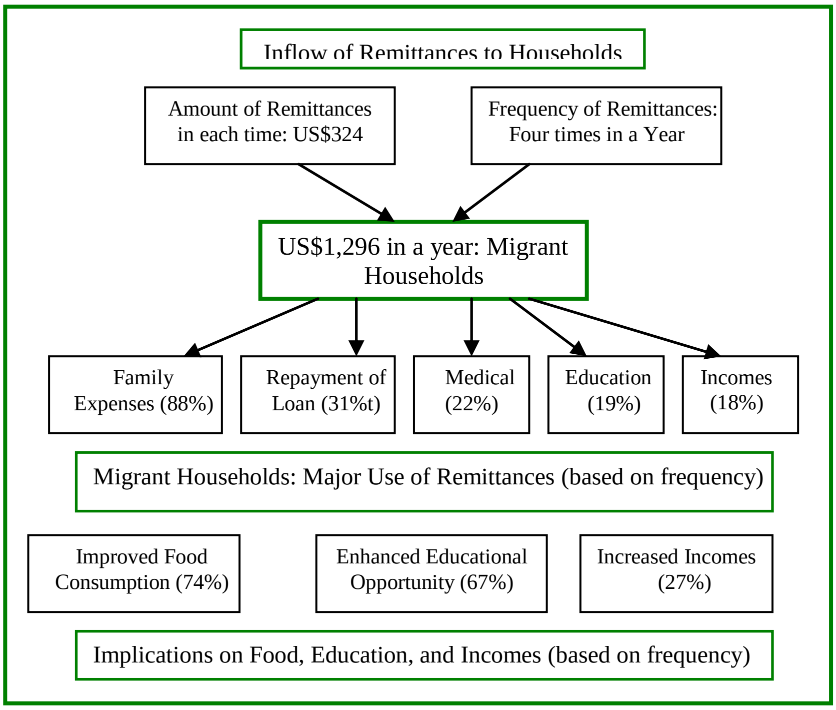
The control and management of remittances, especially when the migrant workers (senders) are away, are critical to the understanding of intra-household relations and the gendered outcomes. With regard to control over remittances, migrants overseas and other members of the family other than the recipients seem to have less control over it. Nearly 83 per cent of recipients of remittances had sole control over remittances, while nearly 10 per cent of migrants and their recipients mutually controlled the remittances. In terms of making decisions about management of remittances, 71 per cent of recipients revealed that they made the decision themselves, while 22 per cent of recipients who were predominantly wives decided how to manage remittances in consultation with their husbands overseas. Thus, when recipients of remittances are wives, the negotiation and consultation about the management of remittances take place to a greater extent across husband-wife remittance routes, signalling improved gender relations between wife and migrant husband overseas.

The use of remittances is an important indicator for assessing family development dynamics. Migrant families used the funds for a myriad of purposes, such as basic expenses (food and clothing), followed by purchasing of land or property, repayment of debts, savings, construction of house, marrying off brothers and sisters, education, medical treatment, religious festivals (*Eid-ul-Fitr* and *Eid-ul-Azha*), purchasing of livestock and so on. The five major areas of use of remittances, as per frequency of uses, are family expenses, followed by loan repayment, medical treatment, education and incomes. As per frequency, 88 per cent of households used remittances for family basic expenses, 31 per cent used remittances for repayment of loan, 22 per cent for medical treatment, 19 per cent for education, and 18 per cent for income generation.

In addition to economic purposes, remittances were also used for religious festivals (six per cent) and marrying off brothers or sisters (1.31 per cent). Nearly six per cent of households saved a part of the remittances for future use. The use of remittances in the above fields suggests that migrant households prioritised the expenses as per local requirements. For instance, it may seem unproductive to spend hard-earned remittances for religious festivals or marrying of siblings. Yet, the social expectation from migrant households in the communities of origin and the local perception about development (such as affordability to marry off grown up sisters) are so important for migrant households that they cannot overlook them in their communities, claiming honour and prestige (Gamburd, 1995; Rahman, 2009a). Therefore, there is a need to incorporate the local meaning of development in the broader migration and development debate.

Remittances showed visible impact on migrant families in terms of food consumption, educational opportunity and local income generation. As per frequency, around 74 per cent of families reported having improved food consumption and nearly 67 per cent of families reported having enhanced educational opportunities. However, the role of remittances in income generation was mixed: nearly 27 per cent of migrant families reported an increase in incomes through establishing new sources of incomes, investing or expanding existing sources and making deposits in banks/ buying stocks or saving certificates. However, given the extent of landlessness and indebtedness, it is not surprising that remittances cannot account for income generation.

<u>Figure 5:</u> Remittances and Family Development Dynamics



Conclusion

The study has challenged the conventional assumption relating to economic advantage of temporary migration for migrants and their families. It has instead depicted emigration in terms of insurmountable economic disadvantage to the emigrants and their families. This study draws from the experiences of Bangladesh migrants in Saudi Arabia.

The research has examined labour migration as a process by highlighting its key aspects, such as recruitment, economic cost of migration, incomes, and remittances, and implications of economic cost and remittances on family economics. In the context of recruitment, this study has identified two areas where migrants are exposed to victimisation and exploitation. One is in the delaying of recruitment by intermediaries that increases the economic cost of migration and the other is the provision of ‘free visas’ for migrant workers. ‘Free visas’ do not guarantee work under approved *kafeel*. The ‘free visa’ is legal but when a ‘free visa’ holder works for another, he becomes illegal by law and vulnerable to deportation. The ‘free visa’ is ‘double-rewarding’ for *kafeel*, as it generates kickback fees for the *kafeel* without guaranteeing work for sponsored migrant. In short, while ‘work visas’ and ‘flying (work) visas’ generate kickback fees it also requires offering gainful employment to sponsored migrant workers. The ‘free visa’ also generates kickback fees but it does not entail offering a job to sponsored migrants. As a result, migrants encounter a different type of risk that even prevents them from very basic right of working in Saudi Arabia.

The economic cost of migration is another area that not only exposes migrants to victimisation and exploitation but also undermines family economics. The study has shown how the payment of financial costs for migration exposes migrant families to risks of losing local incomes and of incurring debts in the migration process. For instance, procurement of financial costs for migration damages regular family incomes, due to the dispossession of income-generating assets. As reported, 50 per cent of migrant households sold or mortgaged away land to finance the migration. The loan that comes with 100 per cent interest in a year further drains the family's income. Nearly 61 per cent of migrants had outstanding loans to pay back; the average loan amount to BDT 157,057 or US$ 2,286 or 76 per cent of the economic costs for migration. This is the debt scenario when only 23 per cent of migrants have been working in Saudi Arabia for up to three years and the remaining 77 per cent of the migrants have been working for a period of three years or more.

The study provides a conceptual scheme for studying remittances and family development dynamics by offering a three-layer explanation. The study has reported that a migrant household received on average US$1,296 in a year. The remittances were so little that migrants would need 2.31 years to recover from the actual initial financial cost of migration, given that other expenses are controlled. However, debt and the deficit in the family's regular income can prolong the recovery. With regard to remittance receipt, control, and management, the study reports some important trends. An extremely high percentage of recipients of remittances were wives of migrants overseas. More recipients of remittances enjoyed control over remittances than senders of remittances. In the husband-wife remittance corridor, there was more consultation and negotiation about the use of remittances.

Drawing from the frequency of use of remittances, the study has revealed that 88 per cent of migrant households use remittances for family basic expenses, 31 per cent for repayment of loan, 22 per cent for medical expenses, and 19 per cent for education. Finally, 18 per cent of migrant households are in a position to use remittances for income-generating activities (e.g. businesses). In terms of implications of remittances on family development dynamics, the study report that 74 per cent of migrant households enjoyed improved food consumption, 67 per cent enhanced educational opportunities, and 27 per cent increased incomes. Temporary migration of labour to Saudi Arabia thus damages family economics that external resources like remittances cannot restore in the short run. However, we need some sort of longitudinal data to comprehend the complexity of this relationship between migration and family economics in the long run.[46]

This research has attempted to shed light on some areas that demand policy interventions to ensure the welfare of migrants and their families and enhance the economic benefits of migration. First, specific policy intervention is required to stop migrating under the 'free visa' category. Second, financial cost of migration is excessively high and the governments

[46] Md Mizanur Rahman, 'Temporary Migration and Changing Family dynamics: Implications for social development', *Population, Space and Place*, Vol.15 (2009), pp.161-174.

involved may consider imposing restrictions on maximum recruitment costs and implement it strictly. In doing so, Saudi Arabia should take necessary initiatives to eliminate visa trade immediately. Third and finally, the Bangladesh government may introduce a soft-loan for overseas migration, so that migrants do not need to carry a burden of 100 per cent interest rates. This will also help retain existing regular income flows to households and help enjoy the benefits of remittance inflows to family economics.

It is imperative that around eight million migrants from Saudi Arabia sent around US$29 billion[47] as remittances to their families in the countries of origin in 2010. It is not only eight million migrants but also eight million families that have been benefited from remittances. These are often the sole source of family incomes for these families in the developing world. By providing gainful employment to such a large number of foreigners and allowing them to remit back home, Saudi Arabia is indeed making a vital contribution to the socio-economic transformation in the selected Maghreb, the Mashreq and the Asian countries. This contribution of Saudi Arabia to the capital-poor but labour-rich countries deserves greater recognition from academics and policy makers.

Similarly, the outside world is also concerned about the economic cost of migration and treatment of migrant workers in Saudi Arabia[48]. Therefore, there is a need to adopt policy measures to ensure the fair treatment and welfare of migrant workers in this single largest temporary migrant-worker recipient in the world. The burden of improving the conditions of migrant workers lies principally on Saudi Arabia as it is the host country that has authority to bring about changes in the management of foreign workers on its own soil. An additional factor Saudi Arabia has the moral obligation given that it is the birth place of a great religion that enshrines and promotes core human values including fair treatment and social justice.

---

47 Zawya – Leading Business Intelligence on the Middle East and North Africa, http://www.zawya.com/story.cfm/sidZAWYA20110908030328/Foreigners_in_Saudi_remitted_over_29bn_in_2010. Accessed on 12 September 2011.

48 See also, Human Rights Watch, "*As if I am not human": Abuses against Asian domestic workers*, (New York: Human Rights Watch, July 2008), pp.1-137.

Acknowledgement

Author wishes to thank International Organisation for Migration (IOM) – Dhaka, Bangladesh for providing access to dataset on 'Bangladesh Household Remittance Survey', which was performed by International Organization for Migration in Dhaka with the financial support from Department for International Development – the United Kingdom (DFID-UK) in 2009. Special thanks go to Rabab Fatima, Samiha Huda and Disha Sonata Faruque from IOM-Dhaka for support and cooperation. Author also wishes to thank the anonymous reviewer for very useful suggestions and comments.

. . . . .

ISAS Working Paper

No. 135 – 20 October 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

Pakistan and Patrons: The United States, PR China and Saudi Arabia

Ishtiaq Ahmed[1]

Abstract

Many Asian and African polities entered into alliances with the two main superpowers of the post-Second World War era – the United States (US) and the Soviet Union – in the hope of getting economic and military aid. Some chose to tread a middle path by joining the Non-Aligned Movement (NAM). Pakistan initially entered into an alliance with the US, followed by alliances with the People's Republic of China and Saudi Arabia to assert itself in relation to the much bigger and more powerful India. However, the alliances placed Pakistan in a relationship of dependency vis-a-vis its three patrons. This paper examines the implications and ramifications of such dependency for Pakistan in the wake of the 9/11 terrorist attacks ordered by Al Qaeda on the US and especially in the aftermath of the killing of Osama bin Laden by US Special Forces in Abbotabad, Pakistan.

[1] Ishtiaq Ahmed is Honorary Senior Fellow at the Institute of South Asian Studies, an autonomous research institute, Professor at the National University of Singapore and Professor Emeritus of Political Science, Stockholm University. He can be contacted at billumian@gmail.com. The views expressed are those of the authors and do not necessarily reflect those of the institute.

Introduction

This study examines the following chain of hypotheses:
A state beset with the fear of foreign aggression can solicit the support of a powerful patron state or states willing to brace its economic and military power. However, foreign economic and military aid also means that the donor state gains influence over the recipient state. Given the anarchical nature of international politics room for manoeuvre exists for dependent states. The latter can mitigate donor pressure through diversification of dependence. However, the relationship is an unequal one and foreign donors through carrot-and-stick methods can strive to change the behaviour of the recipient state.

The Pakistan-US Relationship

Pakistan's security concerns were built into the peculiar geography and historical legacy that devolved upon the power elite of Pakistan to whom the British transferred power on 14 August 1947. The power elite included political leaders, senior civil servants and military commanders. The historical antecedents included the fact of a painful birth that through a bitter and bloody partition of British India. It left at least one million Hindus, Muslims and Sikhs dead and at least 14 million people were uprooted and driven across an international border that was demarcated between India and Pakistan through the Radcliffe Award of 17 August 1947. Since Pakistan was claimed as a separate state for the Indian Muslim minority (some one-fourth of the total 400 million population of India at that time) who its leaders claimed constituted a distinct cultural nation entitled to independent statehood, the application of such a principle for partitioning India resulted in Pakistan emerging as a sovereign state comprising two separate geographical entities – the north-eastern and north-western zones of the subcontinent where the Muslims were in a majority. In between was 1,500 kilometres of Indian territory.

More importantly, the border between the two states was drawn very close to some important Pakistani cities such as Lahore, Sialkot, Okara and so on. Additionally, Afghanistan, on the western border disputed with Pakistan the border that existed between them in the form of the Durand Line drawn by the British in the late 19th century. Thus from the beginning Pakistan's defence and security needs and requirements posed extraordinary challenges to its civilian and military leaders.[2] The India-Pakistan relationship was from the onset a bad one and over the years remained so. In the process three wars and some lesser armed conflicts, mutual fear and animosity and recurring zero-sum competitions and contests in the South Asian region and in international forums came to typify their behaviour towards one another, some friendly

[2] Dennis Kux, *The United States and Pakistan 1947-2000: Disenchanted Allies* (New York: Oxford University Press, 2001), pp. 20-47.

gestures notwithstanding. In Pakistan, fear-of-India became the leitmotif of its security paradigm causing an arms race that in the long run was profoundly vitiating for Pakistan's economic development as the limited scarce resources available to the state were direct towards defence. Equally the dispute over Kashmir between the two states overwhelmed Pakistan's foreign policy priorities.

On the other hand, Pakistan's unique geostrategic location in the eastern and western regions of the Indian subcontinent encouraged the Pakistani power elite to try convincing the Americans that Pakistan could be an ally in the containment of communism not only in South Asia but also in the Middle East and South-east Asia. The Pakistan Army, created out a division of the British Indian Army had been deployed during the First and Second World Wars in the Middle East, Africa, Europe and South-east Asia. The calculation simply was that if the US were to co-opt it into its policy of containment of communism it would help Pakistan acquire infrastructure it needed to become an effective and credible military force.

It is interesting to note that for several years the United States remained unconvinced about such a role for Pakistan in its strategy of containing communism. However, when Indian Prime Minister Jawaharlal Nehru decided not to take sides in the Cold War, Pakistan began to receive a sympathetic hearing from the Truman administration. The first consignment of US military aid arrived in Pakistan in 1951. With Dwight D. Eisenhower becoming president in 1953, Pakistan began to be considered a major ally in Asia. Military agreements in 1954 and 1959 meant military and economic aid pouring into Pakistan in a substantial way. However, all along the Americans made it very clear to the Pakistanis that US military hardware was not to be used in a war with India. With minor reservations and deviations the Americans remained steadfast in their calculation that India was the paramount power in the subcontinent and also the only democracy, notwithstanding its policy of non-alignment.[3]

During the 1962 Sino-Indian border showdown, it became clear that the Americans were committed to the unity of India and would render it all help against China and other hostile powers. Much to the chagrin of the Pakistanis, a sharp increase in US economic and military aid to India took place. On the other hand, the Americans were alarmed when Pakistan deployed the Patton tank and other advanced US military equipment in the Rann of Kutch military showdown with India during the spring of 1965. A few months later when Pakistan dispatched infiltrators into the Indian-administered Kashmir and India crossed the international border in the Punjab on 6 September 1965, the US imposed an arms embargo on both India and Pakistan but it hurt Pakistan mainly because it was almost entirely dependent on US armaments. President Ayub Khan regretted that the US did not stand by an ally but came to the rescue of a non-aligned country such as India.[4]

[3] Jain, Rashmi (ed), *The United States and Pakistan 1947-2006: A Documentary Study* (New Delhi: Radiant Books, 2007), p. 35.
[4] Mohammad Ayub Khan, *Friends not Masters* (Islamabad: Mr. Books, 2006), p. 153.

The US, however, did not come to the rescue of Pakistan during the 1971 civil war in East Pakistan, but warned India not to invade West Pakistan. As a result, while Pakistan broke up, truncated Pakistan, now confined only to West Pakistan, survived as an independent state. In July 1971, Pakistan facilitated a secret meeting between Henry Kissinger and the Chinese leaders which paved the way for a process that ultimately led to normalisation of relations between the US and China. After the Soviet Union sent the Red Army to Afghanistan in 1979 to help the Afghan communists, the US-Pakistan military alliance revived, though without any trust surplus being generated beyond the objective of driving the Soviets out of Afghanistan. Pakistan received large amounts of US economic and military aid. It used that opportunity to pursue clandestinely a nuclear weapons programme as India had already demonstrated its nuclear capability with a test in 1974. The US Congress was perturbed by Pakistan's nuclear ambitions, but the Reagan administration turned a blind eye to it.[5] The withdrawal of the Soviet Union from Afghanistan in 1989 also resulted in the US exiting from it.

It was followed by a bloody civil war that ended with the Taliban capturing power in Kabul in 1996. Pakistan became a close ally of the Taliban and along with Saudi Arabia and the Arab Emirates its main international backer. The Taliban gained international notoriety as an Islamist scourge that wanted to eradicate all traces of Western modernity, especially any signs of female emancipation, and accretions to unadulterated monotheistic Islam from Shiite or Sufi sources. They also began to target the tiny Hindu and Sikh minorities that lived in Afghanistan and hounded up and executed Afghans who may have converted to Christianity. From the Taliban point of view, the whole non-Muslim world was involved in a sinister conspiracy against Islam and Muslims.[6]

During this period, Pak-US relations remained intact though disagreement emerged on the Taliban regime – while Pakistan hailed it as a great Islamic ally the Americans expressed concerns over its massive human rights violations. On the other hand, the Americans were interested in using the good offices of Pakistan to probe cooperation with the Taliban in pursuit of oil and gas exploration in central Asia.[7]

However, a marked deterioration in US-Pakistan relations took place when in May 1998 Pakistan exploded nuclear devices in response to India's test explosions a few days earlier. No doubt President Bill Clinton was equally agitated by India initiating the nuclear test explosions, but relations with Pakistan touched the nadir when General Pervez Musharraf carried out the Kargil military operation along the Line of Control in Kashmir in May 1999. Only in February that year Pakistani Prime Minister Nawaz Sharif and Indian Prime Minister

---

[5] Husain Haqqani, *Pakistan between Mosque and Military* (Washington DC: Carnegie Endowment for International Peace, 2005), p. 216.

[6] Ishtiaq Ahmed, 'The Pakistan Garrison State' in Tan Tai Yong (ed), *South Asia: Societies in Political and Economic Transition* (New Delhi: Manohar, 2010), pp. 116-118.

[7] Husain Haqqani, *Pakistan between Mosque and Military* (Washington DC: Carnegie Endowment for International Peace, 2005), p. 238-40.

Atal Behari Vajpayee had met in Lahore to pledge commitment to peace between their nations. Musharraf's military adventure cast Pakistan in a very bad light internationally. That relationship aggravated further when in October 1999, Musharraf overthrew Nawaz Sharif. Pakistan began to be treated as a pariah state; whatever sympathy it enjoyed in international forums on its Kashmir stand dissipated, and instead arch rival India began to be courted by the Americans.[8] Meanwhile, India had adopted free market principles and was fast emerging as a future industrial powerhouse and market. Additionally, its democratic credentials rendered it ideologically benign to the Americans.

9/11 Terrorist Attacks and Revival of US Interest in Pakistan

However, Pakistan became indispensable to US interests when Al Qaeda masterminded the 11 September 2001 terrorist attacks that claimed thousands of lives in the US. The famous threat from the Bush administration to Pakistan induced General Musharraf to declare Pakistan an ally in the war on terror. Forthwith, the US launched massive aerial bombing and within weeks US, NATO and anti-Taliban Afghan forces belonging to the Northern Alliance drove the Taliban out of Afghanistan. Taliban and Al Qaeda leaders dispersed in the tribal belt on both sides of the Durand Line and later found sanctuary in Quetta, the capital of the Pakistani Balochistan province. A pro-US Pukhtun leader, Hamid Karzai, was appointed as Afghanistan president. Karzai had a good rapport with India.

This time round the alliance between Pakistan and the United States was even more markedly instrumentalist. The Americans were willing to pay the Pakistan military for intelligence about Al Qaeda and capturing and handing over of Al Qaeda operatives to them.[9] On the other hand, the Pakistanis were not willing to hand over Afghan Taliban leaders to the Americans because they were considered as 'strategic assets' to contain Indian influence in the post-US period. Those considered strategic assets were Mulla Omar, his other close associates, and the Jalaluddin, Sirajuddin Haqqani group. Later, an anti-Pakistan Taliban group known as the Tehrik-e-Taliban Pakistan (TTP) also emerged against whom the Pakistan military took punitive action. Nevertheless, the US and NATO were allowed several facilities including use of some air bases and transport facilities.

Meanwhile, after lying low for some time the Taliban began to menace the US and NATO forces in real earnest from 2005 onwards. More interestingly a section of the Taliban belonging to the tribal areas on the Pakistani side of the border established the Tehrik Taliban Pakistan (TTP) that unleashed terrorist attacks on Pakistani civilian and military targets because Pakistan had allied itself with the Americans. On the other hand, the TTP was denounced in the Pakistani media as a terrorist organisation funded by India and some even accused the US of supporting the TTP. During 2007-2011 terrorist attacks in Pakistan

8 Strobe Talbott, *Engaging India: Diplomacy, Democracy and the Bomb* (New Delhi: Penguin Books, 2004).
9 Pervez Musharraf, *In the Line of Fire* (London: Simon and Schuster, 2006), p. 237.

increased dramatically claiming 35,000 lives including 5,000 military personnel. All such developments did not alter the basic incongruence of interests between the US and Pakistan: while the former wanted the Pakistan military to crush Al Qaeda and the Afghan Taliban, the latter undertook military operations essentially against strongholds of the TTP and its allies in their strongholds in Swat and South Waziristan and adjoining tribal areas.

Obama Administration and Pakistan

After Barack Obama was elected as president in late 2009, a more focused US policy purporting to tackle terrorism in Afghanistan and Pakistan as a common objective, known as AfPak, was devised. In the subsequent unfolding of such policy, the Kerry-Lugar bill of September 2010, that offered US$7.5 billion over a period of five years, set up the framework for strict monitoring of military aid to Pakistan as well as greater transparency and accountability with regard to the economic aid further cooperation between the United States and Pakistan.[10] The Pakistan military protested over provisions in the bill that alluded to civilian supremacy and restricted its discretion to use the military aid. In any case, the Americans began to exert intense pressure on Pakistan accusing it of not taking resolute action against those forces hiding in the tribal belt and in the capital of the southern province of Balochistan, who were behind recurring terrorist attacks in Afghanistan on US, NATO and Afghan troops and civilians. Secretary of State Hillary Clinton and other senior officials aired misgivings that Al Qaeda leader Osama bin Laden, Afghan Taliban leader Mullah Omar and others were hiding in Pakistan and that the Pakistan government was not taking action against them. Pakistan vehemently denied any such policy, deploring the lack of sympathy and understanding from its Western allies for its losses in life and property and other sacrifices. On the other hand, General Ashfaq Parvez Kayani said that Pakistan could not slacken its preparations for a conflict with India as it remained the main threat to Pakistan's existence.[11]

Usually such rhetorical rituals ended with some senior US official expressing words of appreciation for Pakistan's contribution to the war on terror and the great suffering its people had incurred because of it. All along a refrain that Pakistan had become the epicentre of global terrorism and that Al Qaeda and Taliban extremists could pose a threat to regional and global peace in case they captured the state and thus could access Pakistan's nuclear weapons estimated to be between 80-100 bombs could be heard in the United States, India and elsewhere too.

[10] 'The Kerry-Lugar Bill Full-Text', *Forum Pakistan*, http://www.forumpakistan.com/full-text-of-the-kerry-lugar-bill-details-and-conditions-t36999.html. Accessed on 12 October 2011.
[11] Cyril Almeida, 'Kayani spells out threat posed by Indian doctrine', *Dawn* (4 February 2010), http://archives.dawn.com/archives/44561. Accessed on 12 October 2011.

The Hunt for Osama bin Laden

Secretly the Americans obtained visa from the Pakistan government for hundreds of their undercover agents to conduct the search for Osama bin Laden.

Such a concession was exposed in a dramatic manner when an undercover agent, Raymond Davis was apprehended after he killed two Pakistanis, belonging to the ubiquitous Pakistani Inter-Services Intelligence (ISI), who were trailing his vehicle on a motorcycle. It generated mass hysteria as right-wing politicians, newspapers and talk-show pundits and even ordinary Pakistanis protested against such blatantly violent behaviour of a foreigner against Pakistanis on Pakistani soil. However, the Americans got their man freed by a clever exploitation of Islamic law that allowed the payment of blood-money to victims.[12] The Americans continued to pressure Pakistan relentlessly to continue pursuing Al Qaeda and Afghan Taliban leaders suspected of hiding in Pakistan while simultaneously expanding their independent search for them.

The Execution of Osama bin Laden

On 2 May 2011, the US carried out a spectacular raid on the garrison town of Abbotabad just north of the Pakistani capital, Islamabad. US Special Forces commandos, known as the Navy Seals, arrived in complete secrecy from bases in Afghanistan to the rather large building in which bin Laden was hiding. They killed him and some of his accomplices, taking his and their bodies away with them back to their base in Afghanistan. The Americans claimed that the whole operation had been carried out in complete secrecy and the Pakistan government had not been taken into confidence because of fear that the information could be leaked from the Pakistani side.

After a few weeks of farcical protests from Pakistan about the violation of Pakistani sovereignty and equally phoney expressions of appreciation by the Americans for Pakistan making many sacrifices in the war on terror, it turned out that the particular assault on Abbotabad was indeed carried out in total secrecy by the Americans. Some weeks later, Pakistan arrested a number of military and intelligence functionaries who had been providing information to the Americans about that particular building in Abbotabad and its mysterious occupants. On the other hand, a number of secret communications between the US and Pakistani military functionaries revealed by Wikileaks showed that US drone attacks that had been going on in FATA for years were not only requested by the Pakistan military but also assisted by the them.[13] Publicly each time such attacks killed innocent people the military

[12] *The News* (17 March 2011), http://www.thenews.com.pk/TodaysPrintDetail.aspx?ID=4665&Cat=13&dt=3/17/2011. Accessed on 13 October 2011.

[13] 'Cables Reveal Role of US Troops in Pakistan', *Dawn* (21 May 2011), http://www.dawn.com/2011/05/21/cables-reveal-role-of-us-troops-in-pakistan.html. Accessed on 19 October 2011.

would protest. However, notwithstanding an understanding on the drone attacks there can be no denying that the trust deficit increased enormously in the aftermath of the 2 May raid on bin Laden's hideout in Abbotabad. Voices were raised in the US Congress to cut off aid to Pakistan but then the Obama administration issued statements that Pakistan's role in the fight against terrorism was important. Since then relations between Pakistan and the US have nosedived and are currently considered critically strained and can take the form of some sort of military confrontation.

In this connection, some of the most recent statements by top US officials are noteworthy. For example, on 22 September 2011, the outgoing US Chief of Army Staff, Admiral Mike Mullen asserted in a US Senate hearing that the Haqqani network in Pakistan's North Waziristan was a 'veritable arm of the ISI'. This statement was made in the wake of an assault on the US embassy in Kabul a week earlier. Mullen went on to say that Pakistan was exporting violent extremism to Afghanistan and warned of US action to protect American troops. He remarked: 'If they keep killing our troops that would not be something we would just sit idly by and watch'. Defence Secretary Leon Panetta, who was also present at the hearing, also expressed frustration and reiterated that the US would safeguard its troops.[14]

Next day, White House spokesman Jay Carney said: 'It is critical that the government of Pakistan breaks any links they have and take strong and immediate action against this [Haqqani] network'.[15] This strong-worded statement was made while Pakistani Foreign Minister Hina Rabbani Khar was in New York. She expressed her feelings in the following words: 'Anything which is said about an ally, about a partner, publicly to recriminate, to humiliate, is not acceptable'.[16] Pakistan's top soldier, General Kayani termed Mullen's remarks as 'very unfortunate and not based on facts'. He went on to say that such remarks did not help create a climate for a 'constructive and meaningful engagement for a stable and peaceful Afghanistan, an objective to which Pakistan is fully committed'.[17] It was followed by a statement by a Pakistani official that Pakistan had no plans to immediately go after the Haqqani Group.[18]

Apparently such a standpoint indicated that Pakistan was willing to defy the US when it came to its vital interests of maintaining the Haqqani Group as an asset in Afghan politics to contain Indian influence and clout in Kabul. A couple of days later, the US modified its stand by saying that the White House did not categorically endorse Admiral Mullen's claims.

[14] 'Haqqani Network is a "veritable arm" of the ISI: Mullen', *Dawn* (22 September 2011), http://www.dawn.com/2011/09/22/haqqani-network-is-a-%E2%80%9Cveritable-arm%E2%80%9D-of-isi-mullen.html. Accessed on 21 October 2011.

[15] 'White House Backs Mullen Allegations', *Dawn* (24 September 2011), http://www.dawn.com/2011/09/24/white-house-backs-mullen-allegations.html. Accessed on 13 October 2011.

[16] *The Strait Times* (24 September 2011).

[17] 'Allegations against ISI 'baseless': Kayani', *Daily Times* (24 September 2011), http://www.dailytimes.com.pk/default.asp?page=2011%5C09%5C24%5Cstory_24-9-2011_pg1_3. Accessed on 21 October 2011.

[18] 'Pakistan will not Launch Haqqani Offensive', *Dawn,* (26 September 2011), http://www.dawn.com/2011/09/26/pakistan-will-not-launch-haqqani-offensive.html. Accessed on 13 October 2011.

White House spokesman Jay Carney put the concerns of his government in the following words: ‘It is not the language I would use. I think the fact that there are links that exist between the Pakistan government and the Haqqani network – the nature of those can be assessed and is complicated. But there is no question that they have safe havens in Pakistan’.[19]

It seems that the US at present is not prepared for a direct clash with Pakistan that could escalate to military action comparable to the raid on Abbotabad. On the other hand, such public posturing does not preclude the possibility that behind the scenes Pakistan has assured that it will take action later. One cannot overrule US troops being deployed in North Waziristan in case the Americans decide that they must do it, even if it may mean some sort of violent conflict with the Pakistan military. On the whole, the Americans have in the past managed to achieve their objectives in Pakistan.

The Pakistan-China Liaison

The Pakistan-China liaison has been down-to-earth balance-of-power, my-enemy’s-enemy-is-my-friend type of calculation. Pakistan used the Chinese connection to reduce its dependence on US weaponry. Consequently China began to supply MIG aircraft and other hardware to Pakistan. However, it was not willing to risk its own security by invading India either in 1965 or 1971. On the former occasion, it advised Ayub Khan and Bhutto to fight protracted guerrilla warfare even if Lahore and other parts of Pakistan were occupied by the Indians. Such advice was of no practical use to Pakistan as its leaders feared an imminent Indian advance on Lahore.[20]

During the 1970s Pakistan played an important go-between role to facilitate Sino-US contacts but when Zulfikar Ali Bhutto was despatched by Yahya Khan to China to solicit help against India, the Chinese refused to give any guarantees to Bhutto of intervening in East Pakistan on behalf of Pakistan in spite of the fact that India was supporting the resistance movement of the Bengalis against the Pakistan Army.[21] India had entered into a peace treaty with the Soviet Union and a Chinese intervention could have resulted in a war between the two estranged communist states. This, the Chinese were not willing to risk. It was Richard Nixon’s threat to India that prevented an Indian invasion of West Pakistan, presuming that India had such a plan. However, when India tested a nuclear device to confront a perceived threat from China with which it disputed the status of Tibet and its border in the north-east,

[19] ‘White House Refuses To Endorse Mullens Claims’, *Dawn* (Karachi, 29 September, 2011), http://www .dawn.com/2011/09/29/white-house-refuses-to-endorse-mullens claims.html. Accessed on 13 October 2011.

[20] Altaf Gauhar, *Ayub Khan: Pakistan’s first military ruler* (Lahore: Sang-e-Meel Publications, 1998), pp. 253-5.

[21] Sultan Muhammad Khan, *Memories & Reflections of a Pakistani Diplomat* (second edition) (Karachi: Paramount Books, 2006), pp. 346-7.

the Chinese allegedly helped Pakistan to attain nuclear weapon capability. It was consistent with Chinese policy to keep India pinned down on the western border with Pakistan.

China and Pakistan were part of the Afghan jihad as well, but after 9/11 a complication and tension began to arise. While China expanded its role in the construction of the Gwadar port city on the coast of southern Pakistan and acquired mining rights for gold and other precious minerals in Balochistan, the Islamist movement of the Uyghur of China's north-western province of Xinxiang was networking with Pakistani jihadist organisations. Some of them went back and formented unrest and resistance to Chinese rule. Chinese protests resulted in the Pakistan government harshly treating them.

Similarly, when the Red Mosque Brigades raided Chinese massage parlours and killed Chinese working on different projects in Pakistan, the Chinese publicly expressed their anguish and the government of General Musharraf quickly decided to take stern action. One can wonder if military action against the extremists barricading inside the Lal Masjid complex was not expedited because it was preceded by attacks on the Chinese in Pakistan that had caused a number of deaths. Pakistan's resolve not to displease the Chinese has not meant that the latter continue to support Pakistan unreservedly in its disputes with India. A significant change in Chinese policy was discernible when during the Kargil mini-war they did not issue even a token threat to India. On the contrary, the Chinese leaders urged both sides to resolve the Kashmir dispute through negotiations. Prior to that, a Sino-India thaw had started when Rajiv Gandhi visited China and talked trade and cooperation. On its part, the Indian government moved away gradually from its stand on the Tibet question conceding Chinese suzerainty over it but with provisions for substantive Tibetan autonomy. On the question of Kashmir there was a visible change in when China remained neutral during the Kargil conflict and urged both sides to settle their disputes peacefully.[22]

More importantly, the so-called Afghan jihad had found its converts even among the Chinese Muslim minority of Uighurs and some of them had come to training camps in Pakistan. Within Pakistan, notwithstanding the official declaration of everlasting friendship with China, in 2007 Chinese nationals in Pakistan were subjected to harassment, abduction and some were even killed by extremist Islamists. That was the first time the Chinese government publicly aired its concerns and demanded that Pakistan should take proper measures to protect its citizens.[23] The Pakistan government then carried out a crackdown, which included the raid on the Red Mosque where some of the extremists were entrenched.

[22] Swaran Singh, 'The Kargil Conflict: The Why and How of China's Neutrality', http://www.idsa-india.org/an-oct9-3.html. Accessed 13 October 2011.

[23] Ishtiaq Ahmed, 'The Pakistan Garrison State' in Tan Tai Yong (ed), *South Asia: Societies in Political and Economic Transition* (New Delhi: Manohar, 2010), pp. 131-2.

In January 2011 Chinese Premier Wen Jiabao visited India. The visit aroused great curiosity and concern in Pakistan. He talked of peace and place for both India and China in Asia as leaders. In practical terms it resulted in a great boost to trade between them as both sides expressed desire to normalise their relations. Trade was to increase to US$100 billion between them. Wen Jiabao continued his South Asian trip and arrived in Pakistan where he assured the Pakistanis of continued Chinese help and friendship. Several business deals were agreed and Pak-Chinese economic cooperation was to increase to US$25 billion in the years ahead.

However, China's security concerns with regard to Muslim separatists trained allegedly in Pakistan remained. Thus, on 1 August, the Chinese blamed Muslim terrorists, allegedly trained in Pakistan, for an outbreak of deadly violence. It resulted in the imposition of heavy security but still 19 people lost their lives in two separate terrorist incidents. It was bluntly stated that, 'the group had learned skills of making explosives and firearms in overseas camps of the terrorist group East Turkestan Islamic Movement (ETIM) in Pakistan before entering Xinjiang'. The Pakistan government reportedly assured the Chinese authorities that it would extend full cooperation to their Chinese counterparts in dealing firmly with the separatists. However, Xinjiang expert Michael Dillon said that there was little evidence the group had any links to Pakistan.[24] Much worse was to follow. A Chinese mining company pulled out of what was to be Pakistan's biggest deal with a foreign mining company, complicating Islamabad's effort to position its giant neighbour as an alternative to the US as its main ally. An official at China Kingho Group, one of China's largest private coal miners, confirmed it had backed out in August from a $19 billion deal in southern Sindh province because of concerns for its personnel after recent bombings in Pakistan's major cities.

The cancellation of the deal was acknowledged by Zubair Motiwala, chairman of the Sindh Board of Investment. After relations with the United States cooled off in the aftermath of bin Laden's execution in Abbotabad, Pakistan had probably begun to emphasise friendship with China. However, China's response had been lukewarm and the cancellation of the coal mining deal was some indication that China was not willing to become a substitute for the United States. Consequently Pakistan may remain dependent on billions of dollars in military and civilian aid from Washington for some time to come.[25]

Pakistan-Saudi Relationship

The third major patron that Pakistan managed to obtain was Saudi Arabia. Linkages between the Wahabi regime and its admirers in Pakistan were established quite early as the leading

[24] *Daily Times* (2 August 2011), http://www.dailytimes.com.pk/default.asp?page=2011\08\02\story_2-8-2011_pg7_3. Accessed on 13 October 2011.

[25] *The Wall Street Journal* (New York, 30 September 2011), http://online.wsj.com/article/SB10001424052970203405504576600671644602028.html. Accessed on 13 October 2011.

fundamentalist ideologue of Pakistan, Syed Abul Ala Maududi, was sympathetic to the severe type of Islamic state and society that existed in that super-rich rentier state on the Arab Peninsula. Already in the 1960s an ideological network had been established with the connivance of the Americans who backed Islamism to counter the left-leaning nationalist regime of Gamel Abdul Nasser of Egypt.[26] Zulfikar Ali Bhutto's Islamic Summit at Lahore probably helped market Pakistan to the Saudis as well because thereafter thousands of Pakistani workers found work in the Persian Gulf.

It was however, General Zia's coup against Bhutto, the 1978 Afghan Communist coup, the rise of Shiite Iran under Khomeini in February 1979 and the December 1979 Soviet intervention in Afghanistan that in a big way furnished the Saudis with a leading role in Pakistani politics, internal and external. In particular the sectarian tangle between Iran and Saudi Arabia needs to be put in perspective. The Iranian clerics demonstrated the power of political Islam as an ideology that can be used to capture power and establish a medieval tyranny with trappings of modern practices and institutions such as elections and a parliament, albeit both distorted to return a government dominated by Shiite clerics. That message reverberated throughout the Muslim world but the arithmetic of sectarian numbers favoured Sunni leadership. That role was taken over by the Saudis who found the regime of General Zia and the Soviet intervention in Afghanistan opportunities that could be exploited to its advantage. The Iranian-Saudi proxy war in the context of Pakistan meant sectarian terrorism between Pakistani Shias and Sunnis.[27]

More well-known is the leading role that Saudi Arabia began to play in the aftermath of the Soviet Red Army's intervention in Afghanistan. The Saudis not only provided ideological leadership but also large economic aid to Pakistan to conduct the jihad. Moreover, the Saudis endorsed the so-called Islamisation policy of General Zia, which meant the imposition of harsh laws sanctioned in medieval jurisprudential Islamic texts.[28] This became very obvious in 2007, when the two main opposition leaders, the self-exiled Benazir Bhutto was allowed to return to Pakistan under US pressure while Nawaz Sharif, whom General Musharraf had banished to Saudi Arabia, was allowed to return because of Saudi pressure.[29]

The depth of the vitiating impact of Saudi influence is not yet fully fathomed but it would not be an exaggeration to say that brutalisation of sensibilities of Pakistani society at all levels of society has taken place because of it.

---

[26] Robert Dreyfuss, *Devil's Game: How the United States helped Unleash Islamic Fundamentalism* (New York: Dell Publishing), pp. 120-21.

[27] Ishtiaq Ahmed, 'Religious nationalism and minorities in Pakistan' in Ishtiaq Ahmed (ed), *The Politics of Religion in South and Southeast Asia* (London and New York: Routledge, 2011), pp. 94-5.

[28] Hilary Synnott, 'Chapter Four: Regional Relationships: India, China, Saudi Arabia and the Gulf' in Adephi Papers Special Edition, 49:406, *Transforming Pakistan: Ways out of Instability* (London: International Institute for Strategic Studies, 2010), pp. 153-6.

[29] Ishtiaq Ahmed, 'The Pakistan Garrison State' in Tan Tai Yong (ed), *South Asia: Societies in Political and Economic Transition* (New Delhi: Monohar, 2010), pp. 137-8.

Thousands of Pakistani military personnel have been posted in Saudi Arabia and made fortunes big and small because of the lucrative salaries available to them. Therefore an ‘institutional interest’ in maintaining the Saudi connection is rooted in the officer corps of the Pakistan military. Moreover, hundreds of thousands of Pakistanis who work in Saudi Arabia are exposed to a form of Islamic which is very different from their own syncretic traditions. It is puzzling that despite being comprehensively treated with contempt by the Saudi state and society, many return to Pakistan immersed in a culture of extremism and intolerance.

The age old Persian-Arab rivalry in the garb of Shia-Sunni extremism has since the 1990s been wrecking innocent lives in Pakistan. From 2001 onwards, sectarian terrorism has been on the rise and over time has also taken the shape of sub-sectarian between Deobandi and Brelawi Sunnis. On the whole, Islamic extremism has resulted in recurring violence against women, non-Muslims and deviant sects of Muslims.[30]

Conclusion

Pakistan’s dependence on the US, China and Saudi Arabia evolved over time: each relationship resulted in the three patrons gaining influence on the Pakistan state. With regard to the US, it can be claimed that after the fall of the Soviet Union, Pakistan’s frontline status has become redundant and the current relationship is brittle, precarious and cynical. It is not likely to last longer than the need for US to use Pakistan to destroy whatever threat Al Qaeda and its affiliates pose to its security. Current American backing is conditional and limited and it involves penalties as well. Moreover, the US and the West in general are always going to be concerned about Pakistan’s nuclear assets. A Taliban-type takeover or some mad generals declaring an intention to use nuclear weapons will almost certainly be met with determined pre-emptive action from the West. It is important that Pakistan curbs extremism and terrorism at home and abides by the norms and standards of international law to dissuade punitive US action. On the other hand, there is no reason to believe that a more balanced and normal relationship cannot be achieved between them. Pakistan will continue to need US technological and economic aid to modernise and develop; equally from the American point of view, a democratic and peaceful Pakistan can create stability in South Asia and Pakistan can be accommodated in the economic cooperation that is now developing between India and the US.

The Chinese connection will continue, provided Islamic extremism is curbed. Also if the containment of India remains a paramount concern of Chinese defence and foreign policy,

[30] *PIPS Security Report for 2009*, Islamabad: Pakistan Institute of Peace Studies (PIPS, 2010).

then Pakistan will remain important as an ally on India's western front. China will probably always back Pakistan to keep a handle on India, but is not likely to back Pakistani military misadventures on Kashmir or elsewhere. It has in recent times openly expressed displeasure over alleged linkages between its Muslim separatists and training camps in Pakistan. On the whole, China is not likely to endanger its own security for the sake of Pakistan.

The Saudi influence has been ideologically very pervasive, while also including an economic dimension that has meant lucrative appointments in that state and other Arab emirates in the Persian Gulf. On the whole, such a connection has seriously harmed the modicum of democratic modernity that existed in Pakistan. The Arab Spring of 2011 has kindled hopes of a democratic development in the Muslim world, but as long as the rentier states of Iran and Saudi Arab continue to exercise their clout in the Muslim world, the struggle for democracy will always face the threat of subversion through their client terrorist militias and inflow of extremist propaganda.

On the whole, reliance on external support cannot be taken for granted and it is questionable if it is good for Pakistan. In one sense, Pakistan and India now enjoy parity in terms of nuclear weapons and capabilities. Therefore the threat from India, real and imagined, can more or less be neutralised. It is time to probe if both states can turn the corner and instead invest their resources in economic and human development. Pakistan can benefit most from such change.

. . . . .

ISAS Working Paper

No. 137 – 29 November 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

'Inclusive Growth': How is India Doing?[1]

John Harriss[2]

Abstract

Inclusive growth was the over-arching objective set in India's 11th Five-Year Plan for the period 2007-2012; and the aim of this paper is briefly to review evidence and argument about India's progress towards realising this vision. Prime Minister Manmohan Singh, in his Foreword to the Plan document, wrote of the need to ensure that 'income and employment are adequately shared by the poor and weaker sections of our society', and there is – unfortunately - a lot of evidence suggesting that this is not happening. Rather there is evidence in support of the view that India is characterised by extensive exclusion of labour. Data from the National Sample Survey show that productive jobs are not being created at anything like the rate required for 'inclusive growth' to be realised, and it is possible that there is even an inverse relationship between economic growth in India, and productive employment. The agricultural economy, meanwhile, remains both inefficient and inequitable. Recent developments in India's policies for social protection – such as the National Rural Employment Guarantee scheme – may perhaps be understood as reflecting the failures of 'inclusive growth'.

---

[1] This paper draws extensively on work done by the author, at ISAS, for a collaboratively written book entitled *India Today: Economy, Politics and Society* (Cambridge: Polity, forthcoming 2012), with Stuart Corbridge (London School of Economics) and Craig Jeffrey (Oxford).

[2] Professor John Harriss is Visiting Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous institute within the National University of Singapore (NUS). The author can be reached at isasjch@nus.edu.sg. The views expressed are those of the author and do not necessarily reflect those of the institute.

Introduction

'Inclusive Growth' was the theme of India's Eleventh Five Year Plan, for the period 2007-2012, and it was the title of the first main volume of the Plan document. The Prime Minister, Manmohan Singh, spoke of the Plan in his Foreword as 'a comprehensive strategy for inclusive development', and it was said that:

> 'The central vision of the Eleventh Plan is to build on our strengths to trigger a development process which ensures broad-based improvement in the quality of life of the people, especially the poor, SCs/STs, other backward castes (OBCs), minorities and women.[3]'

The aim of this paper is briefly to review evidence and argument about India's progress towards realising this vision. The Prime Minister, in his Foreword, wrote of the need to ensure that 'income and employment are adequately shared by the poor and weaker sections of our society', and there is – unfortunately - a lot of evidence that suggests this is not happening.

The most recent findings of the National Sample Survey show that productive jobs are not being created at anything like the rate which is required for 'inclusive growth', and there are even indications that there may be an inverse relationship between economic growth in India, and the creation of productive employment. Further, even if income poverty, as this is conventionally defined, has been declining – and there is much debate over this, associated with the technical problems of determining the incidence of poverty that are reflected in the radically different estimates produced by different government bodies[4] - the estimations made by Burgess and Besley[5] of the elasticity of poverty with respect to income per capita, for India by comparison with the various regions of the developing world from 1990 to 2015, suggest that India has done rather poorly. India dominates the score for South Asia, which is minus 0.59. Separately, Besley, Burgess and Esteve-Volart[6] estimate the average elasticity score for India as -0.65. These scores are bettered by all regions, save for sub-Saharan Africa. According to these calculations, and assuming constancy in other factors, growth in East Asia and the Pacific - dominated by China - is likely to be almost twice as effective in reducing poverty as in South Asia over the same period. Other indicators, meanwhile, of the quality of

---

3 Planning Commission (Government of India), *Eleventh five-year plan 2007-2012. Volume 1: inclusive growth* (Delhi, Oxford University Press, 2008), p.2.

4 Jean Dreze reports with regard to rural poverty that four alternative estimates are available: 28 per cent from the Planning Commission, 50 per cent from the N.C.Saxena Committee Report, 42 per cent from the Tendulkar Committee Report, and 80 per cent or so from the NCEUS. As he goes on to say '…it is important to remember that the poverty line is, ultimately little more than an arbitrary benchmark'. ('Poverty estimates vs food entitlements', *The Hindu* 24 February, 2010).

5 Robin Burgess and Timothy Besley, 'Halving global poverty', *Journal of Economic Perspectives*, Vol.17, no 3(2003), pp.3-22.

6 Timothy Besley; Robin Burgess and Berta Esteve-Volart, 'The policy origins of poverty and growth in India', in Timothy Besley and Louise Cord (eds). *Delivering the promise of pro-poor growth: insights and lessons from country experiences* (New Delhi,World Bank, 2007), p.62

life of the people have hardly improved and some have shown deterioration. India's failure, so far, to reduce malnutrition amongst small children (aged 0-5) – the proportion of such children who are underweight, according to data from successive national Family Health Surveys, declined by less than one percentage point between 1999-99 and 2005-06, from 46.7 to 45.9 per cent – is one particularly poignant marker of the still very poor quality of life of a great majority of the people.

The paper starts by explaining the context of the problem of realising inclusive growth. This is in the limited structural transformation of India's economy, or what some refer to as failed transition. There follow accounts of the particular problems of the agricultural economy and of employment trends. As the paper explains, the agricultural economy in which the majority of the people are still employed, remains in difficulty, while high rates of economic growth outside agriculture have not generated very many of the kinds of jobs that would have enabled people from the 'poorer and weaker sections' of society – to whom the 11th Plan specifically refers - to share in the benefits of growth.

The Context: India's 'Lopsided', 'Failed' or 'Tortuous' Transition

The three adjectives of this heading refer to the different ways in which different authors (the *National Commission on Enterprises in the Unorganized Sector (NCEUS),* Partha Chatterjee[7], and Pranab Bardhan[8] respectively) describe a cardinal fact about India's economy. This is that the structural transformation of the economy has not been completed, in spite of years of high rates of economic growth - and India's 'transition to an enlarged and dominating sphere of capital in the economy'[9] is correspondingly problematic. In India, the declining relative share of income from the agricultural sector has not been accompanied by an equivalent decline in employment in that sector. In 1950-51, agriculture accounted for 61 per cent of GDP and for 76 per cent of employment[10] while it now contributes less than 20 per cent of GDP (16 per cent in 2007-08) but still employs around 60 per cent of the labour force, according to Census data from 2001, or 54 per cent in 2004-05, according to data from the National Sample Survey (NSS) showing the daily employment status of individuals, by activity (see Table 1, but note that NSS data for 2007-08 show the share of farm employment as 55.4 per cent [11]). The lowest share of agriculture in GDP across states is 9.5 per cent, in

7 Partha Chatterjee, 'Democracy and economic transformation in India', *Economic and Political Weekly*, Vol. 43, no 16(2008), pp.53-62.

8 Pranab Bardhan, 'Notes on the political economy of India's tortuous transition', *Economic and Political Weekly*, Vol. 44 , no.49 (2009), pp.31-36.

9 *Ibid.*,p. 3.

10 C.P. Chandrasekhar, 'Progress of "reform" and retrogression of agriculture', Retrieved from http://www.macroscan.org/anl/apr07/anl250407Agriculture.htm. Accessed June 21, 2010.

11 Himanshu, 'Employment trends in India: a re-examination', *Economic and Political Weekly*, Vol.46, no.37 (2011), p.47.

Maharashtra, where the level of agricultural employment, however, remains at more than 53 per cent.[12]

<u>Table 1:</u> Employment Structure in India – Daily Status (per cent)

Year	**Agr**	**Mfg**	**CTT**	**G&P**	**Total**
2004-05	53.9	12.8	21.8	09.00	97.5
1999-2000	58.0	12.1	18.9	08.90	97.9
1993-94	61.1	11.4	14.8	10.80	98.1
1983	63.4	11.8	13.3	09.90	98.4

Source: after Eswaran *et al*.[13]

Agr=Agriculture; Mfg=Manufacturing; CTT=Construction, Trade and Hotels, Transport, Storage and Communications; G&P=Government Services, Education, Health, Community Services, Personal Services. Total less than 100 per cent because employment shares of mining and of real estate and finance are not included.

The shift of labour from agriculture in India has been less than in some comparator countries (Table 2), though there is less sharp a contrast with China than Bardhan[14] suggests an important point of difference between India and China is that in China 55 per cent of the cumulative increase in GDP between 1990 and 2005 was accounted for by manufacturing, which has generated relatively more employment than the services sector that accounts for 60 per cent of the increase in GDP over the same period in India – though in China, too, labour is now being absorbed increasingly into services.

[12] Mahendra S. Dev, *Inclusive growth in India: agriculture, poverty and human development* (Delhi, Oxford University Press, 2008), Table 7.11.

[13] Mukesh Eswaran; Ashok Kotwal; Bharat Ramaswami and Wilima Wadhwa, ‘Sectoral labour flows and agricultural wages in India, 1983-2004: Has growth trickled down?’, *Economic and Political Weekly*, Vol.44, no.2(2009), Table 6.

[14] Pranab Bardhan, ‘Notes on the political economy of India’s tortuous transition’, p.33.

Table 2: Distribution of GDP and of Employment across Sectors in India and comparator countries

Country	*GDP (2007)*			*Employment*	*(2005/2006)*	
	agriculture	*industry*	*services*	*agriculture*	*industry*	*services*
India	**17.7**	**29.4**	**52.8**	**53.9**	**12.8**	**30.8**
China	11.3	48.6	40.1	42.6	23.8	32.2
Brazil	5.5	28.7	65.8	19.3	21.4	57.9
Indonesia	13.8	46.7	39.4	42.0	18.7	37.2
Pakistan	20.6	26.6	52.8	43.4	20.3	36.6
Bangladesh	19.0	28.7	52.3	48.1	14.5	37.4

Note: 'Employment' refers to distribution of the labour force by occupation/sector
Source: World Bank Data (accessed at www.worldbank.org/data September 2011)

Dispossession of small-scale agricultural producers has gone on, and continues to go on, for industrial, mining and infrastructural projects across the country, and has increasingly encountered resistance from them in actions that may involve the Maoists, who are now organised across about one-third of the districts of the country. The Indian agricultural economy, however, is still characterised by extensive small-scale, household-based production. The distribution both of ownership and of operational holdings is distinctly pear-shaped, and what are described as 'marginal' operated holdings (of one hectare, or less, in extent) now account for 70 per cent of the total. Most such holdings are unlikely to be capable of 'providing enough work or income to be the main livelihood of the household'[15]. Estimations made by Vikas Rawal[16], using data from the 59th round of the National Sample Survey (NSS) for 2003-04 show that 31 per cent of rural households across the country as a whole own no land at all, and another 30 per cent own less than 0.4 hectare (or about one acre of land), while only a little over five per cent of households own more than three hectares (and just 0.52 per cent own more than 10). The absolute numbers and the relative share in the rural population of households without land – which have for long been considerable – have been increasing. The data from 2003-04 are not strictly comparable with those from an earlier round of the NSS, for 1992, but Rawal believes that they suggest an increase of as much as six percentage points in landlessness, while inequality in land ownership also increased. Still, over most of the country landlordism, where small producers depend for access to land and other assets upon the owners of large estates, has declined. The share of leased-in land in the total operated area, according to the NSS, declined from 10.7 per cent in 1960-61 to just 6.5

15 Peter, Hazell; C. Poulton; S.Wiggins and A. Dorward , *The future of small farms for poverty reduction and growth* (Washington, International Food Policy Research Institute, 2007).

16 Vikas Rawal, 'Ownership holdings of land in rural India: putting the record straight', *Economic and Political Weekly*, Vol.43, no.10 (2008), pp.43-47.

per cent in the *kharif* (summer) season of 2002-03.[17] Traces of classic 'landlordism' remain, however, and inequality in land ownership still gives considerable power locally – economic, social and political - to the relatively small numbers of larger landowners and the increasing numbers of capitalist farmers.

At the same time those depending upon wage employment have not, generally, been able to find what we might label as good jobs in the organised or formal sector, and the most dynamic and productive sectors of the economy, and they take up activities in the unorganised or informal economy, outside the purview of most employment legislation, and which are often not very productive. Workers who are informally employed have no protection – against the loss of their jobs, or in event of illness - and receive no benefits from employers. They are usually low paid, and their work and their incomes are commonly irregular, though they may also work very long hours and in hazardous workplaces. It is reliably estimated that about two-thirds of India's GDP comes from such unregistered, informal activity, and that it accounts for more than 90 per cent of livelihoods – more than half of them being generated from self-employment (see Lerche 2010 for discussion of the informal economy and classes of labour). Meanwhile, according to data presented by the NCEUS the absolute numbers of protected 'formal sector' jobs actually declined marginally from 33.7 million to 33.4 million between 1999-2000 and 2005-05 (Table 3) – though they have increased again since then.[18]

Table 3: Employment by type and sector (millions)

	1999-2000			2004-05		
Sector	Informal workers	Formal workers	Total workers	Informal Workers	Formal workers	Total workers
Informal	341.3	1.4	342.6	393.5	1.4	394.9
Formal	20.5	33.7	54.1	29.1	33.4	62.6
Total	361.7	35	396.8	422.6	34.9	457.5

Source: Sanyal and Bhattacharyya (2009), citing NCEUS

[17] Recent findings from village surveys conducted by the Foundation for Agrarian Studies in several parts of the country - western UP, coastal Andhra and parts of Punjab, for instance – suggest that the incidence of tenancy is increasing again, rather rapidly, and at onerous rates for tenants (Professor V.K.Ramachandran, personal communication).

[18] Himanshu, 'Employment trends in India: a re-examination',p.56.

While a classic theory holds that those employed (often self-employed) in informal activities constitute a reserve army of labour, necessary for the development of industrial capitalism over the longer run, it has been suggested (in an argument that will be considered further below) that in India now a large share of the labour force as a whole is better described as 'excluded', being unnecessary for the growth of the economy as a whole, and surviving in a wide range of activities that are of only marginal significance for the dynamic, corporate sector.[19] Whatever one makes of this argument it is clear that the narrative of structural transformation and societal transition breaks down in regard to modern India. This paper analyses the implications of the 'failed' transition.

Trends in Indian Agriculture – a Record of Failure?

The fact that there has been such little movement out of agricultural employment, even as the share of agriculture in GDP has declined, means that the majority of the people of India still depend on agriculture for their livelihoods. So if the agricultural economy is not doing well – if productivity is not increasing - then it follows that most of the people won't be doing very well either. As the London *Economist*[20] puts it 'the (Indian) government cannot achieve the 'inclusive' growth it aspires to without robust progress in agriculture'.

Yet, as Pranab Bardhanargues forcefully 'the agriculture sector is in bad shape'[21], after a decade – 1994-5 to 2004-05 – of the lowest growth rates in the sector (0.6 per cent per annum, according to his calculations) since Independence. This is the result of the very high incidence, now, of marginal holdings, of the costs of inputs, the degradation of the natural resource base, declining public investment, and decreased access to public sector credit. One tragic but powerful marker of the fact that many cultivators have not been doing at all well in recent times is the high rate of suicides amongst them, that began to be reported in the later 1990s. A systematic study of this phenomenon, by K. Nagaraj[22], based on an analysis of the data on 'Accidental Deaths and Suicides in India', published by the National Crime Records Bureau (NCRB), for suicides amongst those described as 'self-employed in farming/agriculture' over the period 1997-2006, confirms that the rate of suicides amongst farmers is high by comparison with that for the general population. More significantly, Nagaraj believes that the suicide rate amongst farmers has been increasing, at least from the year 2001 onwards, while the general rate has been more or less stable. The finding that the suicide rate amongst farmers has been increasing is confirmed in the most recent data from the NCRB, which show that India has seen over a quarter of a million of farmer suicides between 1995 and 2010, with the numbers having accelerated over the second half of this

[19] K. Sanyal and R. Bhattacharyya, 'Beyond the factory: globalisation, informalisation of production and the new locations of labour', *Economic and Political Weekly*, Vol. 44, no.22 (2009), pp.35-44.
[20] Editorial, 'Jobless growth', *Economic and Political Weekly*, Vol.45, no.39 (2010), pp.7-8.
[21] Pranab Bardhan, 'Notes on the political economy of India's tortuous transition', p.31.
[22] Karkada Nagaraj, 'Farmers' suicides in India: magnitudes, trends and spatial patterns'. Retrieved from www.macroscan.org/anl/mar08/anl030308Farmers_Suicides.htm. Accessed June 21, 2010.

period.[23] These data confirm, too, that the five states of Maharashtra, Karnataka, Andhra Pradesh, Chhattisgarh and Madhya Pradesh are the ones that have been most affected (accounting for two-thirds of the national total of farmer suicides), and Nagaraj argues that 'there is a contiguous, dry, semi-arid, poor, backward region within these states…where the problem must be very severe'. This is a region, he suggests, in which agro-ecological conditions make for high levels of vulnerability, where under the impact of policies of economic liberalisation, agriculture has been particularly badly affected by the withdrawal of state services, and where there is a lack of alternative livelihood opportunities. Arvind Panagariya, on the other hand, though he refers to comparable findings about the trends, argues that 'existing studies do not systematically connect the dramatic rise in farmer suicides in certain regions to the reforms'[24]. This follows from his reliance on sources that analyse reasons given for individual suicides by close relatives and friends – an approach that is sensibly critiqued by Nagaraj, drawing not least on the authority of Durkheim's arguments in his classic *Suicide*. Structural, social conditions – in this case having to do at least in part with changes relating to liberalisation - underlie the enormously diverse reasons that are attributed to individual acts of suicide.

'Farmers' suicides' is an emotive indicator of the existence of an agrarian crisis. But what of other evidence to justify this idea with reference to the current state of Indian agriculture? While it is extremely difficult, given the considerable variance in the performance of the agricultural economy from year to year – due to the highly uncertain climatic conditions characteristic of most of India - to draw clear-cut conclusions about growth trends, and much depends of course on which years or groups of years are taken for comparison over time, there is no doubt about the fact that the growth of agriculture has lagged behind that of the rest of the economy. That this has been particularly marked in the period of high overall growth after 2003 was recognised both by the Prime Minister, Manmohan Singh, and by Montek Singh Ahluwalia, the Deputy Chairman of the Planning Commission, in speeches made in 2010[25]. Both regretted that agriculture had been growing at a rate of only about two per cent per annum (though see also Bardhan 2009, cited above), as against the target of four per cent per annum set in the Eleventh Plan, and both spoke of the need to raise the growth rate. Table 4 sets out two different estimates of growth rates by acknowledged authorities.

[23] *The Hindu*, 29 October 2011.
[24] Arvind Panagariya, *India: the emerging giant* (Oxford, Oxford University Press, 2008), p.154.
[25] *The Hindu*, 18 and 20 June 2011.

Table 4: Agricultural Growth Rates

Bhalla and Singh (2009)

Annual compound growth rate (%) of value of output

1980-83/1962-65	1990-93/1980-83	2003-06/1990-93	2003-06/1962-65
2.24	**3.37**	**1.74**	**2.36**

Source: calculated from Ministry of Agriculture data

Panagariya (2008)

Annual growth rates (%) of agricultural output (at factor cost)

1951-65	1965-81	1981-88	1988-2006
2.9	**2.1**	**2.1**	**3.4 ***

*But 2.3% in 2000-2006

Source: calculated from data in the RBI *Handbook of Statistics on the Indian Economy*

Other estimates suggest, like those calculated by Bhalla and Singh, that the period of India's economic reforms has been marked by lower rates of growth of the agricultural economy[26,27]. The noted agricultural economist A. Vaidyanathan argues, however, that 'rigorous statistical tests on official time series do not provide strong corroboration of a progressive deceleration of agricultural growth'[28]. But he points out as well that these data also show that the average of annual changes in total output, area and yields are lower, and much more volatile, over the 15 years after 1989 than they were in the preceding period of 20 years.

Not only this, but disproportionality – the gap, that is, between the growth rates of agriculture and of non-agriculture has increased sharply from about two per cent in the 1970s to just under four per cent in the 1990s, and to more than five per cent between 2000-01 and 2003-04. The acceleration of non-agricultural growth in the first decade of the century has actually been accompanied by declining rates of growth of agriculture, but alongside low levels of inflation (until the recent past). It appears, then, that domestic agricultural growth is no longer such a constraint on the growth of non-agriculture as was the case before. Previously disproportionate growth between agriculture and non-agriculture tended to be self-correcting, because sluggish growth of agriculture would give rise to inflationary pressures and higher prices for industrial inputs and wage goods, and so tend to slow the rate of growth of non-agriculture. But non-agriculture is now much less dependent on inputs from agriculture, while (as we discuss in depth later in this paper) non-agricultural growth has not generated very

[26] Mukesh Eswaran; Ashok Kotwal; Bharat Ramaswami and Wilima Wadhwa, 'Sectoral labour flows and agricultural wages in India, 1983-2004: Has growth trickled down?', pp.46-55.

[27] A.Vaidyanathan, 'Agricultural Growth in India: Role of Technology, Incentives and Institutions', (New Delhi, Oxford University Press, 2010), Chapter 1.

[28] A. Vaidyanathan, 'Farmers' suicides and the agrarian crisis', *Economic and Political Weekly*, Vol.41, no.38,(2006) p.4011.

much employment. Though the growth of the labour force somewhat recovered after 2000 real wages for most groups of workers actually declined, and a large share of the increase in employment was accounted for by self-employment, much of it amongst women. There are strong reasons, indeed, for thinking that employment growth in this period was distress-driven (see below[29]). The net result has been that agriculture has been facing increasing demand constraints while inputs costs have been rising. C.P. Chandrasekhar concludes from his analysis that 'it appears…the growth process in a more open and liberalised environment is (such) that the peasantry has a much smaller role in sustaining economic growth and can thus be partially *excluded* from development'. Increasing disproportionality, and the factors that account for it, underlie the agrarian distress that is now found over much of the country.[30]

Agrarian distress is reflected in Prabhat Patnaik's calculation[31] that over the period from 1994-5 to 2003-04 the real per capita incomes of India's agriculturally dependent population remained stagnant, when per capita incomes for the country as a whole increased by more than four per cent (see also the similar findings of Krishna and Bajpai[32]). The point is brought home in findings of the Foundation for Agrarian Studies from village surveys in Andhra Pradesh, Uttar Pradesh and Maharashtra that it was virtually impossible in 2005-06 for households with operational holdings of two hectares of land or less (who account for all but a small share of all the cultivators in the country, remember), to earn an income sufficient for family survival. The net annual incomes from crop production of very many households were actually negative.[33]

The rural poor include large numbers of cultivating households, but an even greater share of agricultural labour households, as we show in Table 5. They might be expected to have been even more badly affected by the agricultural crisis than have been cultivating households. The NSS data suggest that agricultural wage employment increased at about one per cent per annum between 1993-94 and 1999-2000 (a lower rate than in the 1980s), even while total agricultural employment stagnated, but that it has subsequently declined. In line with these trends, the NSS data show that the annualised rate of growth of weekly earnings in agriculture declined from 3.27 per cent in 1983 to 1993-94, to 1.82 per cent in 1993-94 to 1999-2000, and to 1.11 per cent in the period from 2000 to 2004-05. The series, *Agricultural Wages in India*, shows a similar path of declining wage increases, and also that real wage rates in most operations actually fell in many districts across the country in the 1990s. In line with these trends there is evidence of increasing indebtedness amongst agricultural labourers,

---

29 Himanshu, 'Employment trends in India: a re-examination', pp.53-55

30 C.P. Chandrasekhar, 'Progress of "reform" and retrogression of agriculture'. Retrieved from http://www.macroscan.org/anl/apr07/anl250407Agriculture.htm. Accessed June 21, 2010.

31 Praveen Jha, 'Some aspects of the well-being of India's agricultural labour in the context of the contemporary agrarian crisis'. Retrieved from http://www.macroscan.org/anl/feb07/anl220207Agrarian_Crisis.htm. Accessed 21 June, 2010.

32 Anirudh Krishna and Devendra Bajpai, 'Lineal spread and radial dissipation: experiencing growth in rural India, 1993-2005', *Economic and Political Weekly*, Vol.46, no.38 (2011), pp.44-51

33 V.K Ramachandran and Vikas Rawal, 'The impact of liberalisation and globalisation on India's agrarian economy', *Global Labour Journal*, Vol.1, no.1 (2010), pp.56-91.

especially to informal lenders, and of weakening of school attendance amongst children from agricultural labour households[34][35] (See Pangariya[36], for a contrary view, depending on data from the annual Costs of Cultivation surveys. There is uncertainty about wage trends).

Table 5: Classification of rural households according to major earnings source, 2004-05

Income source	**Non-poor households**	**Poor households**
Self-employed in non-agriculture	16.5	12.9
Agricultural labour	22.1	41.8
Other labour	10.3	12.1
Self-employed in agriculture	38.4	26.7
Others	12.7	6.5

Calculated from NSS data[37]

Where real agricultural wages have increased, as in some parts of rural Tamil Nadu, it is in circumstances in which there has been an increase in non-agricultural employment opportunities[38] . Agricultural labour itself has become increasingly feminised, and – most likely – increasingly '*dalitised*', as those from the Scheduled Castes confront particular barriers in entering even many casual laboring jobs outside agriculture.[39,40] The rate of growth of rural non-agricultural employment in India, however, over the period from 1993-94 to 1999-2000, at 2.26 per cent per annum, was more than twice the rate of growth of agricultural employment (1.06 per cent), and was higher still in the period to 2004-5, at 5.27 per cent per annum, according to NSS data.[41] Such increases in agricultural wages as have taken place have probably followed from tightening in rural labour markets where non-farm

---

34 Mukesh Eswaran; Ashok Kotwal; Bharat Ramaswami and Wilima Wadhwa, 'Sectoral labour flows and agricultural wages in India, 1983-2004: Has growth trickled down?', pp.46-55

35 Praveen Jha, 'Some aspects of the well-being of India's agricultural labour in the context of the contemporary agrarian crisis'. Retrieved from http://www.macroscan.org/anl/feb07/anl220207Agrarian_Crisis.htm. Accessed 21 June, 2010.

36 Arvind Panagariya, *India: the emerging giant* (Oxford, Oxford University Press, 2008), p.148.

37 Mukesh Eswaran; Ashok Kotwal; Bharat Ramaswami and Wilima Wadhwa, 'Sectoral labour flows and agricultural wages in India, 1983-2004: Has growth trickled down?', pp.46-55.

38 John Harriss; J. Jeyaranjan and K.Nagaraj, 'Land, labour and caste politics in rural Tamil Nadu in the 20th century: Iruvelpattu (1916-2008)', *Economic and Political Weekly*, Vol.45, no.31 (2010), pp.47-61.

39 Barbara Harriss-White, *India Working: Essays on Economy and Society* (Cambridge, Cambridge University Press, 2003).

40 Judith Heyer, 'The marginalisation of dalits in a modernising economy', in Barbara Harriss-White and Judith Heyer (eds), *The comparative political economy of development* (London, Routledge, 2010).

41 Himanshu, 'Recent trends in poverty and inequality: some preliminary results' *Economic and Political Weekly*, Vol.42, no.6 (2007), Table 8.

employment is available. Rural distress, following from the crisis in agriculture that is attested most tragically in farmer suicides, but shown up in the evidence on declining trends in the growth of agricultural output and productivity, has been offset, no doubt, by the growth in non-farm employment opportunities. This is often associated, however, with increased migration, both rural-rural and rural-urban, much of it circular (when people move to and fro between village homes and distant work sites). One recent estimate is that the numbers of such circulating migrants have reached 100 million, though the NCEUS estimates that the number of seasonal migrants is of the order of 30 million[42] [43]. What we know of the conditions of life and work of this mobile labour force is limited[44], but shows that though workers may earn more than in agriculture, their livelihoods are characterised by high levels of vulnerability – exactly as are those of the larger numbers of those in the mobile labour force of China. Thus far, however, there has been less political mobilisation in protest against rural distress in the major agricultural regions of India than there has been in China, where the widespread occurrence of violent incidents has led the government to elevate rural development as a national priority[45] .

Why such a Crisis?

The proximate causes of the problems of the Indian agricultural economy are quite well understood. The sector has depended historically on substantial state intervention, including investments in research and infrastructure, and the provision of extensive subsidies, both for key inputs (fertilisers, electricity and water supplied through public irrigation schemes) and underpinning the prices that farmers receive for their products. It also benefited from legislation requiring major banks to open rural branches and to meet certain targets for the supply of credit to agriculture. In the context of India's economic reforms all these have been reduced or eliminated, and at the same time domestic agriculture has been progressively opened up to the world market, exposing some cultivators to much greater price volatility (for an account of liberalisation measures in agriculture see Vakulabharanam[46]).

42 Kate Bird and Priya Deshingkar, 'Circular migration in India', *ODI Policy Brief*, no.4 (2009).

43 Priya Deshingkar and John Farrington (eds), *Circular migration and multi-locational livelihood strategies in Rural India* (Delhi, Oxford University Press,2009).

44 Ben Rogaly; Daniel Coppard; Abdur Safique; Kumar Rana; Amrita Sengupta and Jhuma Biswas, 'Seasonal migration and welfare/ill-fare in eastern India: a social analysis', *Journal of Development Studies*, Vol.38, no.5 (2002), pp. 89-114.

45 Xian Yuan Dong; Paul Bowles and Hongqin Chang, 'Managing liberalisation and globalisation in rural China: trends in rural labour allocation, income and inequality', *Global Labour Journal*, Vol.1, no.1 (2010), pp.31-55.

46 Vamsi Vakulabharanam, 'Growth and distress in a south Indian peasant economy during the era of economic liberalisation', *Journal of Development Studies*, Vol.41, no.6 (2005), pp.971-997.

As Ramachandran and Rawal[47] have pointed out, government expenditure in the countryside has declined in relative terms; investment in agriculture as a proportion of GDP fell from 1.92 per cent in 1990 to 1.31 per cent in 2003, and gross capital formation in agriculture, again as a percentage of GDP, declined from 3.8 per cent in 1980-81 to 1.7 per cent during 2004-05. The same authors explain how financial liberalisation meant that the expansion of public sector rural banking was brought to an end, and many rural branches of commercial banks were shut down; the credit-deposit ratios of rural commercial banks fell sharply; advances to small farmers, to *dalits* and to *adivasis* declined – while the share of informal credit in the principal borrowed by rural households increased. There has been some reversal of these trends in the most recent past, under the United Progressive Alliance government after 2004. At the same time, however, the costs of inputs have increased sharply, because of the decline in administrative price support, while the Minimum Support Prices offered by government to ensure remunerative prices for farmers' output 'have not compensated the actual costs of production per unit of output for most crops in a majority of states'[48]– so farmers have been subjected to a severe cost-price squeeze. Until 2007-08 the prices of most agricultural commodities in world markets witnessed a secular downward trend, though not without fluctuations. Vaidyanathan has argued that 'available evidence does not corroborate apprehensions that liberalisation has adversely affected domestic prices of farm products'.[49] Other economists, however, believe that price volatility, in particular, has increased the vulnerability of many cultivators. Altogether, policy changes inspired by a liberal approach in economic policy – particularly the slowing down of public investment - have had an adverse impact upon agriculture, certainly in the short term (perhaps especially, as Nagaraj – cited earlier – argues in regard to farmer suicides, in the dry belt where most of them have taken place).

Neither liberalisation policies, however, nor the earlier mode of state intervention in agriculture, effectively addresses fundamental problems having to do with the inefficient and often wasteful use of agricultural resources – including the failure to use irrigation water efficiently, partly because of neglect in the maintenance of irrigation structures and limitations of their design, excessive use of chemical fertilizers and degradation of soils. There is a long history of poor use of key agricultural resources in India, by comparison with China and elsewhere in East Asia. This was a theme developed years ago by Gunnar Myrdal in his monumental *Asian Drama* (1968). In the early 1950s, Myrdal showed, the overall productivity of agriculture (in relation to land) was roughly twice as high in China as in India – and it remains so still. In 1999-2000 yields of rice per hectare in China stood at 4.1 tonnes, while in India they were just under 2 tonnes (and still only 2.1 tonnes in 2009-10). The problems of agricultural productivity are connected with institutional weaknesses, as in irrigation management – which is also generally much more efficient in East Asia - and in

[47] V.K Ramachandran and Vikas Rawal, 'The impact of liberalisation and globalisation on India's agrarian economy', *Global Labour Journal*, Vol.1, no.1 (2010), pp.56-91.

[48] V.K. Ramachandran, and Vikas Rawal, 'The impact of liberalisation and globalisation on India's agrarian economy', p.74.

[49] A. Vaidyanathan, 'Farmers' suicides and the agrarian crisis', *Economic and Political Weekly*, p.4010.

credit and marketing organisation, that are in turn compounded, argues Vaidyanathan, 'by government policies for pricing of water, electricity, fertilisers and credit which induce demand growth far in excess of available supplies…and encourage inefficient use of scarce agricultural resources'[50] (for detailed corroboration Harriss-White and Janakarajan[51]). Tackling such problems calls for more than just increasing public investment[52].

And What is to be Done About it?

The critical policy questions, therefore, are not well addressed either by a dogmatic adherence to economic liberalism or by the restoration of older policies of state intervention in agriculture. Arvind Panagariya[53] is a champion of the broader liberal policy framework, but his advocacy of reducing subsidies and increasing investment in agriculture is shared by other economists, who are not. His point that the policy of setting Minimum Support Prices for agricultural products mainly subsidises farmers in the relatively rich states of Andhra Pradesh, Punjab and Haryana, is also well taken, and there are strong arguments, no doubt, in favour of using direct cash transfers for poverty reduction – which Panagariya supports, but which, until very recently, Indian policy-makers generally rejected – to replace the Public Distribution System that supplies rations of essential commodities at controlled prices to those who are defined as being Below Poverty Line (BPL).

What is most controversial in Panagariya's policy argument is his advocacy of contract farming and with it of much more corporate involvement in agriculture – bound up with the supermarket revolution that continues to encounter political resistance in India – and supported by reversal of the policy of redistributive land reform to which the Indian state has been formally committed historically. He believes that the development of contract farming is severely constrained if it has to involve transacting with large numbers of marginal and small farmers, and that the fragmentation of agricultural holdings has negative effects on productivity. The policy of redistributive land reform has largely failed – by 1992 the total area of land redistributed amounted to only 1.25 per cent of operational holdings across 18 major states – and the protection of user rights of cultivators is now much more important, in Panagariya's view, than is redistribution.

There are strong arguments, no doubt, in favour of contract farming. A group of leading Bengali economists, for example, in proposing a 'Strategy for Economic Reform in West Bengal' in 2003, noted the achievements of agrarian reform in the state, but – given the long-

---

50 A. Vaidyanathan, 'Farmers' suicides and the agrarian crisis',p.4013.

51 Barbara Harriss-White and S.Janakarajan (eds), *Rural India faces the 21st century* (London, Anthem Press, 2004).

52 A.Vaidyanathan, 'Agricultural Growth in India: Role of Technology, Incentives and Institutions', Chapters 4 and 5.

53 Arvind Panagariya, *India: the emerging giant*, Chapter 14.

run demand constraints on rice agriculture and the need for agricultural diversification - argued forcefully in favour of exploring the potential of contract farming in the production of vegetables, fruit and flowers.[54] They, and others, argue that contract farming can be 'win-win' under appropriate institutional conditions that ensure transparency and provide some protection for farmers.[55] But a recent report from the Government of India on supermarket retail chains reaches rather negative conclusions, arguing that 'the noise about smallholder benefit in high value crops due to retail chain linkage is exaggerated and the linkage is either weak or absent'.[56] Exactly as Panagariya suggests, supermarkets and other corporates are not interested in transacting with large numbers of small farmers. So what is the future for the vast majority of Indian farmers? The sequencing here is all important – and there are very good reasons for fearing that in the absence of employment opportunities outside of agriculture then their exclusion from contract farming and even more the displacement of small farmers by the corporate take-over of agricultural land will lead to further impoverishment.

On the other hand, the fact that land redistribution has not taken place to any great extent does not mean that there is no longer a case for it. We noted earlier the extent of inequality in the distribution of agricultural land, and that inequality has been increasing; and Vikas Rawal provides 'ballpark estimates', on the basis of the admittedly crude assumption of a uniform ceiling on ownership holdings of 20 acres, to show that 'there is about 15 million acres of ceiling surplus land in India'. As he goes on to say 'this is more than three times the total amount of land that has ever been redistributed under land reform programmes in all states'.[57] This is not to say that there is a large potential for redistribution, given the fact that only a very small proportion of agricultural land in India has been redistributed hitherto, but it does lend weight to Michael Lipton's conclusion in his recent comprehensive restatement of the case for land reform, that '*In South Asia*, still containing half the world's poor, 10ha is in most countries a large owned farm (and) *there is scope for some further land reform*, but land shortage and growing (though still, surely, seriously inadequate) non-farm work opportunities may largely limit it to creating tiny 'home-gardens' for increasingly part-time rural farmers'.[58] Legislation is being considered, however, and some has been passed that actually raises ceilings on the size of agricultural land-holdings, and facilitates absentee farming by large owners and corporations. As Ramachandran and Rawal say 'such policies reduce the

[54] Abhijit Banerjee; Pranab Bardhan; Kaushik Basu; Mrinal Datta Chaudhuri; Maitreesh Ghatak; Ashok Sanjay Guha; Mukul Majumdar; Dilip Mookherjee, and Debray Ray, 'Strategy for economic reform in West Bengal', *Economic and Political Weekly,* Vol.37, no.41 (2003), pp.4203-4218.

[55] Haque, 2003.

[56] S. Singh, 'Implementation of FDI in food supermarkets', *Economic and Political Weekly*, Vol.45, no.34 (2010), p.17.

[57] Vikas Rawal, 'Ownership holdings of land in rural India: putting the record straight', p.47.

[58] Michael Lipton, *Land reform in developing countries: property rights and property wrongs*, (London, Routledge, 2009).

extent of land for redistribution, accelerate the loss of land by poor peasants and worsen inequalities in the distribution of land'.[59]

At least as controversial as the matter of contract farming, is the question of whether or not genetic-modification ('GM') has an important part to play in the future of Indian agriculture[60]. Opponents of GM (more accurately, transgenic varieties) have very successfully framed the matter in negative terms, in the face of evidence suggesting quite strongly that cultivation of genetically modified varieties may drastically cut both farmers' expenditure on agro-chemicals, and the environmental and health hazards entailed in their use. Thus it was in 2010 that the Environment Minister, Jairam Ramesh, was persuaded to impose a moratorium on the release of a transgenic brinjal hybrid.[61]

Panagariya argues that the sustainable solution to poverty lies outside agriculture and depends upon moving a much larger share of the total labour force of the country out of agriculture altogether. Reducing the ratio of labour to land, he claims, offers a greater potential for increasing agricultural wages than any conceivable productivity-enhancing reforms in agriculture. These arguments are strong ones, but so long as there isn't such a movement of labour out of agriculture it surely is imperative to improve agricultural productivity and incomes. We return, then, to the problem of the failure of structural transformation in India.

Employment Trends, 'Jobless Growth' and Workers' Responses

One significant indicator of employment trends in India in the period of economic liberalisation is that the highly successful information technology industry, which now contributes such an important share of GDP and of export earnings, generates so little employment. According to NSS data, the IT sector accounted for just 0.7 per cent of the non-agricultural labour force in 2004-5. The sector's revenues by that time accounted for 4.5 per cent of GDP while contributing only 0.21 per cent of aggregate employment.[62] In the following discussion it should be noted that the numbers of those in the Indian workforce grow at the moment by about 10 million persons per year[63], a figure that greatly exceeds the one for all current employment in 'private sector establishments' (8.8 million in 2006 – of which the IT sector makes up only a small part, according to figures from the Directorate General of Employment and Training[64]).

[59] V.K. Ramachandran, and Vikas Rawal, 'The impact of liberalisation and globalisation on India's agrarian economy', p.57

[60] Ronald Herring (ed), 'Transgenics and the poor: biotechnology and development Studies', Special Issue of *Journal of Development Studies*, Vol. 43, no.1, pp.63-78

[61] *The Hindu*, 10 February 2011.

[62] C.P. Chandrasekhar, 'Progress of "reform" and retrogression of agriculture'. Retrieved from http://www.macroscan.org/anl/apr07/anl250407Agriculture.htm. Accessed June 21, 2010.

[63] Himanshu, 'Employment trends in India: a re-examination', p.52.

[64] Government of India, *Statistical pocket book for 2008* (New Delhi, Planning Commission, 2008).

It has been widely argued that India is experiencing 'jobless growth' – a view supported by National Sample Survey (NSS) data showing that the rate of growth of the workforce as a whole, in the later 1990s, fell below the rate of growth of population, and well below its rate of growth in the 1980s and early 1990s (Table 6; see also Dev[65]; Himanshu[66]; and Unni and Raveendran[67], all of whom estimate the total growth of the workforce between 1993-94 and 1999-2000 at less than one per cent per annum).

<u>Table 6:</u> Annual rates of employment growth for usual status workers (%)

Period	Rural	Urban
1983 to 1987-8	1.36	2.77
1987-8 to 1993-4	2.03	3.39
1993-4 to 1999-2000	0.66	2.27
1999-2000 to 2004-5	1.97	3.22
2004-5 to 2009-10	-0.34	1.36

Source: National Sample Survey, various rounds[68] (1983 to 2004-5 calculated by Chandrasekhar 2007)

This notion was contested, however, in interpretations of more recent NSS data that showed acceleration of employment growth in 2000-2005, within both urban and rural areas and amongst both men and women (the authors referred to immediately above all estimate employment growth over this period at a little less than three per cent per year). The 'jobless growth' thesis was apparently refuted, and official claims were made that the employment problem had finally been resolved.[69] It was also argued by Sundaram[70] that there had been a marked increase of 'good quality employment'. The essential points in this case were that self-employment had grown markedly in urban non-agriculture, especially amongst women; casual employment generally had declined; and regular salaried non-agricultural employment had increased, especially for women - at over five per cent per annum in the recent decade. This argument depended heavily upon the assumption that self-employment represents good

[65] Mahendra S. Dev, *Inclusive growth in India: agriculture, poverty and human development* (Delhi, Oxford University Press, 2008).

[66] Himanshu, 'Recent trends in poverty and inequality: some preliminary results' *Economic and Political Weekly*, Vol.42, no.6 (2007).

[67] Jeemol Unni and G.Raveendran, 'Growth of employment (1993-4 to 2004-5): illusion of inclusiveness', *Economic and Political Weekly*, Vol.42, no.3 (2007), pp.196-199.

[68] C.P. Chandrasekhar, 'Progress of "reform" and retrogression of agriculture'. Retrieved from http://www.macroscan.org/anl/apr07/anl250407Agriculture.htm. Accessed June 21, 2010.

[69] Himanshu, 'Employment trends in India: a re-examination', p.44.

[70] K.Sundaram, 'Employment and poverty in India, 2000-2005', *Economic and Political Weekly* Vol. 42 (2007), pp.3121-3131.

quality employment because over the period in question there had actually been a decline in all wage employment and a very significant increase in self-employment among all categories of workers. All told about half of all those in the workforce were by that time self-employed. The idea that this is good quality employment reflects the emphasis in current development thinking, internationally, about the virtues of self-employment, which is understood as 'enterprise' (a way of thinking that is reflected in the title of India's 'National Commission on Enterprises in the Unorganized Sector'). But there are many reluctant entrepreneurs amongst the poor, and the NSS data show that just under a half of all self-employed workers do not find their work remunerative, in spite of their usually low expectations of reasonable returns. Chandrasekhar concludes that a large part of the increase in self-employment has been distress-driven, and that 'the apparent increase in aggregate employment growth may be more an outcome of the search for survival strategies than a demand-led expansion of productive employment opportunities'.[71]

For Unni and Raveendran, too, the apparently rosy picture painted by Sundaram has to be qualified by recognition that some of the increase of regular salaried jobs was in a subsidiary capacity, indicating part-time working, while the increase in female participation was of women mainly at lower levels of education, implying that their access to employment was either in self-employment or at the bottom of the wage-salaried employment hierarchy. There was evidence, too, from the NSS that the extent of home-working had increased quite significantly, especially amongst women. The increased employment of women in particular in subsidiary, part-time occupations, some of them involving home-working, and large numbers of them being poorly remunerated, are developments that have been characteristic of economies that have participated in economic globalisation.[72] Most significant of all, however, for Unni and Raveendran, was the fact that the average daily real wages of regular workers declined in 2004-05, by comparison with 1999-2000 (particularly for females), indicating the growth of poorly remunerated jobs in urban areas in regular salaried employment. It is altogether likely that the growth of employment in the first five years of the new millennium was driven by distress, at a time when the agricultural economy was in crisis – as Himanshu has shown.[73]

The estimates contained in the report on the 64th round of the NSS for 2007-08, and then in those of the 66th round of 2009-10, confirm the misgivings of other scholars as against Sundaram's optimism about the creation of 'good quality employment'.[74] Total employment increased at a rate of only 0.17 per cent per year between 2004-05 and 2007-08 (the lowest rate of employment generation of the last three decades, and occurring in the context of very high rates of growth of GDP); and rural employment actually declined. The 66th round of the NSS shows that between 2005 and 2010 usual status employment increased by just 0.1 per

[71] C.P. Chandrasekhar, 'Progress of "reform" and retrogression of agriculture'. Retrieved from http://www.macroscan.org/anl/apr07/anl250407Agriculture.htm. Accessed June 21, 2010).

[72] Manuel Castells, *The rise of the network society* (Oxford, Blackwell, 1997).

[73] Himanshu, 'Employment trends in India: a re-examination', pp.53-55.

[74] Editorial, 'Jobless growth', *Economic and Political Weekly*, p.7.

cent per annum. In this period the deceleration in urban employment (from 4.22 per cent per annum in 1999-2005, to 1.36 per cent in 2005-10) and the decline in rural areas (the rate was 0.34 per cent per annum in 2005 to 2010) was accounted for largely by the sharp fall in female labour-force participation. 'What seems to have happened is that a large majority of women workers moved into the labour force during 1999-2005 and looked for work outside the home due to the agrarian crisis and distress in rural areas. And it is these women workers who have moved back into their homes as soon as the situation improved because of higher agricultural productivity…'.[75] There is evidence, as Himanshu points out[76], that there is an inverse relationship between output growth and employment growth.

'Informalisation' of employment is of course greatly to be desired according to the advocates of economic liberalisation, for labour market regulation beyond an absolute minimum is held to give rise to inflexibility, and this in turn to reduce employment, because it increases labour costs. Besley and Burgess have concluded from comparison across Indian states that those 'which amended the Industrial Disputes Act in a pro-worker direction experienced lowered output, employment, investment, and productivity in registered or formal manufacturing'[77] . Their arguments have been subjected to significant criticism[78], however, and neither theoretical nor empirical work, in relation to India and to other countries, leads to unequivocal conclusions regarding the impact of employment protection legislation. As Bardhan says 'there is hardly any study on the labour absorption question that conclusively shows that any adverse effect of labour laws is particularly large compared to the effects of other constraints on labour-intensive industrialisation'.[79,80] There is also substantial evidence that 'employers have been able to find ways to reduce the workforce even with 'restrictive' provisions in place'[81] – such as that on the retrenchment of workers - by using the mechanism of the voluntary retirement scheme in the later 1990s. The increase in the numbers of contract workers in the total number of workers in manufacturing , from about 12 per cent in 1990 to over 20 per cent by 2004-05, shows that employers have been able to achieve greater flexibility by effectively informalising a part of the labour force[82, 83].

Informalisation/'Flexibilisation' has certainly been taking place, and its negative consequences for workers are attested in a number of case studies. It is not necessarily the case that total household incomes decline, partly because of increased workforce participation

---

75 *Ibid.,p.7.*

76 Himanshu, 'Employment trends in India: a re-examination', p.56.

77 Timothy Besley and Robin Burgess, 'Can regulation hinder economic performance? Evidence from India', *Quarterly Journal of Economics*, Vol.119, no.1 (2004), p. 91.

78 A.Bhattacharjea, 'The effects of employment legislation on Indian manufacturing', *Economic and Political Weekly*, Vol.44, no.2 (2009), pp.55-62.

79 Pranab Bardhan, 'Notes on the political economy of India's tortuous transition', p.33.

80 K.P. Kannan and G.Raveendran, 'Growth sans employment: a quarter century of jobless growth in Indian manufacturing', *Economic and Political Weekly*, Vol. 44, no.10, pp.80-91.

81 A.N. Sharma,'Flexibility, employment and labour market reforms in India', *Economic and Political Weekly* Vol.41, no.21, p.2081.

82 A.N. Sharma,'Flexibility, employment and labour market reforms in India',p.2081.

83 R. Nagaraj, 'Fall in manufacturing employment', *Economic and Political Weekly*, Vol.39, no.30 (2004), pp.3387-3390.

on the part of women, and in some cases of children, but livelihoods have become much more vulnerable. Jan Breman's analysis of the impact of informalisation in Ahmedabad makes this point very forcefully[84]; and it is shown up as well in Nandini Gooptu's studies of once permanently employed workers in Kolkata.[85] In both cities the decline of 'permanent' formal employment in cotton (in Ahmedabad) and jute mills (in Kolkata) has led to what Mike Davis[86] has referred to – with reference to cities throughout the erstwhile 'third world' - as 'urban involution', meaning the crowding of workers into such activities as local petty trade, transport and construction and (generally in relatively smaller numbers) into small manufacturing workshops. Coping with their changed circumstances has meant, in many households, that women, and children, have entered the labour force in larger numbers (contributing to the phenomenon of increasing self-employment, especially amongst women, that we noted earlier). It is for this reason that household incomes have not necessarily declined, but livelihoods have become more vulnerable and – according to Breman's observations in Ahmedabad – living standards have declined. Karin Kapadia, from fieldwork in low income households in Chennai, too, thinks that it is likely that in many of them women have become the main breadwinners – though this coincides with evidence of decline in the status of women in Tamil society[87]. Amongst men affected by labour force changes in all these cities, there has developed a strong sense of their powerlessness and of loss of dignity. Some have responded to their material and identity crises by resorting to criminality, and some to violence. Domestic violence may have increased. But these are not the only or necessarily the dominant responses. Some men have turned rather to clubs, and some of these to social service activities. There are signs, too, of increasing religiosity, and both Gooptu and Breman think that religious ideologies are gaining ground.

Conclusion: 'Excluded Labour'?

The evidence and argument that we have reviewed show that India's 'lopsided transition', with the limited movement of labour out of marginal smallholding agriculture as the economy grew over the first five decades from Independence, has continued through the more recent years of very high rates of growth and in the context of India's partial pursuit of economic liberalism. These years are fairly described as a period of 'jobless growth', in spite of claims based on the apparently contrary evidence for the period 1999-2005. Himanshu sums up: 'The acceleration of GDP growth from an average of six per cent to eight per cent after 2005 has not been accompanied by any corresponding generation of decent

[84] Jan Breman,'An informalised labour system', *Economic and Political Weekly* Vol.36, no.52 (2001), pp.4804-4821.

[85] Nandini Gooptu, 'Economic liberalisation, work and democracy: industrial decline and urban politics in Kolkata', *Economic and Political Weekly*, Vol.42, no.25, pp.1922-1933.

[86] Mike Davis, *Planet of slums* (London, Verso, 2006).

[87] Karen Kapadia, 'Liberalisation and transformations in India's informal economy: female breadwinners in working-class households in Chennai', in Barbara Harriss-White and Judith Heyer (eds), *The comparative political economy of development* (London, Routledge, 2010).

employment…(and)…with over 80 per cent of all new jobs created being in casual work, overwhelmingly in construction, there are serious questions about the ability of the growth process to offer sustained employment as the cornerstone of inclusive growth'[88]. Perhaps the most critical question, therefore, about labour in India, is that of whether the argument proposed by Sanyal and Bhattacharyya, that a very large share of Indian labour is 'excluded' carries weight, or not. What are the prospects for incomes and welfare for those in informal employment?

Both Sanyal and Bhattacharyya, and Tania Li[89], warn against the easy assumption of the inevitability of the linear pathway of structural transformation – such as appears, for example, in the arguments of the *World Development Report* for 2008 on *Agriculture for Development* – and critique the residual functionalism (as Li puts it) in the idea of the reserve army of labour. They refer to (and Li describes in some detail, from across Asia) the 'new round of enclosures that have dispossessed large numbers of rural people from the land, and the low absorption of their labour, which is "surplus" to the requirements of capital accumulation'.[90] Of course there are informal activities that are integrated within the circuit of capital, as they may be through sub-contracting and outsourcing, but a great deal of informal activity, which – as we have seen - involves extensive self-employment, constitutes a non-capitalist production space (in Sanyal and Bhattacharyya's view). This is the economy of surplus or 'excluded' labour that does not contribute to capital accumulation.

As Bardhan has pointed out the problem with this argument is that the authors suggest that the non-capitalist space accounts for the great majority of informal workers, when the evidence on the point is scanty. This is a fair criticism, though Bardhan's own further arguments certainly provide no convincing rebuttal of the idea that there is an extensive force of excluded labour. He refers to data showing that 'the all-India average market value of fixed assets owned per enterprise was Rs 58,000 in 2005-06 (USD$1200+) in the informal manufacturing sector' – but the conclusion that he draws when he says 'so the average informal enterprise is not run by destitute people'[91] is misleading. The great majority of informal enterprises, after all, are not in the manufacturing sector. Those that are may well include units that have become more capital intensive over time, as Dibyendu Maiti and Kunal Sen report. But these authors also say that 'whether the informal sector can be a source of robust and productivity driven employment growth in the future, in the face of weak employment growth in the formal manufacturing sector, is a question that remains to be answered'.[92] The further question, of course – posed by Li, Sanyal and Bhattacharyya - is that of just how much informal activity really can be considered to be the site of capital

[88] Himanshu, 'Employment trends in India: a re-examination', pp.58-59.
[89] Tania Li, 'To make live or let die? Rural dispossession and the protection of surplus populations', *Antipode*, Vol.41, no.1 (2010), pp.66-93.
[90] *Ibid.*, p.66.
[91] Pranab Bardhan, 'Notes on the political economy of India's tortuous transition', p.34.
[92] Dibyendu Maiti and Kunal Sen, 'The informal sector in India: a means of exploitation or accumulation?', *Journal of South Asian Development* Vol.5, no.1 (2010), pp.1-13.

accumulation. Isn't much of it reasonably seen as lying altogether outside the sphere of capital accumulation?

We have no means for mapping the distribution of informal economic activity and employment between that which is firmly within circuits of capital accumulation and that which can be held to be outside them, and the notion of exclusion is, to say the least, tendentious when we do know that garbage pickers, say, often are linked in ultimately to circuits of capital (as when they supply scrap metal for industry). Rather than referring to a large share of the labour force as being outside the sphere of capital accumulation, therefore, it is probably more sensible to think in terms of its being 'excluded' from the dynamic sectors of the economy and engaged in activities of such low productivity as barely to allow for survival. There is no question that India's transition is indeed 'tortuous' and there remains a 'marginal mass' of labour which barely survives without welfare provisioning on the part of the state, now through the Mahatma Gandhi National Rural Employment Guarantee (NREGA) and (it is to be hoped) through enhanced support for food security and more adequate public health. 'Inclusive growth' has remained elusive – and it is in this context, and in part perhaps because of the failure of aspirations to 'inclusive growth', that the Government of India, under pressure from within civil society, has passed social welfare legislation such as NREGA. The persistence of mass poverty in India has become politically unacceptable – whether because of fear of 'les classes dangereuses', as Chatterjee suggests[93] , or because it is an affront in a country that intends to be a major power – and given the failures of inclusive growth the state has had little alternative but to resort to the provision of a social safety net. Schemes such, notably, as NREGA, may deliver important benefits to poor people but they do little to address the problems of human capital formation in India that are the outcome of decades of under-investment in the public sector in education and health[94], and that help to limit the possibilities for inclusive growth.

.....

[93] Partha Chatterjee, "Democracy and economic transformation in India', *Economic and Political Weekly,* Vol.43, no.16 (2008), pp.53-62.

[94] John Harriss, 'Have India's economic reforms been "guided by compassion and justice?"', in Sanjay Ruparelia, Sanjay Reddy, John Harriss and Stuart Corbridge (eds), *Understanding India's New Political Economy: A Great Transformation?* (London, Routledge, 2011).

ISAS Working Paper

No. 138 – 12 December 2011

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isassec@nus.edu.sg
Website: www.isas.nus.edu.sg

India's Engagement with Afghanistan: Developing a 'Durable Policy Architecture'

Daniel Norfolk[1]

Abstract

Calls for a regional approach to stabilise Afghanistan have not been accompanied by serious efforts to analyse the evolving motivations and strategies of regional actors. Occupying a unique position as Afghanistan's leading regional development partner, India is poised to play an instrumental role. The development partnership between India and Afghanistan, which emerged in the wake of the United State (US) invasion in 2001, has been recalibrated according to a revised conception of India's own strengths and limitations in its region and a sober reassessment of geopolitical realities. Built into this revision is a measured accommodation of Pakistan. While India may now succeed in carving out a strategically viable place for itself, the ability of India to achieve its goals in Afghanistan crucially depends on its capacity to leverage regional cooperation.

Introduction

There is growing consensus that India's global ambitions are constrained by the difficulties it encounters closer to home. Contending with domestic crises, unstable neighbours, and an ascendant China leaves India little scope to manoeuvre in the international arena. Confronting its region as a constraint rather than an opportunity, Delhi adheres to a cautious foreign policy

---

[1] Daniel Norfolk is currently conducting research on India's regional foreign policy and development programming at the International Development Research Centre (IDRC). He was based in New Delhi until 2010, where he analysed regional conflict for the International Institute for Strategic Studies (IISS). He can be contacted at dnorfolk@idrc.ca. The views expressed are those of the author and do not necessarily reflect the views of IDRC or ISAS.

framework, designed to guide outcomes but not to create them.[2] Concluding a review of two recent additions to the compendium of Indian foreign policy analysis, one author writes: 'India's quiescent strategic culture means that Indian experts who wish to see their country match its surging economic means with a more geopolitically active posture will likely remain disappointed.'[3]

For the better part of its independent life, the Indian government has engaged with Afghanistan along these familiar lines. On India's early relations with Afghanistan, I.P. Khosla explains: '(Jawaharlal) Nehru himself set a tone, which echoes in today's policy pronouncements. Talking in 1950 about Afghanistan and the demands of the Pashtuns, he said, "the Government of India is intimately interested, but it is a matter for abiding regret to us that we can only be interested from a distance without being able to help in any way".'[4] Prime Minister Nehru's sympathetic but detached Afghanistan policy survived his death in 1964 and persisted, virtually unchanged, under successive governments until the end of the Cold War.[5] Following which, despite evidence linking the Taliban regime to the Pakistani military establishment and militant groups operating in Kashmir, India did not actively intervene to prevent the Taliban from coming to power in Kabul.[6]

Similar interpretations pervade contemporary analyses of India's engagement with post-Taliban Afghanistan.[7] However, the position taken here is that Delhi's strategic framework underwent an important shift in Afghanistan following the US invasion in 2001. India sought to take advantage of US-NATO occupation and adopt a geopolitically active posture, more in tune with its perceived political and economic means. Departing from the guarded principles that had anchored its Afghan policy from independence, the Indian government initiated an ambitious new phase of engagement, intended to create an outcome conducive to Indian interests. Over nearly a decade, however, India's approach to Afghanistan repeatedly failed to achieve lasting objectives. Imminent US-NATO withdrawal has further jeopardised India's position. Facing what a retired Indian Brigadier has described as 'strategic stalemate',[8] the

---

[2] Nitin Pai, *The Paradox of Proximity: India's Approach to Fragility in the Neighbourhood* (New York: Center on International Cooperation, New York University, 2011), p.7.

[3] David J. Karl, 'Is India Ready for Prime Time? (A review of David M. Malone, *Does the Elephant Dance? Contemporary Indian Foreign Policy* and Stephen P. Cohen and Sunil Dasgupta, *Arming Without Aiming: India's Military Modernisation*),' Asian Policy #12 (July 2011), p.178.

[4] I.P. Khosla, 'India and Afghanistan,' in Atish Sinha and Madhup Mohta eds., *Indian Foreign Policy: Challenges and Opportunities* (New Delhi: Academic Foundation, 2007), p.549.

[5] See Harish Kapur, *Foreign Policies of India's Prime Ministers* (New Delhi: Lancer Publishers, 2009).

[6] India did provide modest support to the so-called Northern Alliance in its efforts to unseat the Taliban, but did not support opposition to the Taliban militarily. See Vikash Yadav and Conrad Barwa, 'Relational Control: India's Grand Strategy in Afghanistan and Pakistan,' *India Review* 10:2 (April-June 2011), p.108.

[7] See, for example: Khosla, 'India and Afghanistan,' 2007; Pai, 'Paradox of Proximity,' 2011; Sushant K. Singh, 'A Bigger Military Presence is Essential if India is going to Shape Afghanistan's Future,' *Pragati: The Indian National Interest Review* No.17 (August, 2008); Shanthie Mariet D'Souza, 'India, Afghanistan, and the "End Game"?' *ISAS Working Paper* No.124 (Singapore: ISAS, National University of Singapore, March 2011); Jorge Heine and Partha Ghosh, 'The Elephant in the War: India and the Afghan-Pakistan Link,' *Canadian Foreign Policy Journal* 17:1 (June 2011).

[8] Conversation with Brigadier Gurmeet Kanwal (retired), Director of Centre for Land Warfare Studies (CLAWS), Delhi, 23 September 2011.

Manmohan Singh government began to retrench and recalibrate its engagement so as to shore-up what political capital it had gained.

Under these new circumstances, India may acquire influence that will allow it to secure some of its interests in Afghanistan. It will be argued that, since 2009, Delhi has been tailoring an Afghanistan policy that accords with India's strategic regional interests and reflects a sober reassessment of its geopolitical limitations. The shift marks a return to India's traditionally restrained policy, retaining flexibility in approach and a broad set of policy options without abandoning its core objectives. However, in an effort to spread the risks inherent in its engagement with Afghanistan, Delhi has embarked on a trajectory that requires apprehending its region as an opportunity rather than a constraint. Indeed, Delhi's Afghanistan approach today demands that it engage constructively with regional actors if it is to secure its investments and accrue strategic dividends. From this perspective, Delhi is staking the regional geopolitical landscape with familiar policy markers while asserting itself in such a way that requires wider, innovative engagement.

This analysis offers those who lament India's 'quiescent strategic culture' a lens through which the failures of abandoning its traditional posture might be understood. The objective is not to extol the virtues of static foreign policy. On the contrary, India's experience in Afghanistan demonstrates that capacity in one context does not easily translate into another, and efforts to exact such a translation can restrict rather than expand policy options. In seeking a practical equilibrium, Delhi has broadened its horizons for engagement and increased the flexibility of its policy architecture.

What follows is not grounded in any one body of literature, but draws from a broad range of Indian foreign policy scholars and practitioners, as well as strategic and journalistic analyses. A conscious effort has been made to remain outside any particular theoretical framework. Insofar as it can be situated in a certain theoretical or analytical field, this work is influenced by approaches to regionalism, which, according to one theorist, 'is best viewed as an unstable and indeterminate process of multiple and competing logics with no overriding teleology or single-end point, and dynamic regions are inherently unstable with little possibility of freezing the status quo.'[9] Appropriately, then, the present study eschews the reducible taxonomy of political science.

The following section will briefly introduce India's historical engagement with Afghanistan, and propose that an observable shift in India's Afghan policy is underway. Discussion will then turn to an interpretation and contextualisation of the contemporary India-Afghanistan bilateral relationship, from which it is determined that Indian engagement with Afghanistan following the US invasion of 2001 marked a significant break from its traditional posture. Subsequently, the specific nature and implications of India's evolving strategy in Afghanistan

---

9 Andrew Hurrell, 'One World? Many Worlds? The Place of Regions in the Study of International Society,' *International Affairs* 83:1 (2007), p.130.

will be analysed and motivating factors proposed. Finally, the discussion will look to the horizon, focusing on future options and outcomes.

Setting the Stage: Early Encounters to Contemporary Constraints

India has strategic and economic interests in Afghanistan that are bound up in its complex relationship with Pakistan. Primarily concerned with security, Indian objectives are easily reconciled with those of the international community: the creation of a stable Afghanistan that will no longer export terrorism. Adding a distinctly Indian layer to internationally shared concerns, Delhi perceives its own influence in Afghanistan as a useful countermeasure to a hostile Pakistan.[10] Consequently, Delhi has initiated a programme of development assistance throughout Afghanistan with a view to cultivating a stable and friendly government in Kabul and goodwill amongst the population (analysed in detail below). In this sense, greater influence and increased stability are intertwined objectives and thus do not allow easy distinctions, adding to Pakistani suspicions.

Secondly, as a rapidly growing, energy-deficient country, India is keen to access Central Asian reserves of oil and natural gas. Afghanistan, which is also endowed with a wealth of extractable resources, can provide a convenient transit-way for these commodities. Similarly, a stable Afghanistan has the potential to be the over-ground nexus between regional markets, a convenience of significant benefit to the Indian economy.[11] (Here, too, India's troubled relationship with Pakistan is a major impediment). Finally, aspiring to great power status, India envisages its efforts to stabilise Afghanistan as a means to harness international recognition as a global force for peace and progress, seeking external validation for its role as purveyor of regional security.[12]

India has historically enjoyed good relations with Afghanistan. From ancient civilizational ties to the contemporary influence of Hindi cinema, the two countries nurture cultural affinities.[13] Geography has freed the relationship from the complications of disputed borders that plague relations between Kabul and Islamabad on one side, and Islamabad and Delhi on the other. However, lacking a contiguous border, India's physical detachment from Afghanistan presents a geopolitical dilemma: despite inclinations toward a closer relationship, India cannot realistically sustain its interests in Afghanistan without projecting a physical presence there, and any attempt to do so is anathema to Pakistan's political-military

---

10 C. Christine Fair, 'Under the Shrinking US Security Umbrella: India's End Game in Afghanistan?' *The Washington Quarterly* (Spring 2011), p.181.

11 Harsh V. Pant, 'India in Afghanistan: A Test Case for a Rising Power,' *Contemporary South Asia* 18:2 (June 2010), p.145.

12 Conversation with Harsh V. Pant, King's College, London, 19 March 2011. On India's quest for status, see, for example: Pratap Bhanu Mehta, 'Still Under Nehru's Shadow? The Absence of Foreign Policy Frameworks in India,' *India Review* 8:3 (July-September 2009) p.217.

13 Daniel Norfolk, 'Why India Matters in Afghanistan: Development Assistance at a Decisive Moment,' *Pragati: The Indian National Interest Review* No.51 (June 2011), p.13.

establishment.[14] In fact, the contemporary history of India's engagement with Afghanistan can be understood in precisely these terms, as the process by which a major regional power adapts to an auxiliary role in its own geographical neighbourhood.

The contours of India's relationship with Afghanistan have been shaped over time by geopolitical misadventure, with each contemporary episode reifying the constraints to mutual engagement. The geopolitical entity that is now Afghanistan is the manifestation of competition between the British and Russian empires, which delineated its territory to buffer between their expanding realms. Unable to bring Afghanistan under direct rule, the British subsidised a roughshod state-building project, beginning a process that would incorporate Afghanistan into the international system of states.[15] While Russia subdued the peoples of Central Asia, and Britain the peoples of the Indian subcontinent, Afghanistan endured as a nominally independent client state.

When the British relinquished a partitioned Indian subcontinent in 1947, the buffer between India and Central Asia effectively shifted east, to what became the newly independent Islamic Republic of Pakistan. Although Afghanistan remained inextricably linked to South Asia in the collective psyche, Pakistan drove a geographical and political wedge between India and the states of the northwest. As is the case elsewhere, the borders drawn by colonial administrators to demarcate political-territorial entities had the paradoxical effect of undermining the sovereignty of the South Asian post-colonial states. With Pashtun and Kashmiri populations divided by Pakistan's *de facto* western and eastern borders respectively, competing irredentist and secessionist claims ensued, which have, to a large extent, shaped relations between the three countries to this day.

Independent India's foreign policy was primarily driven by domestic concerns, of which the Kashmir crisis was particularly acute.[16] Supporting the Pashtun cause and Afghanistan's territorial claims would have had the adverse consequence of legitimating Pakistani demands for Kashmir's self-determination. With hands tied, Delhi's approach to Afghanistan was characterised by diplomatic cordiality (albeit at a high level), limited efforts at expanding trade, and cooperation in development and capacity building.[17] Limited, positive engagement continued throughout much of the Cold War period, while both Delhi and Kabul remained normatively non-aligned and nominally pro-Soviet. However, when the Soviets invaded Afghanistan and seized Kabul in 1979, introducing Cold War proxy conflict into India's neighborhood, Delhi's policy options were severely constrained.[18] US support to Pakistan reified the geopolitical divide between India and Afghanistan. Furthermore, Delhi's failure to condemn the Soviet invasion outright cost it valuable political capital both in Afghanistan

14 Conversation with C. Raja Mohan, Centre for Policy Research, New Delhi, 7 April 2011.

15 Barnett R. Rubin, *The Fragmentation of Afghanistan* (Yale University: Yale University Press, 1995), Chapter 3.

16 David Malone, *Does the Elephant Dance? Contemporary Indian Foreign Policy* (New Delhi: Oxford University Press, 2011), pp.48-49.

17 D'Souza, 'India, Afghanistan, and the "End Game"?' 4-5; Khosla, 'India in Afghanistan,' p.549.

18 Surjit Mansingh, *India's Search for Power: Indira Gandhi's Foreign Policy 1966-1982* (New Delhi: Sage Publications, 1984) p.158.

and in the capitalist West. Delhi increased its development assistance to combat the fallout, but was powerless to affect meaningful change.[19] Global bipolarity throughout the Cold War considerably limited Delhi's regional policy options.

The US-Saudi Arabia-sponsored, Pakistan-backed jihad, which ultimately succeeded in pushing the USSR out of Afghanistan in 1989, radically altered the geostrategic landscape as viewed from Delhi. Afghanistan's communist government retained a tenuous hold on power in Kabul, but faced encirclement by various mujahidin factions. Nevertheless, circumstances did not, as might have been expected, elicit a forceful Indian reaction. Exhibiting the 'strategic restraint' that would become a hallmark of its foreign policy throughout the ensuing two decades, India developed an open and tolerant approach to accommodate the volatile circumstances. Then Prime Minister Narasimha Rao knew where India stood in the quickly evolving regional security complex, and accepted Pakistan's growing influence in Afghanistan. Following the fall of the communist government in Kabul, Rao attempted to mitigate the most deleterious effects by engaging with the mujahidin and moderating the differences between Delhi and less-sympathetic Afghan power-brokers.[20] Comparisons have been drawn between India's approach to post-Soviet Afghanistan and the current trajectory of Indian policy, prompting one former Indian diplomat to describe the ongoing changes in terms of a policy 'reset' in Delhi.[21]

In the event, Rao's policy formulations were rendered redundant by the Taliban's conquest of Kabul in 1996 and complicity in the hijacking of an Air India flight in 1999, removing the possibility for compromise.[22] Indian diplomatic and development initiatives in Afghanistan experienced a hiatus while the Taliban ruled Kabul, during which time Delhi extended support to the non-Pashtun Northern Alliance as a strategic imperative.[23] The Northern Alliance provided the only credible counter-balance to a regime in Afghanistan directly threatening India's national security interests. Delhi continued to provide 'quiet and limited support' for the groups fighting the Taliban, but did not use force or overtly support attempts to depose the regime.[24]

Regional dynamics were distorted by the US invasion of Afghanistan in 2001. The American security blanket appeared to offer India an avenue by which to circumvent its geopolitical dilemma: US efforts to stabilise Afghanistan allowed India to establish a greater presence on the ground. In the event, expected security guarantees proved elusive. 'Under the shrinking US security umbrella,' as it has been described by Christine Fair, India was again confronted with the reality of its disadvantageous position. India has had to come to terms with its own geopolitical limitations, and though this process has occurred haphazardly and experienced

19 C. Christine Fair, 'Under the Shrinking US Security Umbrella,' p.182.
20 M.K. Bhadrakumar, 'Manmohan Singh Resets Afghan Policy,' *The Hindu,* 16 May 2011.
21 *Ibid.*
22 Malone, *Does the Elephant Dance?* p.290.
23 See Yadav and Barwa, 'Relational Control,' p.108.
24 Pai, 'Paradox of Proximity,' p.7.

many setbacks, it appears at the time of writing that India may succeed in carving out a strategically viable place for itself in the reconstruction of Afghanistan.

For the purposes of this analysis, the objectives listed above – security, stability, influence, and status – comprise the necessary conditions for Indian engagement in Afghanistan. It will be demonstrated that the sufficient condition, the perceived capacity to achieve these objectives, arose simultaneously with, and as a function of, the US occupation of Afghanistan. The parameters of the Afghan war have been transformed by the initiation of an incremental US-NATO troop withdrawal in 2011. However, the current drawdown of international troops has not precipitated India's withdrawal. Rather, it has encouraged India to recalibrate its approach. Responding to evolving circumstances and anticipating further changes, India is developing a flexible policy framework by which it may acquire influence that will allow it to secure some of its interests in Afghanistan.

Think Global, Act Local: Experiments in Projecting Power, 2001-2009

Following the American invasion of Afghanistan in 2001 and the swift eviction of the Taliban from power in Kabul, Delhi enthusiastically resumed diplomatic relations with Hamid Karzai's new government, reopening its embassy in Kabul and establishing four additional consulates throughout the country. Though still reluctant to engage militarily, India committed very substantial resources to its ambitious, multi-sectoral reconstruction effort. Initially pledging US$1.2 billion (this figure has since climbed to US$2 billion), India became Afghanistan's leading regional development partner and eventually its fifth largest bilateral donor.[25]

Without wasting time, India threw its weight behind large-scale infrastructure projects throughout the country. These include the 218km Zaranj-Delaram highway (connecting interior Afghanistan to the Iranian border), the installation of a transmission line bringing power to Kabul from the northern grid, the construction of a large hydro-electric dam in Herat province, and, symbolically, the erection of a new Afghan parliament building.[26] Beyond this, India initiated an impressive panoply of development projects covering a range of sectors, many of which remain operational today. These have been comprised of capacity building initiatives (particularly in the agricultural sector), small and community-based development projects that concentrate on vulnerable areas and emphasise local ownership, and the general provision of humanitarian assistance.[27] Included under the 'capacity building' umbrella have been modest but politically significant efforts to train police and senior military officials.[28]

---

[25] 'Charity Begins Abroad: Big Developing Countries are Shaking up the World of Aid,' *The Economist* (13 August 2011), http://www.economist.com/node/21525836.

[26] See Indian Ministry of External Affairs, 'India and Afghanistan: A Development Partnership,' Public Diplomacy Division, Ministry of External Affairs, Government of India, http://meaindia.nic.in or http://meakabul.nic.in.

[27] *Ibid.*

[28] Correspondence with Ajai Shukla, 1 July 2011.

Similarly ambitious commercial ventures have been initiated. A Gas Pipeline Framework Agreement was signed by Turkmenistan, Afghanistan, Pakistan, and India in 2008. The TAPI pipeline (so-named after the initials of the four countries involved) has been under discussion since the 1990s, and envisages over a thousand miles of pipe connecting Turkmenistan's natural gas fields with energy-deficient South Asia.[29] Simultaneous plans for an Iran-Pakistan-India (IPI) pipeline are in the offing, but Delhi, wary of Washington's reservations and disruptive sanctions, has been reluctant to move forward.[30] A Preferential Trade Agreement was signed between India and Afghanistan in 2003, reducing customs duty on a range of goods. Bilateral trade has increased considerably as a result, worth approximately $588 million in 2009-2010, with Indian markets absorbing the largest share of Afghan exports after the US.[31]

Delhi's energetic re-engagement with post-Taliban Afghanistan represents a marked break from historically limited Indo-Afghan bilateral relations. More significantly, it signaled a temporary departure from what Pratap Bhanu Mehta has described as the politics of cautious prudence – a conscious effort to behave in such a way that removes the need for force, allies, and any commitment to inducing change abroad.[32] According to this foreign policy formulation, India appreciates its limited capacity to affect change outside its borders (without recourse to force, the application of which remains only a very remote option) and will avoid enduring alliances unless driven to them by necessity.[33] Cautious prudence offers a more nuanced framework to the doctrine of 'strategic restraint', which is often cited as a guiding rationale behind Indian foreign policy, in that strategic restraint refers directly to India's reluctance to resort to force as an instrument of policy.[34]

The distinction is important, as it is clear that India has remained disinclined to engage militarily in Afghanistan, exhibiting considerable strategic restraint. However, Delhi's bold and uncharacteristically proactive engagement with US-occupied Afghanistan does betray an exaggerated notion of its own capacity. Drifting away from its cautiously prudent moorings, the Indian government seized an opportunity, created by the Americans, to advance its regional agenda. Delhi envisioned an Afghanistan dependent, to some degree, on its markets and through which it might access the markets and resources of Central Asia, while

---

[29] John Foster, 'Afghanistan, the TAPI Pipeline, and Energy Geopolitics,' *The IAGS Journal of Energy Security* (23 March, 2010), see: http://www.ensec.org/index.php?option=com_content&view=article&id=233:afghanistan-the-tapi-pipeline-and-energy-geopolitics&catid=103:energysecurityissuecontent&Itemid=358

[30] Sandeep Dikshit, 'US Backs TAPI but Avoids Mention of IPI,' *The Hindu*, 21 July 2011.

[31] See: Press Trust of India, 'Afghanistan Seeks Indian Investment to Boost its Agri Sector,' *Business Standard*, 3 December 2010; See Asian Development Bank Data, http://www.adb.org/afghanistan/main.asp

[32] Pratap Bhanu Mehta, 'Still Under Nehru's Shadow? The Absence of Foreign Policy Frameworks in India,' *India Review* 8.3 (2009), p.230.

[33] *Ibid.*, p.230-231.

[34] Sunil Dasgupta and Stephen P. Cohen, 'Is India Ending its Strategic Restraint Doctrine?' *The Washington Quarterly* (Spring 2011), 163; See also, C. Raja Mohan, 'India and the Balance of Power,' *Foreign Affairs* 85.4 (July/August 2006).

containing Pakistan and cultivating India's status as a global force for stability.[35] In so doing, India amplified tensions between itself and Pakistan (significantly raising the odds of aggressive retaliation), entered voluntarily into the US-led alliance (by making its level of engagement dependent on the US-NATO 'security umbrella'[36]), formalised a 'strategic partnership' with Afghanistan[37], and committed to fostering a friendly government in Kabul.[38]

There are several justifiable reasons why Delhi may have picked this moment for a modest departure from the tenets of its cautious foreign policy. The threat of militant Islam had become intolerable, perceived Pakistani belligerence might be better contained, and energy scarcity necessitated access to Central Asian oil and natural gas reserves. But all of these justifications predated the US invasion of Afghanistan. What defined this particular moment was the concomitant convergence of certain Indian and US objectives in South-Central Asia with the ascendance of India's economic and political power in the region. Put simply, Washington sought stability for a region in which Delhi sought influence consistent with its rising profile.

One scholar has described this episode as 'a test case for a rising power', and it should be understood as exactly that.[39] The prism through which rising powers, and India in particular, have come to be perceived is one that juxtaposes global ambitions with regional constraints. Andrew Hurrell observed that Brazil, Russia, India, and China all illustrate the complexity of the 'regional-global nexus':

> In all four cases foreign policy is heavily shaped by the regional context – by evolving regional balances of power…by changing patterns of regional security (especially in the form of new categories of threat); and by increasingly dense patterns of social and economic regionalisation. Regions are also central to historic self-understandings. Both Russia and India see themselves as the natural leader of a closed region in which outside interference is deeply resented. And yet, on balance, it is the image of the region as constraint rather than as opportunity that emerges most strongly…[40]

Similar conceptualisations of the apparent inability to turn resources into outcomes have been articulated. David Baldwin's paradox of unrealised power describes 'the mistaken belief that power resources useful in one policy-contingency framework will be useful in a different

---

35 Harsh V. Pant, 'The Afghanistan Conflict: India's Changing Role,' *Middle East Quarterly* (Spring 2011), p.31.
36 C. Christine Fair, 'Under the Shrinking US Security Umbrella,' p.180.
37 Indian Ministry of External Affairs, 'Address by Prime Minister to the Joint Session of the Parliament of Afghanistan,' MEA Speeches and Statements, 13 May 2011, see: http://meaindia.nic.in/mystart.php?id=530117626.
38 Pant, 'India's Changing Role,' p.32.
39 Harsh V. Pant, 'India in Afghanistan: A Test Case for a Rising Power,' *Contemporary South Asia* 18.2 (2010), pp.133-153.
40 Andrew Hurrell, 'Hegemony, Liberalism, and Global Order: What Space for Would-be Great Powers?' *International Affairs* 82.1 (2006), p.8.

one.'[41] Moreover, Nitin Pai has asked how India will transcend its 'paradox of proximity', the predicament wherein 'India cannot escape its neighbourhood and that its great power ambitions will be constrained by instability in that neighbourhood.'[42]

Thus, in 2001, Afghanistan presented a multi-faceted challenge to India's foreign policy. As an internationalised arena of political conflict, Afghanistan epitomised the regional-global nexus: in the immediate neighbourhood, it remained inextricably linked to Pakistan, India's traditional regional stumbling block; from the extended neighbourhood it drew various players, in one way or another, notably China, Iran, and Russia; on the global stage, Afghanistan became central to the consciousness of the international community; and permeating all three levels, the US projected its influence as reluctant Pakistani ally and eminent global power.

While the US is now becoming less relevant to the future of South and Central Asia, in 2001 it was poised to play a pivotal role, and no less from Delhi's perspective. India had entered into America's economic and psychological orbit in a big way between the Soviet withdrawal from Afghanistan and the zenith of Taliban power in Kabul (first by opening its doors to American investment in 1991 and then by testing nuclear weapons in 1998[43]), and the US physically entered India's orbit when it invaded Afghanistan. Free from the Soviet gravitational pull, Delhi was no longer on a collision course with Washington. Rather, as the two democracies reconciled their political philosophies, certain mutual objectives began to align and coalesce around the 'war on terror' and the creation of a stable Afghanistan.

Riding a wave of economic growth and a surge in international popularity (buoyed by successful liberalisation reforms initiated in the 1990s), India saw the Afghanistan war as an opportunity to flex its economic muscles in an environment safeguarded by the American military, and to establish a place for itself in determining Afghanistan's future while undermining Pakistan's influence there.[44] Involvement in Afghanistan also looked to provide a means of harnessing international goodwill and raising India's profile as a peace-building global citizen. Its first foray into the reconstruction of US-occupied Afghanistan was adorned in signature Nehruvian rhetoric – emphasising inalienable sovereignty, a partnership of equals, the unity of cause and politics[45] – but now backed, it would seem, with the economic and political tools befitting a regional power.

However, faults in India's regional designs emerged early in its engagement with US-NATO-occupied Afghanistan. Deterred by the international community, by Pakistan's nuclear arsenal and proxy militias, by the fear of triggering an unconventional jihad closer to home,

---

41 David Baldwin, 'Power Analysis and World Politics: New Trends versus Old Tendencies,' *World Politics* 31.2 (1979), 164.
42 Pai, 'The Paradox of Proximity,' p.18.
43 Malone, *Does the Elephant Dance?* p.164-166.
44 Conversation with Harsh V. Pant, King's College, London, 19 March 2011.
45 See Indian Ministry of External Affairs, 'India and Afghanistan: A Development Partnership,' Public Diplomacy Division, Ministry of External Affairs, Government of India, http://meaindia.nic.in or http://meakabul.nic.in.

and by the dictates of domestic political pragmatism, Delhi could not join the coalition of nations engaged militarily in Afghanistan. In absentia, the Indian government found itself relegated to the periphery of the international debate surrounding Afghanistan, and, thus sidelined, spent the better part of a decade as a marginalised player (despite being the country's fifth largest bilateral donor). Few doubt the prudence of the decision to hold back troops. However, the reality is that Delhi's choices were limited by its inability to project power commensurate with its relative strength in the region. India has been labeled a 'premature power' for its incapacity to neutralise vulnerabilities inherent in the political divisions of the Indian subcontinent.[46] Its economic and political preponderance does not translate easily into leverage in the regional context, regardless of the security guarantees underwritten by US forces.

Following the US invasion of Afghanistan, India was presented with a challenge and an opportunity, a test, to which India responded by departing from its characteristically cautious foreign policy framework, exposing certain vulnerabilities, and ultimately failing to secure its interests. The following section will look at how India failed, how it has responded, and why it may now succeed in reversing its fortunes in Afghanistan.

Engineering a 'Durable Policy Architecture' [47]: 2009-Present

Commendable though it has been, the ambitious development programme initiated by India in Afghanistan after 2001 was not the product of grand strategy. Nor was it simply a kneejerk reaction. To adapt the Clausewitzian aphorism, development assistance is, to varying degrees, the continuation of politics by other means.[48] India's development programming was intended to achieve certain political objectives, which will inevitably be interpreted differently from different perspectives. But whether benign or otherwise, the assumptions undergirding the motives are plain: Delhi's Afghanistan policy in the early years of American occupation relied on the assumption that the US would impose upon Afghanistan and Pakistan a degree of stability adequate to allow India greater influence in regional affairs, and that would deliver certain economic and political dividends.[49] Under these circumstances, Delhi hoped to sustain a ground-level presence in Afghanistan (without fear of attack) and develop its people-to-people ties throughout the country, while courting the government in Kabul (ideally gaining access to Central Asian markets and energy reserves). At the very least, the Indian government could assist in creating a stable Afghanistan, free from Pakistani influence and open to trade.

---

46 Shyam Saran, 'Premature Power: India has to Leverage its Swing Status, Engage with all and Align with None,' *Business Standard*, 17 March 2010.

47 The term, 'durable policy architecture,' refers to M.K. Bhadrakumar's description of Delhi's search for a policy framework following the Soviet withdrawal from Afghanistan. See M.K. Bhadrakumar, 'Manmohan Singh Resets Afghan Policy,' *The Hindu*, 16 May 2011.

48 Variously translated, Carl von Clausewitz's famous aphorism holds that 'War is the continuation of politics by other means.' See: Carl Von Clausewitz, in Michael Howard and Peter Paret eds., *On War* (New Jersey: Princeton University Press, 1976), Book 1, Chapter 1, Section 24.

49 Pant, 'India in Afghanistan,' p.133; Conversation with Harsh V. Pant, 19 March 2011.

However, despite some impressive achievements in the development sphere (improving the lives of Afghans and garnering popular goodwill[50]) Indian engagement did not achieve durable strategic objectives. Delhi's calculations fell short on several fronts. The Taliban have not been pacified and Pakistan has descended further into chaos. Attacks on Indian projects, facilities, and personnel increased in size and frequency between 2002 and 2009.[51]

Not only were attacks on its projects and resources on the ground becoming routine, but India's efforts were never genuinely and actively encouraged by the US or coalition governments, which remained highly sensitive to Pakistan's real and imagined grievances.[52] Indian protestations surrounding the prospects of reconciling with the Taliban (maintaining that moderate Taliban did not exist) fell on deaf ears. This international rebuke was most pronounced at the London Conference on Afghanistan in January 2010, where the objections of Indian representatives were roundly ignored.[53] Although the successes of India's Afghan development programme were widely-acknowledged, no effort was made at the international level to consult the Indian government on Afghanistan or bring it into any meaningful decision-making processes.

Furthermore, Indian initiatives were not securing access to markets or significant resources. On the contrary, increased visibility contributed to making India's corporate ventures and development projects more vulnerable.[54] The TAPI pipeline, heralded for its potential to improve energy security and economic interdependence on the subcontinent, came to a virtual standstill. The India-Afghanistan Preferential Trade Agreement has been underutilised, trade between the two nations having to circumvent an obstructive Pakistan, which until recently refused to grant transit rights to trade goods across its borders (and even now insists that all goods must be unloaded at the border and transferred into Indian containers, stalling the export process significantly)**.**[55] India did succeed in ushering Afghanistan into the South Asian Association for Regional Cooperation (SAARC) in 2005, and this may yet prove to be one of the more important steps toward regional cooperation (the SAARC mechanisms could be instrumental in forging future frameworks for energy cooperation, for example[56]) but there have been few tangible yields from Afghanistan's incorporation by the regional body.

Finally, in April 2011, Pakistan's army chief, General Ashfaq Parvez Kayani, and Prime Minister Yusuf Raza Gilani, met with Afghan President Hamid Karzai in Kabul to formalise

---

50 Public opinion surveys have consistently found that India is viewed favourably by Afghans. See: Shubhajit Roy, 'With Thumbs Up from Afghans, India Explores more Areas of Aid,' *Indian Express*, 5 January 2010.

51 Heine and Ghosh, 'The Elephant in the War,' p.51.

52 Malone, *Does the Elephant Dance?* p.291.

53 Arvind Gupta, 'The London Conference: It is Time for India to Reassess its Afghan Policy,' IDSA Comment, *Institute for Defense Studies and Analyses* (1 February 2010).

54 Confidential conversation with Indian Ministry of External Affairs official, 8 April 2011.

55 Frederic, Grare, "Pakistan," in Ashley Tellis and Aroop Mukherjee (eds.) "Is a Regional Strategy Viable in Afghanistan?" *Carnegie Endowment for International Peace* (Washington: Carnegie Endowment, 2010), 21.

56 Shanthie Mariet D'Souza, "India, Afghanistan, and the 'End Game'?" *ISAS Working Paper No.124* (Singapore: ISAS at National University of Singapore, March 2011), p.7.

an agreement that would allow the Pakistani army a role in negotiating a reconciliation between Kabul and the Taliban (Washington has since backed up this commitment, confirming that any reconciliation process will involve Pakistan[57]). The Pakistani media hailed the agreement as a 'historic breakthrough' that could align the 'shared destinies' of Kabul and Islamabad.'[58] It appeared that India's fate had been sealed; Delhi had been unable to achieve the most fundamental of its strategic objectives – preventing Pakistan from exerting influence over Kabul.

Delhi could not justifiably keep to its chosen path in Afghanistan while such an approach manifestly failed to yield the political results initially envisioned by its policy makers. It is evident that Delhi began to internalise the barriers to its expanding physical presence in Afghanistan following the 2008 bombing of its embassy in Kabul and the murder of nine Indian civilians in an attack on a Kabul guesthouse in 2010.[59] The culmination of several of India's largest infrastructure projects in Afghanistan from 2009 onwards has provided India with an opportunity to scale-down its physical presence there without conceding defeat. Delhi insists this is not a direct response to the security vacuum anticipated when the US ends its combat role in 2014. Instead, Indian policy makers frame the shift in terms of seizing an opportune moment to redefine the country's Afghan strategy.[60] It is likely that a combination of factors, including the conditions of the rapprochement between Islamabad and Kabul, began to circumscribe India's position to the point that Delhi could no longer credibly defend its mode of engagement.[61]

Inherent to Delhi's mode of engagement, as discussed above, had been the notion that a friendly government and relative stability in Afghanistan would ultimately allow India to emerge as the purveyor of regional security. If confidence in such an outcome had diminished over the course of the decade, Karzai's overture to Islamabad confounded the notion beyond a doubt. India's strategic reformulation had to acknowledge Pakistan's centrality to the regional algebra: that Pakistan, for better or for worse, would remain a critical variable in the operations and relations between actors in the region, and the disputed porous border between Pakistan and Afghanistan would render durable peace contingent on Pakistani compliance. Rather than withdraw from its commitments to Kabul, the Indian government reaffirmed the development partnership and deepened its financial support to Afghanistan. An exchange of high-level visits between the two countries in 2011 indicates that India is moving towards an enhanced role in developing the full spectrum of Afghan capacity, from workforce to security force. The Indian Prime Minister committed to increasing development outlays, raising total bilateral assistance to US$2 billion, and emphasised India's focus on the social sector,

---

57 Anita Joshua, "Bid to Placate Pakistan on Afghanistan," *The Hindu*, 4 August 2011.

58 C. Raja Mohan, "Two Sides of the Durand Line," *Indian Express*, 19 April 2011.

59 Alissa J. Rubin, "Guesthouses Used by Foreigners in Kabul Hit in Deadly Attacks," *New York Times*, 26 February 2010; See also: Subhash Agrawal, "India's Role in Post-2011 Afghanistan: Can Canada and India Collaborate?" *Asia Pacific Foundation of Canada*, Canada-Asia Agenda, Issue 8 (28 April 2010), p.4.

60 Confidential conversation with Indian Ministry of External Affairs official, 8 April 2011.

61 In January 2011, Afghanistan designated Pakistan a formal facilitator in the process of reconciling with moderate Taliban. The two sides agreed on creating a joint commission for reaching out to Afghan Taliban. This represented an about-face in their bilateral ties. See: 'Pak gets "Facilitator" Role in Afghan Peace Talks with Taliban: Report,' *Indian Express*, 28 January 2011.

agriculture, capacity building, access to the Indian market, and continued investment in infrastructure. The two sides signed a Strategic Partnership agreement, extending to security, law enforcement, and justice, and India pledged to strengthen the capabilities of the Afghan security forces. Significantly, Singh expressed support for Kabul's decision to begin an Afghan-led process of negotiation and reconciliation with the Taliban. [62]

Unpacking India's commitment reveals a policy framework designed to adapt to changing circumstances. Setting aside very justifiable apprehensions, India has adjusted its posture to accommodate the flow of events. By deepening ties with the Afghan security sector and nurturing relations with Afghans on a local level (through increasingly localised development programming) Delhi is refashioning its dual or two-pronged approach towards Afghanistan. Indian policymakers appreciate that by simultaneously providing the Afghan government with what it needs to govern and the people with what they need to live, it has a greater chance of making itself indispensable to whatever situation emerges in Afghanistan. Placating the two spheres (the public and the political elite) improves the environment within which the Indian commercial sector can operate, allowing increased private-sector investment and another layer of influence.

Often referred to as strategy-less, India's approach to Afghanistan has evolved over the years and has experienced several setbacks, but it has nevertheless developed into a flexible strategic framework. Now, by courting Afghanistan's security establishment and introducing itself into the Afghan power equation, Delhi can afford to offer balancing concessions in the form of a nod towards an Afghan-led negotiation with the Taliban. On the surface, this shift appears counterintuitive: Indian policymakers know that reconciling with the Taliban essentially allows an indirect bargain with Pakistan, tacitly conferring to Pakistan's Inter-Services Intelligence (ISI, Pakistan's intelligence agency) a legitimate claim to space within which it can manoeuvre in a post-US-NATO Afghanistan.[63] Furthermore, it is very likely that Pakistan will use this leverage to undermine India's relationship with Kabul. However, India is taking steps to avert such an eventuality.

Making India less visible in Afghanistan, without reducing its influence, has become a priority for policy makers in Delhi.[64] While its larger infrastructure projects wind down, India has expanded its delivery of what one observer has called 'phantom aid', whereby money is channelled through the Afghan government to local communities.[65] These Small Development Projects (SDPs) ensure greater local ownership and participation and, according to the MEA (Ministry of External Affairs), none have been targeted by militants.[66] Programme oversight provided by consulates in Mazar-e-Sharif, Jalalabad, Kandahar, and

[62] See MEA Statements, 'Address by Prime Minister to the Joint Session of the Parliament of Afghanistan,' Ministry of External Affairs Website, 13 May 2011; and Teresita and Howard Schaffer, 'India and the US Moving Closer on Afghanistan,' *The Hindu*, 1 June 2011.

[63] Schaffer, 'India and the US Moving Closer on Afghanistan.'

[64] Confidential conversation with Indian Ministry of External Affairs official, 8 April 2011.

[65] Shanthie Mariet D'Souza, 'ISAS Working Paper 124: India, Afghanistan, and the "End Game"?' *ISAS* (Singapore: National University of Singapore, March 2011), p.10.

[66] Confidential conversation with Indian Ministry of External Affairs official, 8 April 2011.

Herat enables India to cultivate direct links with the communities involved, amongst predominantly Pashtun communities to which India has historically been sympathetic.

While there is little available information surrounding the nature of these interactions, consular activities are publicly construed as acts of espionage by Pakistan, which frequently accuses India of engaging in clandestine efforts to foment insurgency within its borders.[67] While there is little evidence to support these claims, Indian SDPs are highly concentrated in areas of Afghanistan bordering Pakistan's north-west, and a recent study has alluded to intelligence confirming that 'India's involvement in Afghanistan is not entirely benign.'[68] That Indian projects and consulates rouse Pakistani suspicions is expected. That India has been able to expand its network of SDPs and enhance localised programming efforts without eliciting a violent response speaks to the success of the hands-off approach and to the acquiescence of local Taliban.[69]

India has also indicated its openness to engaging in multi-sectoral trilateral projects with international partners.[70] The US has conveyed an interest in collaborating on certain projects and programmes.[71] Such projects could minimise operating costs by exploiting India's proximity to Afghanistan and utilising its relevant expertise (particularly in agriculture and communications technology) while allaying Pakistani suspicions with a third-party guarantee. In a move that will further discredit Pakistan's more excessive claims, the Indian government has pushed through plans to set up its own foreign aid agency, the Indian Agency for Partnership in Development, which will assume the development-oriented functions of the MEA and possibly alleviate political pressure and divert unreasonable criticism.[72] Policymakers have welcomed the move, claiming that the agency will not only make aid delivery more efficient, but it will make way for a cohesive aid strategy that can better incorporate and manage Indian interests.[73]

On the issue of security sector cooperation, Afghan Defence Minister, General Abdul Rahim Wardak, said in Delhi in June 2011, 'We will welcome any cooperation in the field of training and helping our national security forces to be able to defend their country', and added that military equipment supplies were also under discussion.[74] Wardak's Indian counterpart, A.K. Antony, confirmed India's commitment to building the capabilities of the Afghan National Security Forces (ANSF, composed of the Afghan National Army and

---

67 See Jayshree Bajoria, 'RAW: India's External Intelligence Agency,' *Backgrounder* (Washington: Council on Foreign Relations, 7 November 2008); 'RAW is Training 600 Baluchis in Afghanistan: Mushahid Hussein,' Boloji.com, 14 May 2006 (http://www.boloji.com/index.cfm?md=Content&sd=Articles&ArticleID=2503).

68 C. Christine Fair, 'Under the Shrinking US Security Umbrella,' p.184.

69 See: 'Taliban Say they can : "Reconcile" with India,' *The Times of India*, 26 March 2010.

70 Daniel Norfolk, 'Why India Matters in Afghanistan,' *Pragati*, June 2011, p.14.

71 See: White House document, 'The US-India Partnership: The Fact Sheets,' White House website, November 2010 (http://www.whitehouse.gov/the-press-office/2010/11/08/us-india-partnership-fact-sheets).

72 Jayanth Jacob, 'India Setting up Foreign Aid Agency,' *The Hindustan Times*, 17 July 2011.

73 Nishika Patel, 'India to Create Central Foreign Aid Agency,' *The Guardian*, 28 July 2011.

74 See Article: 'India to Help Strengthen Afghan Security Forces,' *Defence News*, 3 June 2011 (http://www.defencenews.in/defence-news-internal.asp?get=new&id=510); or 'India to Help Strengthen Afghan Security Forces,' *Daily Outlook Afghanistan*, 2 June 2011.

Police, ANA and ANP respectively).[75] According to leaked correspondence from the US embassy in Delhi,

> Currently, the GOI [Government of India] trains approximately 100 ANA members annually in India, and would like to step up this programme. India has offered its Advanced Light Helicopter to Afghanistan as well as pilot training to the new Afghan air force. The GOI has provided cars and trucks to the Afghan military. Officials tell us they have discussed with Afghan officials the possibility of training Afghan police women and bomb disposal specialists, but no large-scale training has yet taken place.[76]

India now has an entrenched relationship with the Afghan security forces and has bolstered its assistance to the ANP. By nurturing this relationship, Delhi's ties extend beyond the strictly political to institutions that will likely outlast the present Afghan government.

At the political level, Delhi is bracing itself for an uncertain future. Offering unwavering support to President Karzai's regime, Delhi has endorsed the Taliban reconciliation programme – a presidential initiative that inevitably, and paradoxically, compromises the president's power and, counter intuitively, cedes space for Pakistani influence. Yet this represents a realistic assessment. Negotiations with the Taliban will proceed, however intermittently, with or without Delhi's approval; an obstructive posture would alienate India from the mainstream and secure no dividends. A conciliatory approach brings forth the durable policy architecture adopted by Delhi following Soviet withdrawal from Afghanistan in 1989 (when then-Prime Minister Rao committed to dealing with whoever rose to power in Kabul) and allows India the flexibility it needs to engage Afghanistan in the future. As M.K. Bhadrakumar explains,

> This brings us to a template that is going to be very crucial. The [Indian] government has done extraordinarily well in doing all that is possible to dispel the cloud of suspicion in the Pakistani mind about India's intentions in Afghanistan – that our two countries needn't be locked in a zero-sum game…Of course, Pakistan would have lingering suspicions; and India's security worries, too, are profound. And it is going to be a long way down the line before India and Pakistan can actually think of cooperating in the stabilisation of Afghanistan. But the incremental removal of the 'Afghan contradiction' from the cauldron of India-Pakistan differences…will make a little bit lighter the burden of working out an enduring Afghan settlement.[77]

In this sense, India appears to be heeding the call of its foreign policy analysts; 'Counter-intuitive as this seems to some Indians, given the country's frequent victimisation by cross-border terrorism,' writes David M. Malone, 'it makes sense that India should do all in its

---

[75] See: Special Correspondent, 'India Committed to Building the Capabilities of Afghan Security Forces,' *The Hindu*, 2 June 2011.

[76] Leaked document quoted in article, see: '2010: The Growing US-India Defence Ties,' *The Dawn*, 24 May 2011(http://www.dawn.com/2011/05/24/2010-the-growing-us-india-defence-ties.html).

[77] M.K. Bhadrakumar, 'Manmohan Singh Resets Afghan Policy,' *The Hindu*, 16 May 2011.

power to avoid aggravating Pakistan's torment, and that it should, whenever circumstances allow, reach out.'[78]

As its politicians craft an increasingly flexible strategy, the Indian commercial sector, too, is developing a creative approach to Afghanistan. In an unprecedented move, the Steel Authority of India Limited (SAIL) announced in July 2011 that it would bring together six Indian steel companies to form a consortium designed to acquire Afghanistan's Hajigak iron ore deposits.[79] The consortium's successful bid for four of the five Hajigak blocks was announced in November 2011.[80] The announcement came one month after India revealed plans to construct 900km of railway track, connecting the Hajigak region of Afghanistan with the India-financed Chabahar port in Iran.[81]

Public-Private Partnerships (PPPs) have become popular in India, but the SAIL initiative is a rare instance of an Indian PPP bidding for a foreign raw material asset. The impetus behind the consortium, a first in India and impressive given the companies' traditional rivalry, was twofold: first, the disparate bids of 15 independent and state-run Indian companies could not compete with the global giants (such as the China Metallurgical Group, currently developing Afghanistan's Aynak copper mine); second, there is strength in numbers, the consortium will be better placed to defend its assets. One steel company spokesperson expressed an interest in partnering with an American or European firm to exploit the presence of US-NATO forces (an idea that parallels the trilateral development proposition mentioned above[82]). Opportunities for collaboration in security and transportation could be explored with the Canadian company that acquired the single remaining Hajigak concession.

There are evidently geopolitical considerations behind the Indian government's decision to back the bid, which will allow India a greater role in Afghanistan's transformation. The 1.8 billion tonne Hajigak iron ore mines lie in central Afghanistan's Bamiyan province, once a nodal point along the ancient Silk Route. Today, plans are emerging for an international effort to develop Bamiyan province into a thriving industrial center, reintegrating Afghanistan into the global market.[83] This is part of a larger effort to re-establish Afghanistan's traditional role as a trade and transport hub, linking Europe and the Middle East with the Indian sub-continent and South-east Asia.[84] A future thus envisioned largely depends on the actions and interactions of Afghanistan's neighbours. In this respect, Afghanistan should be understood as a test case for regional cooperation. As India refashions

78 Malone, *Does the Elephant Dance? p.*112.
79 Rajesh Roy and R Jai Krishna, 'Indian Consortium to Bid for Afghanistan Deposits,' *Wall Street Journal,* 26 July 2011.
80 Dion Nissenbaum, 'India Wins Bid for "Jewel" of Afghan Ore Deposits,' *Wall Street Journal,* 30 November 2011.
81 Jayanth Jacob and Saubhadra Chatterji, 'India's Track 3: Afghan-Iran Rail Link,' *Hindustan Times,* 1 November 2011.
82 Sambit Saha, 'Steel Alliance for Afghan Mine,' *The Telegraph (Calcutta),* 6 June 2011.
83 Prince Matthews Thomas and Cuckoo Paul, 'India's Iron Ore Play in Afghanistan,' *Forbes India,* May 2011 (see: http://www.forbes.com/2011/05/10/forbes-india-ore-play-in-afghanistan.html).
84 Andrew C. Kuchins, 'A Truly Regional Economic Strategy for Afghanistan,' *The Washington Quarterly,* Spring 2011, p.77.

its Afghan strategy, and the significance of the US and Pakistan begin to diminish, the emerging test will involve searching for a hitherto elusive regional consensus.

Think Regional, Act Regional: The Way Forward

As described above, India's engagement with Afghanistan in 2001 was driven by the convergence of its enhanced capacity and the opportunity to circumvent Pakistan by way of the American security umbrella. Other regional players were undoubtedly a consideration, but Pakistan and the US were essential to rising-India's keen agenda in Afghanistan – these were the crucial variables at the core of the Afghan 'test case'. Over time it became clear that the US did not have the appetite or the means for stabilising 'Af-Pak' and Pakistan remained an obdurate central feature in Afghanistan, requiring Delhi to develop an accommodative posture.

US withdrawal from volatile Afghanistan, leaving Pakistan and its desperately aid-dependent military vulnerable, recalls the attendant circumstances of the Soviet retreat in 1989. Now, as Delhi reflects on its position, it has recourse to policy markers established fleetingly during that chaotic period two decades earlier. While it appears that Delhi is incorporating these flexible parameters into a strategic framework, there is an important distinction between India's position then and now. In the intervening years, India acquired an enormous amount of economic, political, and social capital. These were the assets that encouraged India's active involvement in Afghanistan after 2001, and these are the assets that will bolster its engagement today. With receding US influence and a stalemate with Pakistan, Delhi needs to redeploy these resources to leverage its neighbours and work towards building a regional consensus.

Discussing Indian foreign policy, Raja Mohan has evoked the image of three concentric circles encompassing, respectively, the immediate neighbourhood, in which India seeks primacy; the extended neighbourhood (reaching across Asia and the Indian Ocean littoral), in which India seeks to balance; and the international arena, in which India seeks status.[85] Regarding Afghanistan at the present juncture, the flexibility and strategic potential of Delhi's policy options are arguably greatest at the intermediate level, where relations with regional players are uncertain but the need to constructively engage is plain.

Relations are uncertain to the extent that the political will necessary to craft a regional approach to Afghanistan is lacking. It is understood that a critical step towards creating an environment conducive to Afghanistan's reconstruction involves the reduction of divergence and competition in regional strategies.[86] Yet, most believe that the 'wider forms of regional cooperation that are in principle desirable to foster stability and development in

[85] See C. Raja Mohan, 'India and the Balance of Powers,' *Foreign Affairs* 85.4 (July/August 2006).

[86] Ashley J. Tellis, 'Creating New Facts on the Ground: Why the Diplomatic Surge Cannot Yet Produce a Regional Solution in Afghanistan,' *Carnegie Endowment for International Peace* (Policy Brief #91), May 2011.

Afghanistan…will in practice be unattainable.'[87] Although competing national interests cannot be easily reconciled, it is certainly possible for incremental efforts to consolidate those interests that do overlap. India is well-placed to encourage such a process. Despite the deviating interests of other key players in the region (China, Russia, Iran, the Central Asian Republics, and Saudi Arabia) and the US, India's interests and policies broadly converge with most involved (with the obvious exception of Pakistan).[88]

Given the divergent strategies of other relevant actors and the limited resources available to the MEA, Delhi cannot facilitate a grand bargain. However, India has already taken a lead by actively promoting the economic integration of Afghanistan and South Asia, and similar efforts should build on this approach. There is a relatively broad consensus amongst development scholars and practitioners that the only viable long-term path to rebuilding and reintegrating Afghanistan is by reviving its historic function as a continental cross-road.[89] India, which has been instrumental in building transit routes within Afghanistan, can be at the forefront of international and regional efforts to this end.

India's unique position has been summed up by Afghanistan's Minister for Mines, Wahidullah Shahrani, in an interview with *Business Standard*:

> India is in a very advantageous position. Besides the traditional and historical linkages between the two countries and their strategic relationship, India has become the fourth largest economy in the world and, by 2030, India will become the world's largest consumer of commodities. After Hajigak, in July this year, I will put five major projects on tender: Three copper and two gold deposits in different parts of the country and, in February 2012, I will put a huge oil basin in the northern city of Mazar-e-Sharif on tender. In addition, we are having good negotiations with Indian companies for developing chromite deposits. The economic advantage of most of Afghanistan's deposits is that they are open-pit deposits, and commercially very viable. Plus the potential of cement. We are a post-conflict country, which is expecting to consume about 6.5 million tonnes of cement annually. India is the world's third largest producer of cement and we have been negotiating with a number of Indian companies for investment in this very important sector.[90]

India's domestic demand for raw materials has the potential to drive growth in Afghanistan, but its industrial investments will also need outlets outside India, which in turn requires cooperative regional partners. India has indicated its support for a suitable forum to bring together the major regional stakeholders in Afghanistan.[91] However, periodic attempts to

[87] Jessica T. Matthews, 'Introduction,' *Through Their Eyes: Possibilities for a Regional Approach to Afghanistan* (Washington: Carnegie Endowment for International Peace, 2010), p.4.

[88] Guatam Mukhopadhaya, 'India,' *Through Their Eyes: Possibilities for a Regional Approach to Afghanistan* (Washington: Carnegie Endowment for International Peace, 2010), p.33.

[89] See: Kuchins, 'A Truly Regional Economic Strategy for Afghanistan.'

[90] Ajai Shukla, 'Q&A with Wahidulla Shahrani, Minister for Mines, Afghanistan,' *Business Standard*, 12 June 2011.

[91] Guatam Mukhopadhaya, 'India,' p.31.

structure a formal regional approach, through such avenues as the Regional Economic Cooperation Conference and the Istanbul Conference, have not yielded concrete results.[92] Beyond the scope of ad hoc initiatives, a move towards more institutionalised mechanisms for regional cooperation might prove successful.

High on the agenda at the 10th summit of the Shanghai Cooperation Organisation (SCO) in June 2011 was the issue of expanding the six-nation regional body, which has been dominated by China and Russia for a decade. India and Pakistan currently hold observer status at the SCO, and both are being considered for full admission. There are also plans to upgrade Afghanistan's status from SCO invitee to observer.[93] The traumatic experience of the Soviet war in Afghanistan makes Russia and the Central Asian states reluctant to engage in security-related activities there.[94] Nevertheless, the SCO is in a position to play an important role in the stabilisation, reconstruction, and reintegration of Afghanistan after 2014. According to Kazakhstan President Nursultan Nazarbayev, whose country held the rotating chairmanship until July 2011, 'We cannot rule out that the SCO may have to bear the brunt of resolving many problems that Afghanistan will face after the withdrawal of the international coalition forces in 2014.'[95]

India's reservations concerning US withdrawal from Afghanistan have been rendered irrelevant by events on the ground – the incremental drawdown of American and coalition troops has commenced. The SCO offers a promising avenue by which India can offset some of its anxiety surrounding the possibility of a security vacuum, and can work to achieve several of the objectives that remained elusive throughout its engagement with US-NATO-occupied Afghanistan. By entering into an association led by China, India will be addressing a wider and more acute strategic priority – managing relations with its larger, more powerful neighbour – but it may also enable Delhi to pressure Pakistan into cooperating in Afghanistan (Beijing's considerable leverage over Islamabad would be instrumental here, particularly given that China's own 'jihadist challenge' is on the rise and increasingly linked to Pakistan[96]). Increased cooperation with the SCO will also improve India's access to Central Asian energy reserves and markets. Here again, the members and mechanisms of the SCO can discourage Pakistani recalcitrance.

Uniquely, Delhi acknowledges the centrality of Iran to the regional security equation, and openly encourages greater engagement with Iran on issues pertaining to Afghanistan. Indian Foreign Secretary, Ranjan Mathai, recently called on the international community to 'add Iran to the list of countries needing to be discussed' when looking at 'the prospects for stability in Asia in connection with Afghanistan.'[97] Despite their troubled trade relations (and

---

[92] Arvind Gupta and Smruti Patnaik, 'Istanbul Conference on Afghanistan: A Feeble Attempt at a Regional Solution,' *IDSA Comment* (New Delhi: Institute for Defence and Security Analyses), 4 November 2011.

[93] Sandeep Dikshit, 'Plan to Upgrade Afghanistan in SCO of Interest to India,' *The Hindu*, 14 June 2011.

[94] Vladimir Radyuhin, 'SCO: 10 Years of Evolution and Impact,' *The Hindu*, 14 June 2011.

[95] *Ibid.*

[96] Praveen Swami, 'Beijing's Increasing Jihadist Challenge,' *The Hindu*, 4 August, 2011.

[97] Ranjan Mathai, 'Forging Stability in Asia: Keynote Address at MEA-IISS-IDSA Dialogue' (New Delhi: Institute for Defence and Security Analyses) 21 November 2011.

Washington's opposition), India has recently extended an overture to Iran concerning Afghanistan, and Delhi and Tehran are now engaged in structured consultations on the issue.[98] To be sure, India realises the need to incorporate actors that share its anxiety over a resurgent Taliban. But in so doing, Delhi is demonstrating its commitment to regional cooperation on Afghanistan (to the detriment of its relations with the US), and endorsing a regional project that involves all stakeholders.

The trajectory of India's current Afghan strategy requires that it engage with its regional counterparts. It is unlikely that India has the capacity to persuade neighbouring states to rally around a broad political agenda.[99] However, regional actors agree that alignment over Afghanistan is necessary. India's historical linkages and increasingly dynamic engagement with Afghanistan will be instrumental in coordinating a regional approach.

Conclusion

But sound foreign policy, as the history of 20th century politics demonstrates, is as much a matter of sound historical judgment and a subtle negotiation with the realities of power as it is a question of raw capabilities. It may turn out that India's caution will serve it better than the recklessness that comes with illusions of power.[100]

The contemporary history of India's engagement with Afghanistan substantiates Pratap Bhanu Mehta's prognosis. Although India's approach to Afghanistan could never be called reckless, the preceding discussion has demonstrated that a departure from traditionally restrained policies occurred in Delhi following the American invasion of Afghanistan in 2001. This policy shift came at the apogee of sustained economic growth and reflected, in part, a misconceived interpretation of Indian geopolitical capacity. India's illusion was not of power itself, but of the ability to translate power resources from one context to another.

Delhi is now developing a flexible policy framework in Afghanistan that accords with its strategic regional interests and reflects a reassessment of its geopolitical limitations. Politically, India is preparing to engage with any formulation of government in Afghanistan. Delhi has entrenched relations with the Afghan security forces, and indicated a willingness to enhance cooperation in this sector. On the development front, India is substituting its high visibility projects for a hands-off approach, while maintaining a wide-spread network of localised assistance and capacity-building initiatives. By deepening its ties with both the population and the political elite, India will increasingly make itself indispensable to whatever situation emerges in Afghanistan. Furthermore, nurturing these relations allows India to better pursue its commercial and energy interests in Afghanistan and Central Asia.

---

98 Harsh V. Pant, 'India's Relations with Iran: Much Ado About Nothing,' *The Washington Quarterly* (Winter 2011), p.65.

99 On cooperative hegemony, see: Thomas Pedersen, 'Cooperative Hegemony: Power, Ideas, and Institutions in Regional Integration,' *Review of International Studies* 28 (2002), p.689.

100 Mehta, 'Still Under Nehru's Shadow,' p.232.

Looking forward, India's strategy in Afghanistan increasingly relies on a conciliatory regional environment. As international forces withdraw from Afghanistan, India is positioned to be at the forefront of a regional approach to the reconstruction of Afghanistan. Moreover, the broad convergence of Indian interests in Afghanistan with those of other key regional actors provides occasion for India to apprehend its region as opportunity, rather than constraint.

.....