BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia[a]

The global economy is fragmenting along geopolitical lines. South Asian economies have limited exposure to geopolitical shocks as they are among the quarter of EMDEs that are least open to global trade and investment. However, their lack of openness is not only protective. It also limits their ability to take advantage of the reshaping of global supply chains and trade. Although South Asian countries maintain fairly diverse trade and investment ties, they would benefit from further opening to global trade and investment, improvements in infrastructure and logistics, and greater institutional effectiveness. Cultivating diversified trading partners and creditors across the geopolitical spectrum could help South Asian countries mitigate vulnerabilities in a more open and dynamic economy.

Introduction

The global economy is fragmenting along geopolitical lines, a process that has been dubbed "geoeconomic fragmentation." Over the past decade, the share of trade and foreign direct investment (FDI) between countries with similar geopolitical stances has been growing (Gopinath et al. 2024; IMF 2023a). This process has been accompanied by rising restrictions on international trade and financial transactions between both blocs (IMF 2023a).

Geopolitical concerns are creating incentives for firms to reorganize and diversify their supply chains by investing in a wider range of emerging market and developing economies (EMDEs). This strategy has been called a "lengthening" of existing supply chains and a "China-Plus-One" strategy (Freund et al. 2023; Qiu, Shin, and Zhang 2023; Seong et al. 2023). For some countries, the reshaping of global value chains presents a window of opportunity to engage with countries across the spectrum of geopolitical views (Aiyar and Ohnsorge 2024; Cerdeiro et al. 2024; Gopinath et al. 2024). Some South Asian countries, too, aspire to integrate into global value chains and bridge geopolitical blocs, building on their long history of being geopolitically non-aligned (Dinkel 2016; Reuters 2024).

Questions. This box examines the implications of geoeconomic fragmentation for South Asia. Specifically, it addresses two questions.

- How vulnerable is South Asia to geopolitical risks?
- Which policies could help South Asia thrive amid shifts in global supply chains and trade?

Contribution. This box adds to the existing literature in two ways. First, it provides a systematic empirical assessment of the implications of geoeconomic fragmentation for South Asia. Earlier research has largely focused on global trends and patterns (Aiyar, Malacrino, and Presbitero 2024; Aiyar and Ohnsorge 2024; Gopinath et al. 2024; IMF 2023b) or the effectiveness of country-specific trade policies (Alfaro and Chor 2023; Fajgelbaum et al. 2024; Freund et al. 2023). Second, this box elaborates on policies that could help South Asia leverage opportunities created by shifts in global supply chains and trade.

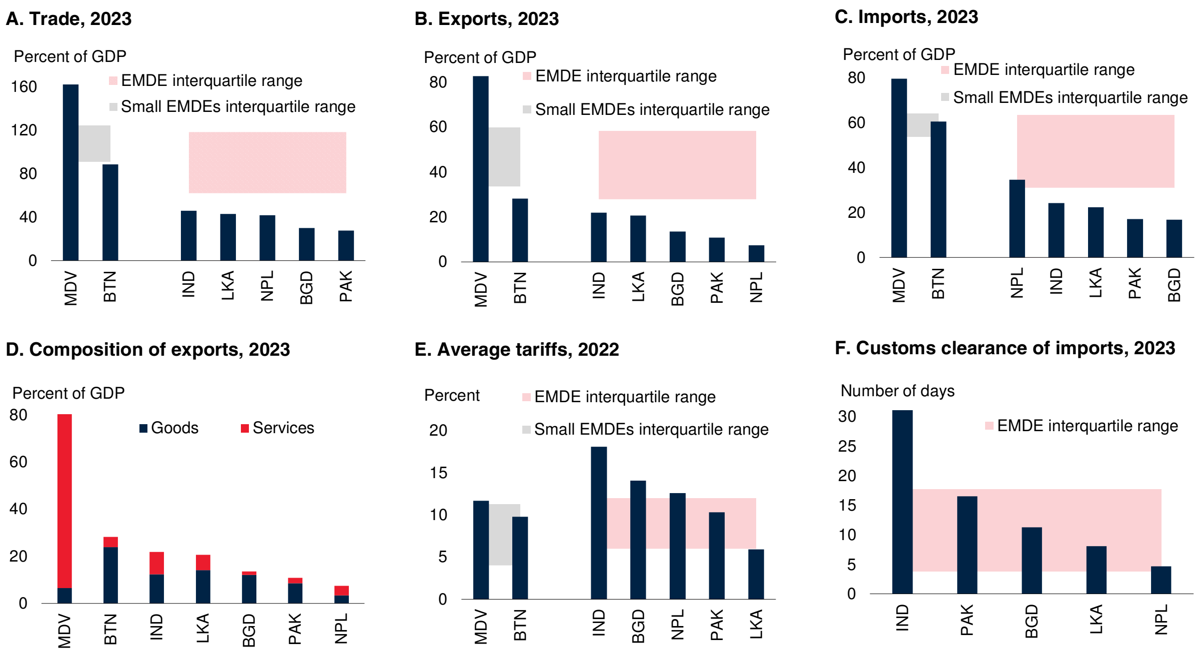
Methodology. Geopolitical distance is a concept that is difficult to measure. Here, in line with the existing literature, the geopolitical distance between two countries is measured using UN voting patterns (Bailey, Strezhnev, and Voeten 2017). This box defines an economy's *geoeconomic vulnerability* as the trade- or liability-weighted average geopolitical distance to its trading partners or creditors. A country or region is more vulnerable if it interacts with geopolitically more distant partners. The index is scaled by trade-to-GDP or by liabilities-to-GDP to account for the fact that less open economies are less vulnerable to all external shocks, including geopolitical ones. By construction, this measure of geoeconomic vulnerability cannot capture future cross-border interactions that have not yet emerged. Nor can it capture the vulnerabilities inherent in rare cross-border interactions such as debt relief negotiations. And it is constrained by the availability of bilateral data and therefore cannot capture important other cross-border transactions such as tourism exports or remittances. In addition to geoeconomic vulnerability, this box examines the diversity of South Asia's economic partners across the geopolitical spectrum. This is captured in the *geopolitical connectedness* index, defined as the trade- or liability-weighted standard deviation of geopolitical distance from trading partners and creditors (Aiyar and Ohnsorge 2024). The focus in this box is on foreign exchange-generating activities, that is exports and financial liabilities.

[a] This box was prepared by Hagen Kruse and Xiao'ou Zhu.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.1 South Asia's openness to global trade

South Asian countries are among the least open to global trade. In part, this reflects higher tariffs and more cumbersome customs procedures than in other EMDEs.



Sources: Aiyar and Ohnsorge (2024); World Development Indicators (database); WTO World Tariff Profiles (database); World Bank.
Note: Red shades denote interquartile ranges for other EMDEs. Gray shades denote interquartile ranges for other small states. BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan.
A. Trade is defined as the sum of goods and services exports and imports. Maldives uses 2022 data. Other EMDEs comprise 72 economies, and other small states comprise 13 economies (as defined in World Bank 2024l).
B.-D. Sub-components of overall trade in GDP by sector or trade flow. Same coverage and aggregation as in A.
E. Simple average of the ad valorem most favored nation duties applied in 2022. Sample comprises 120 other EMDEs, of which 25 are small states.
F. Other EMDEs comprise 68 economies between 2017 and 2023. Sri Lanka uses 2011 data. Nepal uses 2023 data. Bangladesh, Pakistan, and India use 2022 data.

Findings. This box presents several new findings.

- South Asia is more insulated from global shocks, including geopolitical ones, than most other EMDEs because most South Asian economies are less open to global trade and investment.
- Since 2016, the year before trade-restricting measures began to be more widely used globally, most South Asian countries have aligned their geopolitical stance more closely with their major export markets and creditors. This has helped lower their geoeconomic vulnerabilities.
- Although South Asia trades with and receives investment from an unusually diverse set of partner countries, its overall lack of openness limits its ability to take advantage of the foreign investment and export market opportunities that result from shifting global supply chains. To better seize such opportunities, South Asian economies may need to open further to global trade and investment, including by lowering import tariffs, easing restrictions on FDI, improving infrastructure and logistics, and deepening financial markets. Joining a wide range of different trade agreements can help maintain a diverse set of trading partners and creditors and mitigate vulnerabilities to external shocks.

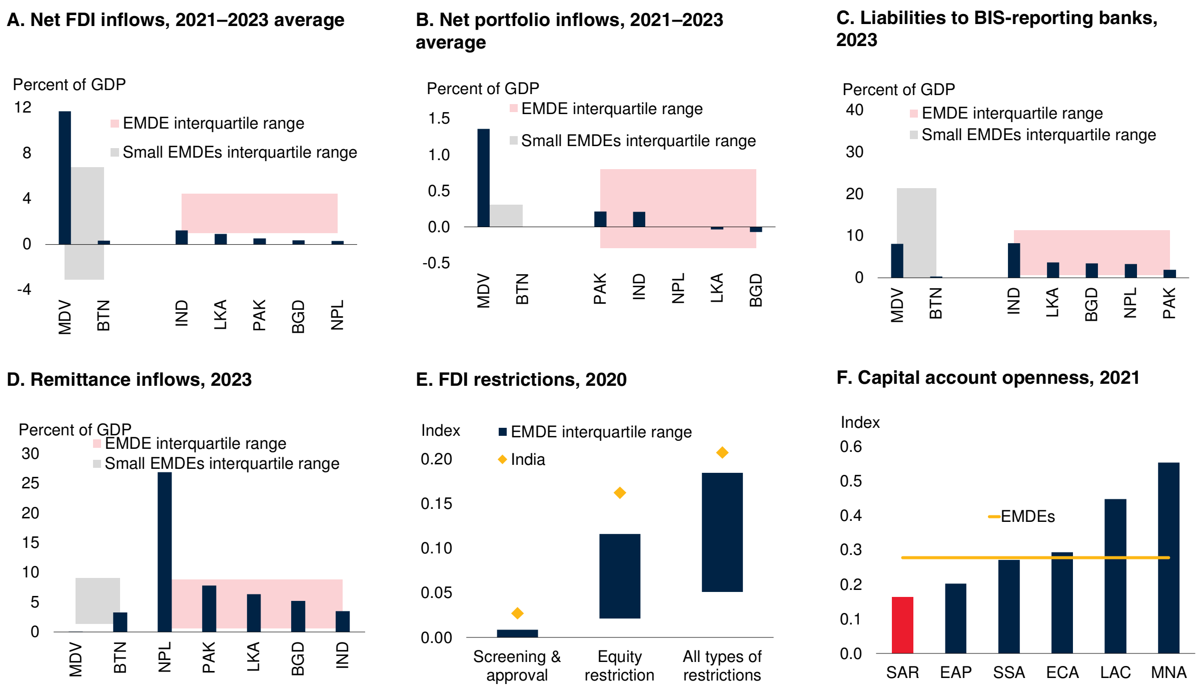
Geoeconomic fragmentation: Implications for South Asia

Nearly all South Asian economies are among the quarter of least open EMDEs to global trade and investment,

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.2 South Asia's openness to global investments

South Asian countries are among the least open to global finance, except for remittance inflows.



Sources: Aiyar and Ohnsorge (2024); IMF Balance of Payments and International Investment Position Statistics (database); OECD Foreign Direct Investment Regulatory Restrictiveness Index (database); World Bank Enterprise Survey (database); World Development Indicators (database); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Other EMDEs exclude China.

A.-D. Red shades denote interquartile ranges for other EMDEs, comprising 67 economies (A), 64 economies (B), 174 economies (C), and 169 economies (D). Gray shades denote interquartile ranges for small state EMDEs (as defined by World Bank 2024l), comprising 8 economies (A), 7 economies (B), 29 economies (C), and 28 economies (D).

C. Bank liabilities refer to stock data.

D. Maldives' share is 0.1 percent and data for Bhutan are for 2022.

E. Latest data are for 2020. Sample comprises 50 EMDEs. India is the only South Asian country covered.

F. Chinn-Ito index of capital account openness. Unweighted averages for each region. Latest available data are for 2021.

which limits their vulnerabilities to external shocks, including geopolitical ones (figures B1.1.1, B1.1.2). Since 2016, South Asia's geoeconomic vulnerabilities have mostly fallen further.

Lack of openness

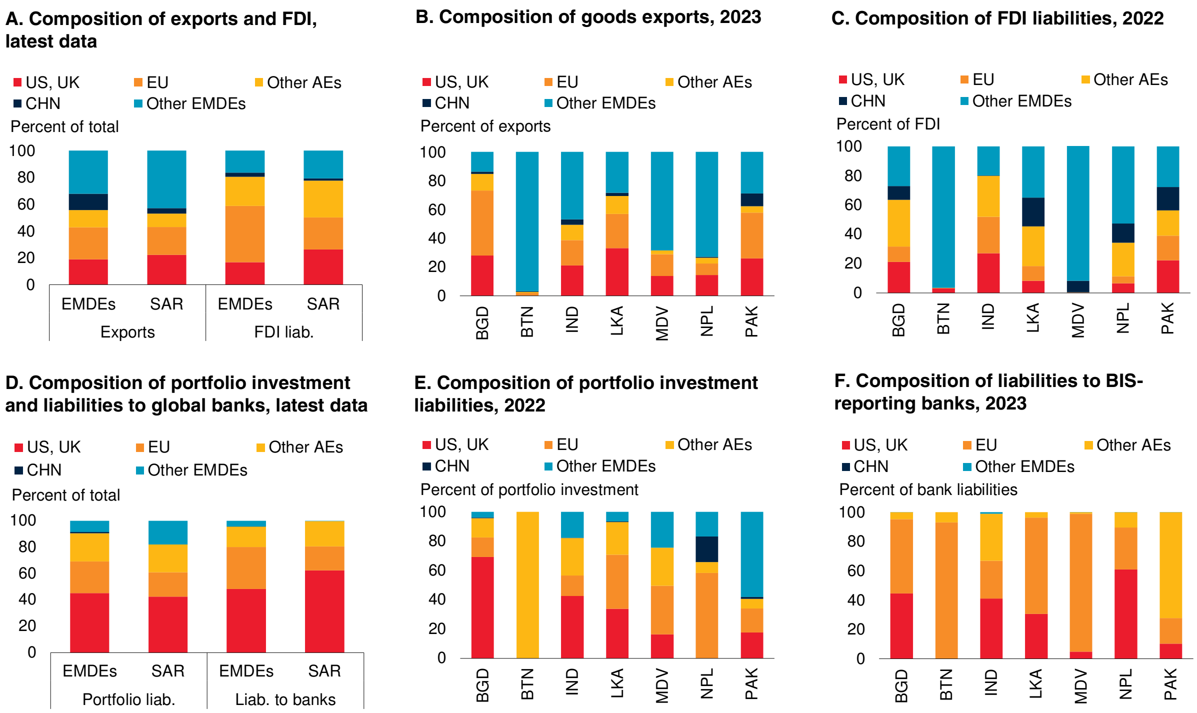
Openness. South Asian economies' lack of openness to global trade and investment limits their vulnerability to all global shocks, including geopolitical ones. All South Asian economies except Maldives are among the least open EMDEs to global trade, FDI, and lending from global banks and have limited portfolio investment liabilities. The only dimension in which South Asia is more open than other EMDEs is in remittance inflows (spotlight 2). In part, this has reflected explicit or implicit policy decisions, such as South Asia's above-average FDI-restrictions, capital controls, tariffs, and customs delays.

Composition of external partner countries. Similar to most EMDEs, South Asia's main export markets and creditors are advanced economies. Unlike most EMDEs, however, South Asia lacks an export market and source of FDI in China and the European Union. Instead, South Asia exports more to EMDEs other than China and receives more FDI from the United States and the United Kingdom (figure B1.1.3). That said, there is wide heterogeneity across South Asian countries.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.3 Composition of South Asia's exports and liabilities

Similar to other EMDEs, South Asia's main export markets and largest investors are the United States and European countries, although with some cross-country variation. China, meanwhile, is a less important export market or source of FDI than for other EMDEs. Less portfolio investment and less bank lending to South Asia originates in Europe than for other EMDEs.



Source: Aiyar and Ohnsorge (2024); World Bank.

Note: AEs = advanced economies; BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; FDI = foreign direct investment; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan; SAR = South Asia. FDI, portfolio investment and bank liabilities all refer to stock data. China, Denmark, France, Netherlands, New Zealand, United Kingdom, and United States include their special administrative regions and overseas territories. Data are for 155 EMDEs.

A. Data are from 2023 for exports and from 2022 for FDI.

C. Only positive FDI stock data are considered.

D. Data are from 2022 for portfolio investment liabilities and from 2023 for liabilities to BIS-reporting banks.

E. Bhutan refers to 2020 data.

D.F. BIS-reporting banks do not include banks from mainland China and most EMDEs.

- ***Exports***. Bhutan, Maldives, and Nepal ship particularly large shares of their exports to other EMDEs, including India, and Bangladesh and Pakistan to Europe.

- ***FDI***. Sri Lanka and Pakistan receive above-average shares of FDI from China; Bhutan and Nepal from India; India from Mauritius; and Maldives from Thailand and Mauritius.

- ***Portfolio investment***. Nepal stands out for receiving negligible portfolio investment from the United States but sizable investment from China; a large share of Pakistan's portfolio investment is from other EMDEs (such as Saudi Arabia).

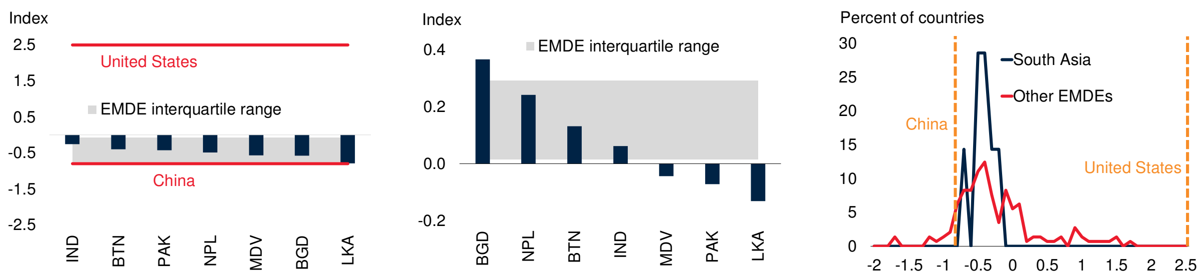
Geopolitical stance. Traditionally, the UN voting patterns of most EMDEs, including those in South Asia, have aligned more closely with China than with the United States (figure B1.1.4). Since 2016, however, most South Asian countries' voting patterns have moved closer to those of the United States—again, similar to most EMDEs. Maldives, Pakistan, and especially Sri Lanka were exceptions, consistent with evidence of geopolitical flexibility among countries with limited financial capacity (Brazys and Panke 2017).

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.4 South Asia's geopolitical stance

Like most EMDEs, South Asia's UN voting aligns more closely with China than with the United States, although most South Asian countries have moved closer to the United States since 2016.

A. South Asia's UN voting patterns, 2023 **B. Change in South Asia's UN voting patterns, 2016-23** **C. Distribution of geopolitical stances, 2023**



Sources: Aiyar and Ohnsorge (2024); Bailey, Strezhnev and Voeten (2017); World Bank.
Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Figures are based on the ideal point index of country voting patterns in the UN General Assembly. The index ranges from -2.5 to +2.5 points. Gray shades indicate the interquartile range of other EMDEs, including 137 economies.

Vulnerability to geoeconomic risks

Limited vulnerability. The vulnerability of most South Asian countries' exports to geopolitical disruptions is comparable to that of other EMDEs (figure B1.1.5). Nepal, Bhutan, and Maldives are the exceptions, ranking among the least vulnerable EMDEs. Nepal and Maldives are less vulnerable because of their low goods export openness, and all three predominantly rely on geopolitically close export markets, such as India and Thailand. For most South Asian countries, FDI has limited vulnerability to geopolitical shocks, largely because of their exceptionally low FDI inflows. Most countries in South Asia are in the least vulnerable quartile of EMDEs for exports and FDI, and in the less vulnerable half of EMDEs for portfolio investment.

Mostly falling vulnerabilities since 2016. Geoeconomic vulnerabilities in South Asia have fallen more than in other EMDEs since 2016, the year before trade- and investment-restricting measures began to be used more widely around the world. However, there was considerable heterogeneity around this average. Geoeconomic vulnerabilities can change either because of changing geopolitical stances or because cross-border transactions change over time. In South Asia, these factors have sometimes offset each other, and sometimes worked in the same direction.

- ***Bangladesh.*** Bangladesh's geopolitical pivot toward advanced economies—the most pronounced among South Asian countries—aligned it more closely with its main source of foreign exchange inflows, exports, FDI and portfolio investment. As a result, the geoeconomic vulnerability of all of Bangladesh's main sources of foreign exchange declined.

- ***Bhutan.*** Bhutan's UN voting patterns have increasingly aligned with India and advanced economies. This has helped lower the measured geoeconomic vulnerability of its goods exports, as well as its FDI and portfolio investment sources.

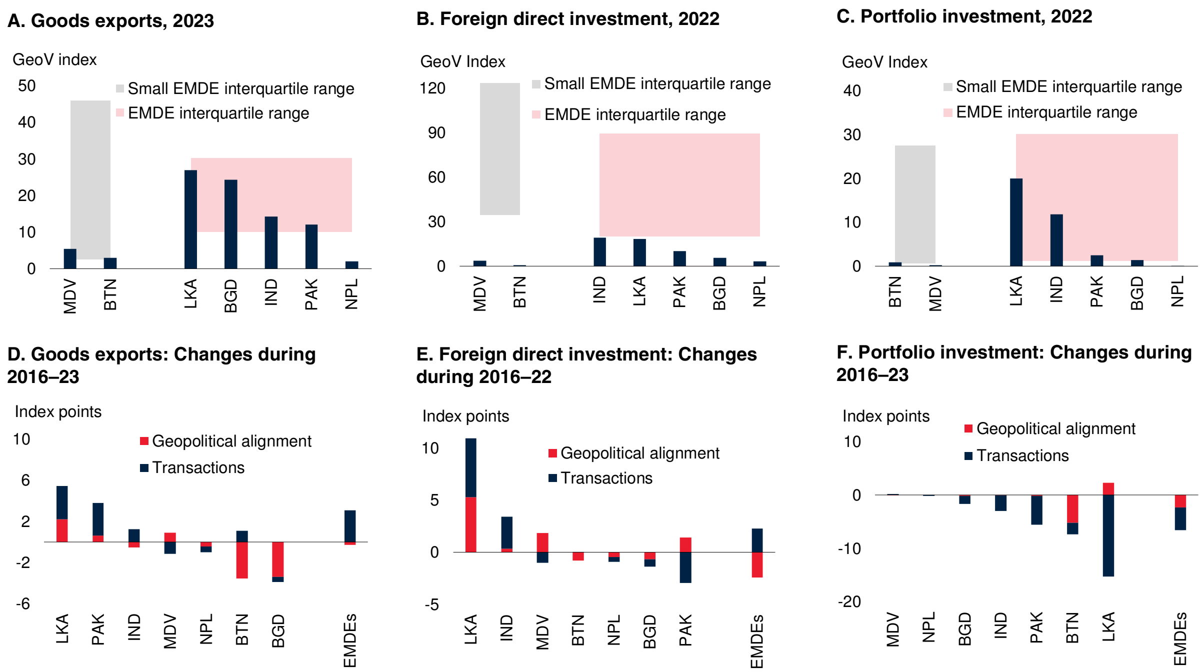
- ***India.*** India's exports and FDI liabilities have shifted toward partner countries whose UN voting patterns differ considerably from India, that is, countries that are geopolitically distant. Specifically, an increasing reliance on exports to geopolitically distant markets (for example, the United States) and FDI from geopolitically distant sources (for example, the United Kingdom) have increased India's vulnerabilities to geopolitical shocks.

- ***Maldives.*** Maldives' UN voting patterns have diverged somewhat from its main sources of FDI (Thailand, Mauritius), suggesting a marginally higher geoeconomic vulnerability of its FDI.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.5 Geopolitical vulnerabilities of exports and liabilities

Most South Asian countries' goods exports, FDI inflows, and portfolio investment inflows are less vulnerable to geopolitical risks than those of other EMDEs. Changes in vulnerabilities have mostly been more favorable in South Asia than in other EMDEs since 2016.



Sources: Aiyar and Ohnsorge (2024); IMF International Investment Position Statistics (database); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; IND = India; EMDE = emerging market and developing economies; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Other EMDEs exclude China. Geoeconomic vulnerability (GeoV index) measures the trade- or liability-weighted average geopolitical distance of a country to its trading partners or creditors. Red shades in A-C denote interquartile ranges for other EMDEs. Gray shades denote interquartile ranges for other small-state EMDEs (as defined in World Bank 2024l). Aggregates are GDP-weighted averages. All charts show geoeconomic vulnerability indices scaled by the share of total transactions in GDP; when aggregate transactions are not available, bilateral aggregates are used.

A.D. Exports refer to merchandise exports. Bhutan uses 2022 data. Other EMDEs comprise 140 economies and 34 small states. Using share of total merchandises and services export as scaler for GeoV gives similar results. Bhutan uses 2022 data for GeoV index and both 2016 and 2022 data for tracking changes.

B.C.E.F. Red shades denote interquartile ranges for other EMDEs, comprising 127 economies (B and E) and 117 economies (C and F). Gray shades denote interquartile range for small states, comprising 26 economies (B and E) and 20 economies (C and F).

C.F. Bhutan uses 2020 data for GeoV index and both 2015 and 2020 data for tracking changes.

- *Nepal.* Along with Bangladesh, Nepal stands out among South Asian countries in both having aligned geopolitically more closely with its main external partners (India and advanced economies) and increasingly shifting its external ties towards countries with more similar UN voting patterns. As a result, similar to Bangladesh, it has reduced all aspects of its current geoeconomic vulnerability.

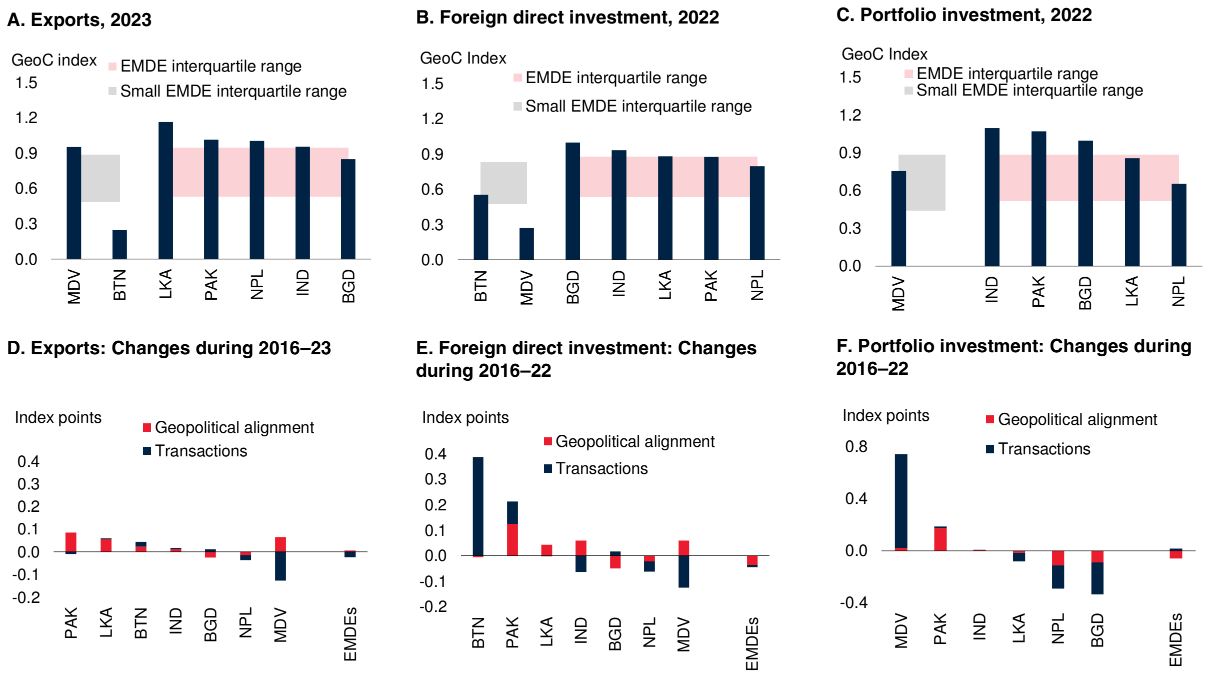
- *Pakistan.* Pakistan's geopolitical shift toward China has brought it geopolitically further from its main export markets in Europe. This has increased the vulnerability of Pakistan's exports while its portfolio investment and FDI vulnerabilities have fallen as a result of sharply higher inflows from other, geopolitically closer EMDEs (especially those in the Gulf).

- *Sri Lanka.* Between 2016 and 2023, Sri Lanka's UN voting patterns, and hence its geopolitical alignment, diverged from those of the United States, the United Kingdom, Singapore, and India—its largest export markets and sources of FDI. This divergence was only partially reversed in 2023. As a result, the measured geopolitical vulnerability of Sri Lanka's exports and sources of FDI has increased.

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.6 Geopolitical diversity of export markets and creditors

Most South Asian countries have more diversified export markets and sources of foreign investment than other EMDEs. Shifts in geopolitical alignment have played a significant role in increasing connectedness since 2016.



Source: Aiyar and Ohnsorge (2024); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Geoeconomic connectedness (GeoC index) measures the trade or liability-weighted standard deviation of the geopolitical distances to export destinations (A, D) or creditors (B, C, E, F); the index captures the diversity of geopolitical views among partner countries. Charts show geoeconomic connectedness index (A-C) or change in geoeconomic connectedness index since 2016 (D-F). Red shades in A-C denote interquartile ranges for other EMDEs, and grey shades denote interquartile ranges for other small states. Other EMDEs exclude China. Aggregates are GDP-weighted averages.

A.D. Exports refer to merchandise exports. Other EMDEs comprise 139 economies and other small states comprise 33 economies.

B.C.E.F. Red shades denote interquartile range for other EMDEs, including 140 economies (B and E) and 121 economies (C and F). Gray shades denote interquartile range for small state economies, including 34 economies (B and E) and 22 economies (C and F).

C.F. Bhutan has no observation as it only has one partner in 2020, the latest available year.

This assessment is necessarily backward-looking since it is data-driven. Geoeconomic vulnerabilities may also arise in the context of future economic ties that have yet to be developed and whose development may be impeded by geopolitical considerations.

Services exports. In addition to vulnerabilities in goods exports, South Asia faces geoeconomic risks from services exports. South Asia has an above-average share of services exports in GDP (figure B1.1.1), especially services exported to geopolitically distant markets such as the United States and Europe (World Bank 2021a, 2024d). Services exports are particularly vulnerable to geopolitical tensions because services trade—whether tourism, call centers, or back-office functions—is closely linked to buyers' trust in the seller (Bhattacharya, Patnaik, and Shah 2012; Wagner 2014).

Diversification of geopolitical risks

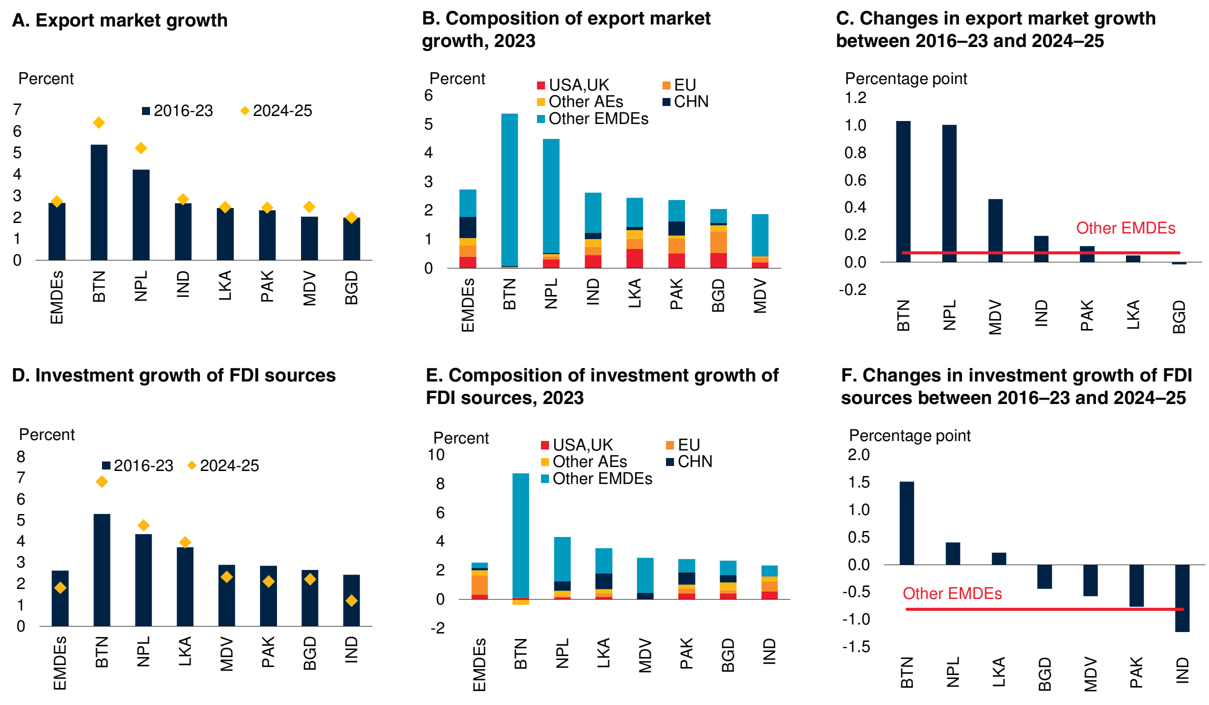
Missed opportunities. South Asia's lack of openness to global trade and investment reduces its ability to benefit from the reshaping of global supply chains and trade (Khandelwal 2022). If South Asia were more open to global trade and investment, it might be in a good position to benefit from these shifts because of the diverse set of countries with which it already engages.

Diverse set of partner countries. Currently, most South Asian countries are in or near the quartile of EMDEs with the most geopolitically diverse export markets, FDI sources, and portfolio investment sources—as captured by the geoeconomic connectedness index, which measures the standard deviation of partner countries' geopolitical stances (figure B1.1.6). However,

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.7 Exposure to growing markets

Since 2016, South Asia's export markets have grown more slowly than those of the average EMDE and are expected to continue to do so over the forecast horizon. Meanwhile, investment growth in most South Asian countries' (except India's) FDI sources has been faster than in the average EMDE and this is also expected to continue.



Sources: Aiyar and Ohnsorge (2024); IMF World Economic Outlook (database).

Note: BGD = Bangladesh; BTN = Bhutan; EMDE = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Red lines denote the median level of other EMDEs. Other EMDEs comprise 146 economies and exclude China.

A.-C. Growth of export markets is measured either as the annual average (A, B) or as the change (C) in annual export-weighted growth. Export market growth between 2016 and 2023 is derived as the export-weighted annual average growth across all export partners between 2016 and 2023. Export market growth between 2024 and 2025 is derived from first computing annual average forecast growth of each export market between 2024 and 2025, then aggregating using 2023 exports as weights, before computing the annual average of these two years.

D.-F. Investment growth of FDI sources is measured as the annual average (D, E) or as the change (F) in FDI-weighted investment growth. FDI sources' investment growth between 2016 and 2023 is derived as the FDI-weighted annual average investment growth across all FDI sources between 2016 and 2023. FDI sources' investment growth between 2024 and 2025 is derived from first computing annual average forecast investment growth of each FDI sources between 2024 and 2025, then using 2022 FDI shares as weights, before computing the annual average of these two years.

official statistics may exaggerate the diversity of South Asia's FDI sources. For example, India receives an above -average share of FDI from geopolitically close Singapore and Mauritius, as well as from geopolitically distant Japan and the European Union—which covers much of the spectrum of geopolitical stances as captured by UN voting patterns. However, between 2004 and 2014, 90 percent or more of FDI from Mauritius and Singapore to India have been estimated to indirectly channel FDI from other countries—including from Indian investors (Jaiswal 2017; Kathuria, Yatawara, and Zhu 2021).

Growing diversity of partner countries. Since 2016, India, Pakistan, Sri Lanka, and Bhutan have increased the diversity of their export markets, as well as their sources of FDI. Pakistan has also widened its sources of portfolio investment (figure B1.1.6). For Bangladesh, in contrast, the reduction in geoeconomic vulnerabilities was accompanied by a narrowing range of geopolitical views of the country's export markets and FDI sources as Bangladesh moved its geopolitical stance closer to that of its main export markets and sources of FDI in advanced economies.

Below-average growth in export markets, above-average growth in FDI sources. Because most South Asian countries have exported less than the average EMDE to China over the past decade, and China was

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

one of the world's fastest-growing economies, South Asia's export market growth has mostly been below that in other EMDEs (figure B1.1.7). This lack of exposure to export markets in China is also expected to allow for an acceleration in most South Asian countries' export markets over 2024–25, whereas export market growth of the average EMDE is expected to be broadly stable. Even with this acceleration, however, export market growth for most South Asian countries (except Bhutan, Nepal, and India) is expected to remain below the EMDE average. Meanwhile, since 2016, most South Asian countries (except Bangladesh and India) have received FDI from sources with higher investment growth than other EMDEs—mainly because of their above-average reliance on FDI from other EMDEs. Above-average investment growth in South Asia's FDI sources is expected to continue to support FDI inflows in most countries in the region over 2024–25. Only India faces a considerably steeper investment growth slowdown in its sources of FDI than the average EMDE over the forecast horizon.

Policy implications

To take advantage of the reshaping of global value chains, policy priorities for South Asian countries include removing obstacles to trade and foreign investment, further improving infrastructure and logistics, and increasing institutional effectiveness.

Some South Asian countries may hope to build on their long-standing non-aligned geopolitical stance to become globally connected manufacturing and services hubs. In this ambition, they face competition from other EMDEs that are similarly non-aligned and also aim to take advantage of shifts in global supply chains. To achieve their aspirations in a competitive global environment, South Asian countries need to implement policies that attract FDI and unlock new export markets and sectors. Cultivating a diversified set of trading partners and creditors across the geopolitical spectrum could help them manage any increases in vulnerabilities in a more open, dynamic economic model. More connected countries tend to have lower tariffs, more efficient logistics, deeper financial markets, predictable policies, and participate in larger free trade areas (Aiyar and Ohnsorge 2024).

Further improving infrastructure and logistics

Upgraded transportation networks and efficient logistics can lower trade costs for exporters and firms importing intermediate inputs. This increases the cost competitiveness of domestic firms in international trade. In particular, the absence of delays related to unexpected transport disruptions at the border or within the country supports participation in global supply chains (Brancaccio, Kalouptsidi, and Papageorgiou 2024).

Multiple large public infrastructure projects, including road and railway networks, as well as ports and airports, have improved the connectivity of South Asia in recent years (EIU 2023; World Bank 2023a). India's National Logistics Policy, announced in 2022, and the Padma bridge construction in Bangladesh illustrate recent efforts by South Asian governments to upgrade the region's infrastructure and connectedness. Despite these improvements, South Asia still tends to score below the EMDE median on indicators for infrastructure quality, as well as on logistics performance (figure B1.1.8). India and Sri Lanka are the two notable exceptions. Both countries score above the median on timeliness of logistics and keeping track of shipments.

The WTO Trade Facilitation Agreement—which entered into force in 2017 and has been ratified by all South Asian countries except Bhutan—provides a clear roadmap for further policy measures. It aims to reduce non-tariff barriers to trade by simplifying, modernizing, and harmonizing import and export regulations and logistics across countries. Member countries can request technical assistance and monitoring for the implementation of specific reforms. As of July 2024, South Asia's median implementation rate has been 78 percent, but Nepal and Sri Lanka have implemented less than 40 percent of all measures.

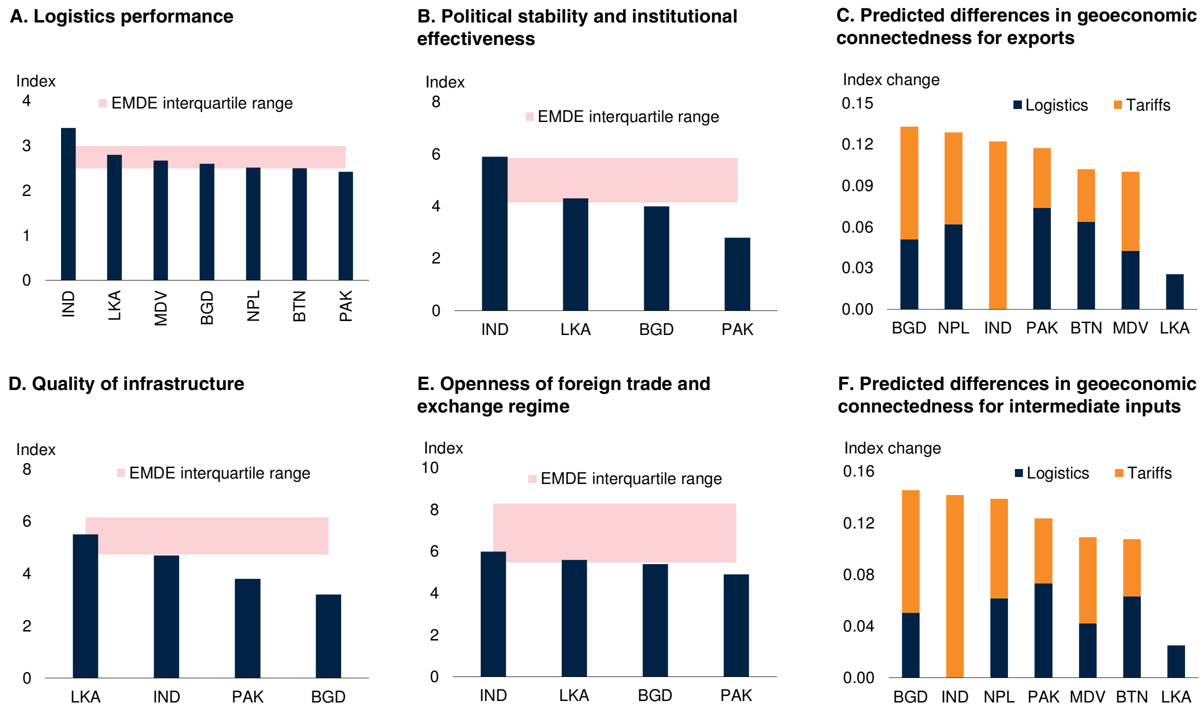
Increasing institutional effectiveness

A stable political environment and effective public institutions promote international trade and attract foreign investment (Beverelli et al. 2024; Heilbron and Whyte 2019). Firm surveys have repeatedly identified policy and regulatory uncertainty as one of the most significant constraints on expanding activities to other countries, especially in EMDEs (Stamm and Vorisek 2024). Uncertainty can, for instance, arise from

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

FIGURE B1.1.8 Factors associated with greater diversity of economic partners

Many South Asian countries score poorly on country characteristics associated with openness to trade and finance, as well as on measures of financial depth. South Asia's geoeconomic connectedness might have been higher had its logistics performance been better and its tariffs lower.



Sources: Aiyar and Ohnsorge (2024); Economist Intelligence Unit Business Environment Rankings (database); World Bank International Logistics Performance Index (database); WTO World Tariff Profiles (database); World Bank.

Note: BGD = Bangladesh; BTN = Bhutan; EMDEs = emerging market and developing economies; IND = India; LKA = Sri Lanka; MDV = Maldives; NPL = Nepal; PAK = Pakistan. Red-shaded areas show the interquartile range for EMDEs. Unless noted differently, data from 2023.

A. Sample comprises 94 other EMDEs. Bars for Maldives, Nepal, and Pakistan show values for 2018.

B.D.E. Sample comprises 44 other EMDEs.

C.F. Estimated through bivariate ordinary least squares regressions in annex B1.1.1. Bars indicate the hypothetical difference in geoeconomic connectedness in exports (C) or intermediate goods exports (F) if South Asia had the same logistics performance and the same average tariffs as the quartile of EMDEs with the lowest tariffs and the best logistics performance. This is derived by multiplying the correlations coefficients by the difference between the 75th percentile EMDE value and the country score on the respective explanatory variable. The geoeconomic connectedness index measures the trade or liability-weighted standard deviation of the geopolitical distances to export destinations or creditors; the index captures the diversity of geopolitical views among partner countries. Sample covers 99 EMDEs for logistics regressions and 105 EMDEs for tariff regressions in 2023.

problems with contract enforcement or unlawful expropriation (for example, as described in Goel and Goel 2020). Reducing such uncertainties and streamlining regulatory frameworks can lower transaction costs for firms and improve the climate for foreign investment and trade (Gao et al. 2024).

The institutional and policy environment in the average South Asian country is considered less stable than in the median EMDE (figure B1.1.8). Three of the four largest South Asian countries rank in the bottom quartile of EMDEs for their institutional and policy environment. This is consistent with firm surveys citing political uncertainty and corruption as significant constraints on doing business in South Asia (World Bank 2024d), which makes credible long-run policy commitments a priority. India's National Logistics Policy could serve as a promising example of such a long-run commitment. To be able to undertake large public investments in other countries, restoring and committing to sound macroeconomic policies will be an important prerequisite (World Bank 2024j, 2024k).

BOX 1.1 Sheltered: Implications of Geoeconomic Fragmentation for South Asia (*continued*)

Removing obstacles to trade

Besides reducing indirect costs through upgraded infrastructure, efficient logistics, and supportive institutions, countries can become more connected by lowering tariffs (Ohnsorge and Quaglietti 2024). Access to cheaper intermediate inputs, in turn, increases the cost competitiveness of domestic firms on international markets (Feng, Li, and Swenson 2016). However, tariffs in South Asia remain well above those in other EMDEs. Bangladesh, India, and Nepal rank among the quartile of EMDEs with the highest average applied tariffs (figure B1.1.1).

Removing obstacles to foreign investment

Openness to foreign investment is crucial to integrating into global supply chains. Multinational corporations, through FDI, establish local subsidiaries that incorporate host countries into their networks. This fosters the diffusion of advanced technology and managerial expertise through extensive supplier relationships and distribution channels. Increased competition also drives domestic firms to become more productive and improve international competitiveness, further embedding the host economy into global supply chains (Qiang, Liu, and Steenbergen 2021).

Many South Asian countries have introduced new restrictions on cross-border financial transactions since 2021. Such measures include increased profit repatriation requirements for foreign investors, foreign exchange quotas, and higher minimum financing requirements (World Bank 2023a). In some cases, legal frameworks specifically discriminate against foreign investors (World Bank 2023b). The removal or easing of these restrictions could help attract FDI.

Deep trade agreements

One option for deepening global trade and investment integration is to initiate or join deep trade agreements with other countries, which go beyond tariff reductions to include provisions that facilitate investment and trade. Deep trade agreements, which have become common, offer an opportunity to ease FDI restrictions. Several Southeast Asian countries—such as Malaysia and Vietnam—have joined large trade and investment agreements, including the 2018 Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the 2020 Regional Comprehensive Economic Partnership (RCEP). Meanwhile, India does not participate in mega trade blocs such as RCEP, and some of its trade agreements have narrower scope than others. For example, the India-EFTA Trade and Economic Partnership Agreement (TEPA) excludes key sectors such as digital trade, e-commerce, pharmaceuticals, and small and medium enterprises (World Bank 2024a). None of the other South Asian countries is a member of RCEP or CPTPP. This means that there is ample potential for countries in South Asia to expand their network of regional trade agreements to include a wider range of countries along the geopolitical spectrum. This can help improve connectedness and reduce vulnerabilities to geopolitical shocks (Maloney et al. 2023).

Potential magnitude of gains

How much more diversified might South Asia's trading partners and creditors have been if South Asia's policy environment had matched that of the top EMDE quartile? Although they cannot establish causality, correlations suggest that economies with lower average tariffs and better logistics performance tend to be more connected in their exports (table B1.1.1). All but one South Asian country scores below the top EMDE quartile on either measure. If all these countries had the same logistics performance as the top EMDE quartile and the lowest EMDE quartile for tariffs, South Asia's median export diversification could have been about 13 percent higher, on par with Malaysia and Indonesia (figure B1.1.8).

A key channel for the positive association between exports and better logistics, or lower tariffs, is the increased availability of cheaper intermediate inputs. This is supported by a strong correlation between the connectedness of intermediate inputs and logistics performance or tariffs. The empirical estimates suggest that South Asia might have had the connectedness of major supply chain participants such as Vietnam or Poland in intermediate inputs if its logistics and tariffs had been on par with those in the best quartile of EMDEs.