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# Is the Indian Ocean Economy a New Global Growth Pole?

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October 2018

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# **Is the Indian Ocean Economy a New Global Growth Pole?**

## **Abstract**

This paper examines whether the Indian Ocean economy—comprising 28 states across three continents—can become a growth pole for the global economy. It considers initial conditions, recent trade-led growth, portrays the near and medium context and various policy challenges. It finds that the strategically located Indian Ocean economy has become a pivotal global shipping hub. Its trade and Gross Domestic Product (GDP) have grown faster than the global economy in recent years. Projections suggest that the Indian Ocean economy will likely account for over 20% of global GDP by 2025 and its GDP per capita is expected to almost double to USD 6150. However, realising this outlook will depend on tackling several pressing policy challenges including improving port quality and logistics, lowering barriers to trade and investment, narrowing development gaps and strengthening the regional economic governance. Tackling these challenges requires a combination of coherent national and regional policy measures.

**Keywords:** Indian Ocean, International Economics, Trade, Regional Economic Integration, Foreign Investment

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## Abbreviations

APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BIMSTEC	Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation
EPG	Eminent Person Group
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GVC	Global Value Chain
IMF	International Monetary Fund
IORA	Indian Ocean Rim Association
LDC	Less Developed Country
MIC	Middle Income Country
NAFTA	North American Free Trade Agreement
NTM	Non-Tariff Measures
OECD	Organisation for Economic Cooperation and Development
PPP	Public Private Partnerships
PPP	Purchasing Power Parity
RCEP	Regional Comprehensive Economic Partnership
SAARC	South Asian Association for Regional Cooperation
SADC	Southern African Development Community
SME	Small and Middle Enterprises
TEU	Twenty-foot equivalent unit
UNCTAD	United Nations Conference on Trade and Development
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UN	United Nations

## 1. Introduction

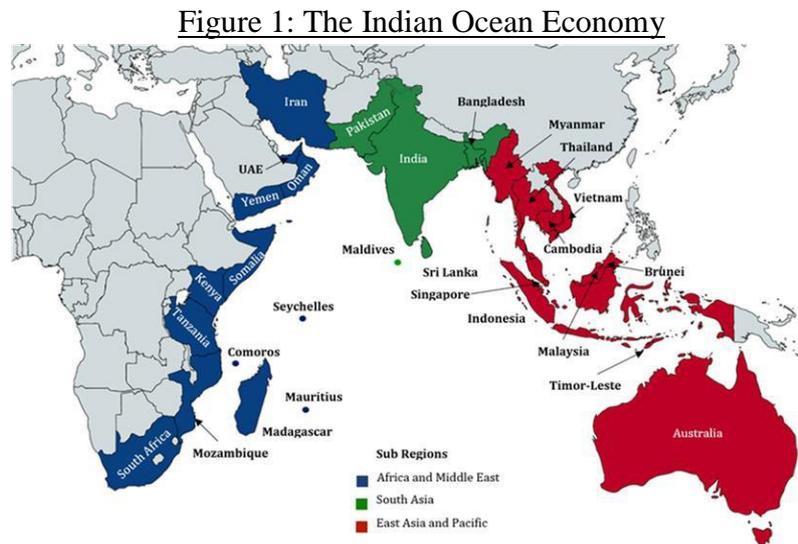
The Indian Ocean region's economy—henceforth the Indian Ocean economy—is in the international spotlight. International relations and its sub-field of international security studies typically views the Indian Ocean economy as a major conduit for international trade, especially energy and as a significant source of fishing and mineral resources. For instance, the CIA World Fact Book 2018 says:

“The Indian Ocean provides major sea routes connecting the Middle East, Africa, and East Asia with Europe and the Americas. It carries a particularly heavy traffic of petroleum and petroleum products from the oilfields of the Persian Gulf and Indonesia. Its fish are of great and growing importance to the bordering countries for domestic consumption and export. Fishing fleets from Russia, Japan, South Korea, and Taiwan also exploit the Indian Ocean, mainly for shrimp and tuna. Large reserves of hydrocarbons are being tapped in the offshore areas of Saudi Arabia, Iran, India, and western Australia. An estimated 40% of the world's offshore oil production comes from the Indian Ocean. Beach sands rich in heavy minerals and offshore placer deposits are actively exploited by bordering countries, particularly India, South Africa, Indonesia, Sri Lanka, and Thailand.” (CIA, 2018 online).

A growing international relations and security studies literature proceeds along three lines: (1) the geo-political risks that threaten the Indian Ocean's security and its economic prosperity (Cordner, 2010; Cordesman and Touskan, 2014), (2) the concept of the 'Blue Economy' and the sustainability of natural resources (Mohanty et al., 2015), and (3) the role of regional institutions in fostering regional cooperation (Dabee and Reddy, 2000; Kelegama, 2002). While this literature provides useful insights on facets of the Indian Ocean economy, it does not chart overall regional economic performance. Macroeconomic monitoring occurs at the economy-level but these national exercises are combined under different regional headings (IMF 2018a and 2018b). This is partly an issue of the aggregated unit of analysis.

This paper examines the economic outlook for the Indian Ocean economy. It focuses on the possibility of the Indian Ocean economy becoming a new growth pole for the global economy. Following a brief literature review, it undertakes three-related empirical tasks on the period since 2000. First, it surveys the region's performance by examining initial conditions like geography and resource endowments as well as trends in trade-led growth (e.g. container port traffic, trade flows, foreign investment, growth and per capita income). Some comparisons are made between regional and global economic performance. Second, it portrays the Indian Ocean economy in the near and medium-term context to 2025 under reasonable assumptions. Third, it explores some policy challenges (e.g. quality of ports and logistics, barriers to trade and investment, development gaps, and nascent regional institutions) to realising this outlook. The paper concludes with implications for the development of a prosperous Indian Ocean economy. The Indian Ocean economy is defined broadly here as the 28 economies that border the Indian Ocean. This includes the 21 members of the Indian Ocean Rim Association (IORA), plus

Brunei, Cambodia, the Maldives, Myanmar, Pakistan, Timor-Leste and Vietnam. For analytical convenience, these economies are grouped into three geographical sub-regions: Africa and the Middle-East, South Asia, and East Asia and the Pacific (see Figure 1).



Source: LKI

## 2. Literature Review

Most existing research on the Indian Ocean economy has been conducted through the lens of international relations and strategic studies. It focuses on the strategic risks that threaten the economy's security and, therefore, could ultimately undermine its economic prosperity. Early work by Walker (2008) provides a broad overview of the changing geo-political and economic landscape of the Indian Ocean. More recently, Cordesman and Touskan (2014) comprehensively assessed the key strategic issues facing the Indian Ocean, as well as the implications of these for international politics and the global economy. The major strategic risks they identify are: the possibility of disruption to energy exports from the Arabian Gulf and Iran to the rest of the world, the risk of an open conflict between India and Pakistan, security threats to the key shipping lanes that pass through the Indian Ocean, and the possibility of military confrontation between major powers in the Indian Ocean.

The Indian Ocean has also become of substantial interest to major powers beyond the region and has increasingly become a theatre in which global geopolitical rivalries play out. This is due to the importance of its maritime trading and communications routes, as well as the rich natural resources of many of its littoral states. Corder (2010, p.69) highlights the importance of the Indian Ocean for the energy security of many major economies as more than half the world's oil passes through the region, and Alden (2009) considers the governance implications of China's growing interests in Africa's natural resources. A large amount of research in this area is focussed on the growing strategic and economic rivalry between India, the largest Indian Ocean littoral state, and China (Bastos, 2014; Brewster, 2014; Chaudhury and Basu, 2016),

though Mohan (2017) and Mendis (2012) have also considered the strategic importance of the Indian Ocean for Europe and the United States respectively.

A second strand of research focussing on the economic aspects of the Indian Ocean is located within the confines of the concept of the 'Blue Economy.' The idea of the 'Blue Economy' emerged at the United Nations Conference on Sustainable Development held in Rio de Janeiro in 2012 (UNCTAD, 2014, p.2). While there is no agreed definition of this concept (Doyle, 2018, p.1), environmental sustainability is a central focus. For example, the World Bank (2017, p.6) has defined it as the 'range of economic sectors and related policies that together determine whether the use of oceanic resources is sustainable,' and Smith-Godfrey (2016, p.3) suggested an even broader definition where the 'Blue Economy' is the sustainable industrialisation of the oceans to the benefit of all." In practice, it has generally been measured by combining all sectors of the economy that rely on the ocean directly or indirectly, including the use of ocean resources like fish and minerals as well as trade and tourism. Mohanty et al. (2015) provide a broad analysis of the importance the 'Blue Economy' in the Indian Ocean region in terms of food security, a basis for tourism, a basis for trade, and as an alternative energy source, as well as the challenge of exploiting shared ocean resources in a sustainable manner. Gamage (2016) and Hussain et al. (2017) explore the use of this idea in Southeast Asia and Bangladesh respectively.

Vover et al. (2018) links the 'Blue Economy' to maritime security in the Indian Ocean by pointing to a peaceful ocean as both an enabler of a prosperous 'Blue Economy' and a potential source of economic development and growth. This is based on the notion that greater demand for maritime security will trigger increased investment in these security capabilities and therefore drive economic activity. Research has also looked at the specific economic cost of non-traditional security threats in the Indian Ocean, particularly piracy off the coast of Somalia. Oceans Beyond Piracy (2013) estimated that Somali piracy cost the global economy USD 5.7-6.1 billion in 2012 due to the additional cost of items such as security, insurance and rerouting of ships.

However, as the 'Blue Economy' concept narrowly refers to the economic importance of ocean resources and ocean-related sectors in a given economy, it excludes the full breadth of economic activity that takes place in the 28 Indian Ocean economies and could be affected by the knock-on impact of a deterioration in maritime security.

A third strand of research examines the possibilities for regional economic cooperation primarily through the Indian Ocean Rim Association (IORA), which counts 21 littoral states as members. However, this research seems relatively dated. And while analysis has tended to point to substantial potential for regional cooperation in the Indian Ocean (Dabee and Reddy, 2000), it has also highlighted the major challenges of progressing a regional agenda due to the diversity of the region's littoral states. Furthermore, despite IORA only being established in 1997, Kelegama (2002) discusses how the interest of many of the major players was already fading by the early 2000s. He goes so far as to call IORA "a regional non-starter" as its members are too diverse and geographically scattered for any meaningful integration to take

place. That said, there has been a renewed interest in IORA more recently, with the organisations first heads of government meeting being held in March 2017 (Waidyatilake, 2017), though this has not been accompanied by additional research assessing the emerging challenges that regional cooperation in the Indian Ocean faces today. As such, there is scope to reassess the situation.

While the International Monetary Fund (IMF), the World Bank, and United Nations (UN) provide regular country and regional macroeconomic analysis, this has been confined to more traditional geographic groupings typically based on shared land borders. For example, the IMF produces a bi-annual *World Economic Outlook* report as well as several *Regional Economic Outlook* reports, including for the Asia-Pacific, Sub-Saharan Africa, the Middle East and Central Asia (IMF 2018a and 2018b). As such, there is an absence of literature on the historic performance and short-term outlook of Indian Ocean littoral states as a grouping or accounting for the importance of economic links between its diverse economies across its three sub-regions. Furthermore, with the exception of some major economies (such as India, Indonesia, and Singapore), most Indian Ocean economies are absent from a medium-term economic perspective studies (see AT Kearney, 2015 and ADB and ADBI, 2014).

### **3. Initial Conditions for Trade-Led Growth**

As Table 1 shows, the countries within the Indian Ocean economy are extremely diverse. It includes small island states, such as the Comoros and the Maldives, as well as some of the most populated economies like India and Indonesia. It also includes countries at all levels of development, from low-income countries, such as Mozambique and Tanzania, to high-income economies like Australia and Singapore.

The Indian Ocean economy's combined GDP amounted to 10.7% of global GDP in 2017. The East Asia and Pacific sub-region contributed 5.1% of global GDP in 2017, while South Asia, and the Middle East and Africa, contributed 3.8% and 1.8% respectively. In terms of geography and demography, the Indian Ocean's global presence is even more significant. The Ocean itself holds 19.5%<sup>1</sup> of the earth's total water and its land area, covering 17.5%<sup>2</sup> of the world's total land area, extends a distance of 10,000 kilometres from southern Africa to western Australia. About 35.0% of the world's total population live in the Indian Ocean economy, with the majority living the South Asian sub-region (20.9%).

The geographical breadth and diversity of the Indian Ocean economy means it possesses a large base of natural resources. A few Middle East economies hold 16.8% of the world's proven oil reserves and 27.9% of proven gas reserves (BP, 2017). For example, Iran alone accounts for 18% of the world's proven gas reserves. The region is similarly abundant in precious and industrial metal. Indian Ocean economies accounted for 35.5% of global iron production and

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<sup>1</sup> Estimate from World Atlas. Available online: <https://www.worldatlas.com/articles/the-oceans-of-the-world-by-size.html> [Accessed 26 July]

<sup>2</sup> Authors calculations based on data from the Food and Agriculture Organization.

17.8% of world gold production in 2017.<sup>3</sup> Australia is the biggest producer of industrial metals primarily due to its large iron ore reserves.

Turning to fishing resources, the Indian Ocean accounted for 28% of global fish capture in 2016,<sup>4</sup> and according to the World Ocean Review 2013,<sup>5</sup> there has been a continuous increase in fish capture in the Western and Eastern Indian Ocean since the 1950s. While much of this is consumed domestically, it also the basis for successful export industries in a number of countries. For example, Indonesia and India accounted for around 4.5% of global frozen fish exports in 2017.<sup>6</sup> This was equivalent to one billion in dollar value.

Demographic trends also favour the Indian Ocean economy. It is home to 35.5% of the world's working-age population, those aged 15-64, and based on UN Department of Economic and Social Affairs projections, this share will rise to 38% by 2050. That said, education and productivity levels vary significantly across the region, though that is partially offset by variation in wages levels. At one extreme, Myanmar's hourly manufacturing wage rate is USD 0.35 (2017), but its labour productivity level is only 8% of the US level. At the other extreme, Australia pays USD 38.19 (2016) per hour and its productivity level is 82% of the US level.<sup>7</sup>

Thus, this brief review of the data indicates that Indian Ocean has broadly favourable initial conditions—in terms of land, natural resources, fish stocks, and human capital—to support trade-led growth.

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<sup>3</sup> LKI Calculations based on Minerals UK - Centre for Sustainable Mineral development. Available online: <https://www.bgs.ac.uk/mineralsUK/statistics/wms.cfc?method=listResults&dataType=Production&commodity=71&dateFrom=2015&dateTo=2016&country=&agreeToTsAndCs=agre> [Accessed 20 August]

<sup>4</sup> Authors calculations based on data from the Food and Agriculture Organization on Global Fish Capture Production. Available online: <http://www.fao.org/fishery/statistics/global-capture-production/en> [Accessed 20 August, 2018]

<sup>5</sup> Available online: [https://worldoceanreview.com/wp-content/downloads/wor2/WOR2\\_english.pdf](https://worldoceanreview.com/wp-content/downloads/wor2/WOR2_english.pdf) [Accessed 26 July, 2018]

<sup>6</sup> Available online: <http://www.worldstopexports.com/frozen-fish-exports-country/> [Accessed 26 July]

<sup>7</sup> Calculated using information from Available on: <http://www.conference-board.org/ilcprogram/index.cfm?id=38269> and <http://sourcingjournal.com/topics/labor/myanmar-minimum-wage-increase-76963/>

Table 1: Key Indicators for Indian Ocean Region Economies

Country	Population (Millions, 2017)	Land Area (Thousand Sq. Km)	GDP (USD Billions, 2017)	GDP (In PPP, 2017)
<b><u>Africa and the Middle East</u></b>	<b>359.4</b>	<b>7,217.8</b>	<b>1,426.8</b>	<b>3,774.2</b>
<i>(Share of World)</i>	<i>(4.8%)</i>	<i>(5.5%)</i>	<i>(1.8%)</i>	<i>(3.0%)</i>
Comoros*	0.8	1.9	0.7	1.3
Iran*	81.2	1,628.8	431.9	1,644.7
Kenya*	49.7	569.1	79.5	163.1
Madagascar*	25.6	581.8	11.5	39.7
Mauritius*	1.3	2.0	12.4	27.5
Mozambique*	29.7	786.4	12.7	36.7
Oman*	4.6	309.5	74.3	186.6
Seychelles*	0.1	0.5	1.5	2.7
Somalia*	14.7	627.3	7.4	18.7
South Africa*	56.7	1,213.1	349.3	765.6
Tanzania*	57.3	885.8	51.7	162.6
UAE*	9.4	83.6	377.4	686.8
Yemen*	28.3	528.0	16.5	38.6
<b><u>South Asia</u></b>	<b>1,578.6</b>	<b>3,819.5</b>	<b>3,031.0</b>	<b>11,485</b>
<i>(Share of World)</i>	<i>(20.9%)</i>	<i>(3.0%)</i>	<i>(3.8%)</i>	<i>(9.0%)</i>
Bangladesh*	164.7	130.2	261.4	687.1
India*	1,339.2	2,973.2	2,611.0	9,459.0
Maldives	0.4	0.3	4.5	6.9
Pakistan	53.4	653.1	66.5	1,057.0
Sri Lanka*	20.9	62.7	87.6	247.7
<b><u>East Asia and the Pacific</u></b>	<b>705.2</b>	<b>11,706.0</b>	<b>4,050.7</b>	<b>8,261</b>
<i>(Share of World)</i>	<i>(9.3%)</i>	<i>(9.0%)</i>	<i>(5.1%)</i>	<i>(6.5%)</i>
Australia*	24.5	7,741.2	1,379.5	1,246.5
Brunei	0.4	5.8	12.7	33.5
Cambodia	16.1	181.0	22.3	64.3
Indonesia*	264.0	1,910.9	1,015.4	3,242.8
Malaysia*	31.6	330.8	314.5	930.8
Myanmar	197.0	676.6	304.0	328.7
Singapore*	5.7	0.7	323.9	527.0
Thailand*	69.0	513.1	455.4	1,233.7
Timor-Leste	1.3	14.9	2.6	6.8
Vietnam	95.6	331.0	220.408	647.4
<b>Indian Ocean Total</b>	<b>2,643.2</b>	<b>22,648.8</b>	<b>8,508.5</b>	<b>23,520</b>
<i>Share of World</i>	<i>35.0%</i>	<i>17.5%</i>	<i>10.7%</i>	<i>18.5%</i>

Notes: \*Members of the Indian Ocean Rim Association (IORA).

Sources: Compiled by LKI based on data from UN DESA, Available at: <https://esa.un.org/unpd/wpp/>, Accessed on July 2018; World Bank, Food and Agriculture Database, Available at: <https://data.worldbank.org/indicator/AG.LND.TOTL.K2>, Accessed on July 2018; IMF, World Economic Outlook Database, Available at: <https://www.imf.org/external/pubs/ft/weo/2017/01/weodata/index.aspx>, Accessed on July 2018

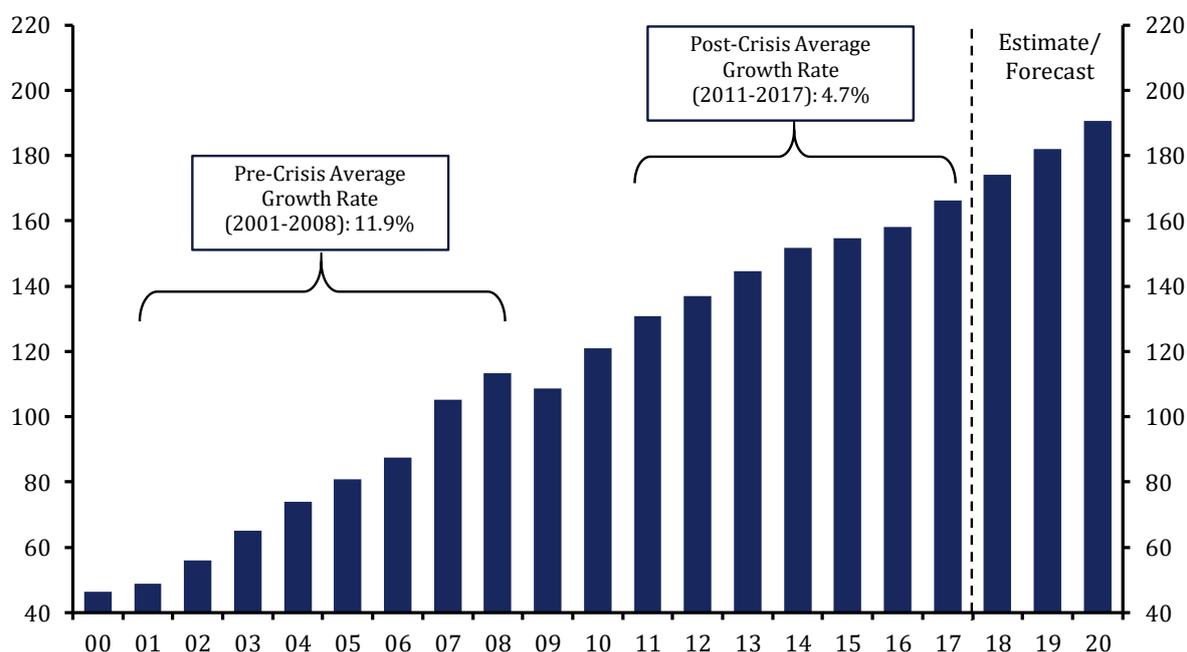
## 4. Mapping Trade-Led Growth

### 4.1. Shipping

The rise of the Indian Ocean economy in global shipping markets has been propelled by the strategic location it holds among global shipping lanes and with ocean freight being the least expensive method of transporting bulk goods internationally (Pandya, Herbert-Burns and Kobayashi, 2011). In 2017, the Indian Ocean economy hosted 23 of the world's top 100 container ports by traffic.<sup>8</sup>

Container traffic through Indian Ocean ports has increased fourfold from just over 40 million TEUs in 2000 to over 160 million TEUs in 2017 (see Figure 2). This is equivalent to around 22% of global container traffic and places the Indian Ocean second only to China's 28.4% share of container shipping and ahead of the US share of 6.8%. The global financial crisis and the accompanying economic downturn also dampened regional shipping. There was a marked slowdown in the annual growth of Indian Ocean container traffic from 11.9% to 4.7% between 2001-2008 and 2011-2017. Assuming a continuation of this lower growth rate during 2017-2019, regional container traffic could rise to over 190 million TEUs by 2020.

Figure 2: Indian Ocean Container Port Traffic\* (Million TEUs)



Sources: LKI calculations based on UNCTAD, Maritime Transport Database, Available at: <http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx>, Accessed on August 2018

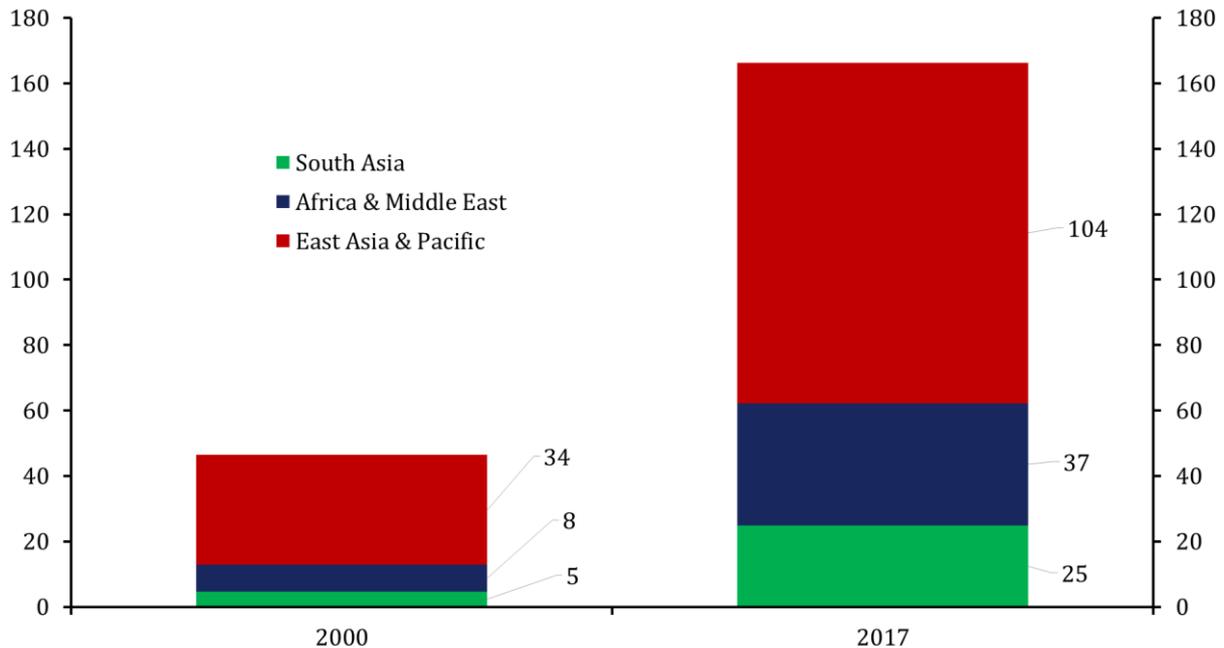
\*2018-2020 data are based on the continuation of post-crisis average growth rate.

Within the Indian Ocean economy, East Asian and Pacific ports dominate container traffic, accounting for 104 million TEUs in 2017, or 63%, of the total regional container port traffic.

<sup>8</sup> According to the 2017 Lloyd's List Top 100 Container Ports Rankings.

(See Figure 3.) Ports in Singapore and Malaysia are particularly large players, with a combined traffic of 58 million TEUs in 2017. In comparison, the Africa and the Middle East and South Asia are relatively small players, accounting for just 22% and 15% of regional container port traffic respectively in 2017.

**Figure 3: Indian Ocean Container Port Traffic\* (Million TEUs)**



Sources: Compiled by LKI based on UNCTAD, Maritime Transport Database, Available at <http://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=13321>, Accessed on June 2018

According to the 2017 Lloyds List, the top Indian Ocean container ports are Singapore (34 million TEUs), Dubai (15 million TEUs) and Port Klang in Malaysia (13 million TEUs). That said, the growth of smaller ports in the Indian Ocean has become an increasingly important factor in driving the ongoing rise in maritime traffic. While between 2011 and 2017 the average annual growth of container traffic through the leading regional ports of Singapore and Dubai has averaged 2.6% and 3.8% respectively,<sup>9</sup> growth of container traffic through smaller ports such as the Port of Colombo in Sri Lanka and Mombasa in Kenya has averaged 6.1% and 8.8% respectively.<sup>10</sup> This represents increased investment in these ports and the increased exploitation of their differing strategic advantages. Sri Lanka’s position along key shipping routes means Colombo has benefited from a high degree of transshipment traffic – around 75% of container traffic through the Port of Colombo in 2017 was for transshipment purposes. Mombasa, in contrast, benefits as a gateway for a number of fast-growing land-locked economies in East Africa, including Uganda and Rwanda.

<sup>9</sup> Growth rate of container traffic based on data from the International Association of Ports & Harbors. Available online: <https://www.iaphworldports.org/statistics>.

<sup>10</sup> As the Ports of Colombo and Mombasa are the only international container ports in Sri Lanka and Kenya, container traffic growth rates are based on country-level data from the UNCTAD Maritime Transport Database.

Going forward, the outlook for shipping in the region depends on the growth of internal markets, their engagement in trade, investment in port capacity, and the health of the global economy. Projections for rapid growth in many of the region’s economies discussed in the following sections and an ongoing recovery in the global economy bode well. What’s more, a number of major multilateral infrastructure initiatives that include substantial investments in ports, such as China’s Belt and Road Initiative (BRI), and the proposed Asia-Africa Growth Corridor led by India and Japan, suggest a substantial rise in the Indian Ocean’s port capacity over the coming year. For example, data compiled by the Center for Strategic and International Studies suggests that around USD 27 billion is being invested in Indian Ocean ports in Asia and the Middle East as part of the BRI (see Table 2).

Table 2: Selected Indian Ocean Belt and Road Initiative Port Projects

<b>Project</b>	<b>Current Status</b>	<b>Total Reported Cost (USD Millions)</b>
Gwadar Port (Pakistan)	Under Construction	299
Hambantota Port (Sri Lanka)	Completed	1,914
Khalifa Port Container Terminal 2 (United Arab Emirates)	Announced/Under Negotiation	738
Kyaukpyu Deep Sea Port (Myanmar)	Preparatory Works	7,300
Malacca Port (Malaysia)	Under Construction	1,900
Payra Deep Sea Port (Bangladesh)	Preparatory Works	15,000

*Source: CSIS Reconnecting Asia Project. Available at: <https://reconnectingasia.csis.org/>, Accessed 10 September 2018*

However, several risks could tilt the regional economic outlook, at least in the short-term. These include escalating trade conflicts between major economies, rising interest rates driven by the tightening of monetary policy in advanced economies, rising oil prices and waning investor confidence in emerging markets. Maritime crime including piracy and risks arising from strategic competition between major powers are other concerns. In addition, ports in the region face a number of mega-trends that may also affect the outlook, including increasing concentration in liner shipping markets, the growing size of ships and changes in demand conditions (UNCTAD, 2017, p.61).

## **4.2. Trade Flows**

Driven by maritime trade, trade growth in the Indian Ocean region has outperformed the world economy since 2000. Trade volumes in the Indian Ocean grew annually at 9.4% in 2000-2008 and settled at a slower pace of 4.8% in 2011-2017 after the global financial crisis (see Figure 4). This compares favourably with 6.9% and 3.9% for world trade volume growth over the same periods. As a result, the value of the Indian Ocean’s trade rose from USD1.4 trillion to USD5.9 trillion in 2017, increasing its share of world trade from 8.7% to 13.1%.

This has partly reflected the increasing openness of the region's economies – trade as a share of regional GDP rose from 60% in 2000 to a peak of over 80% in 2008. While it has since dropped back below 70% as a result of slower growth in trade volumes and lower global commodity prices, this ratio remains notably higher than in the world as a whole (around 55%). This demonstrates the importance of trade to the region and highlights that Indian Ocean economies are more closely integrated into global trade flows than the world at large.

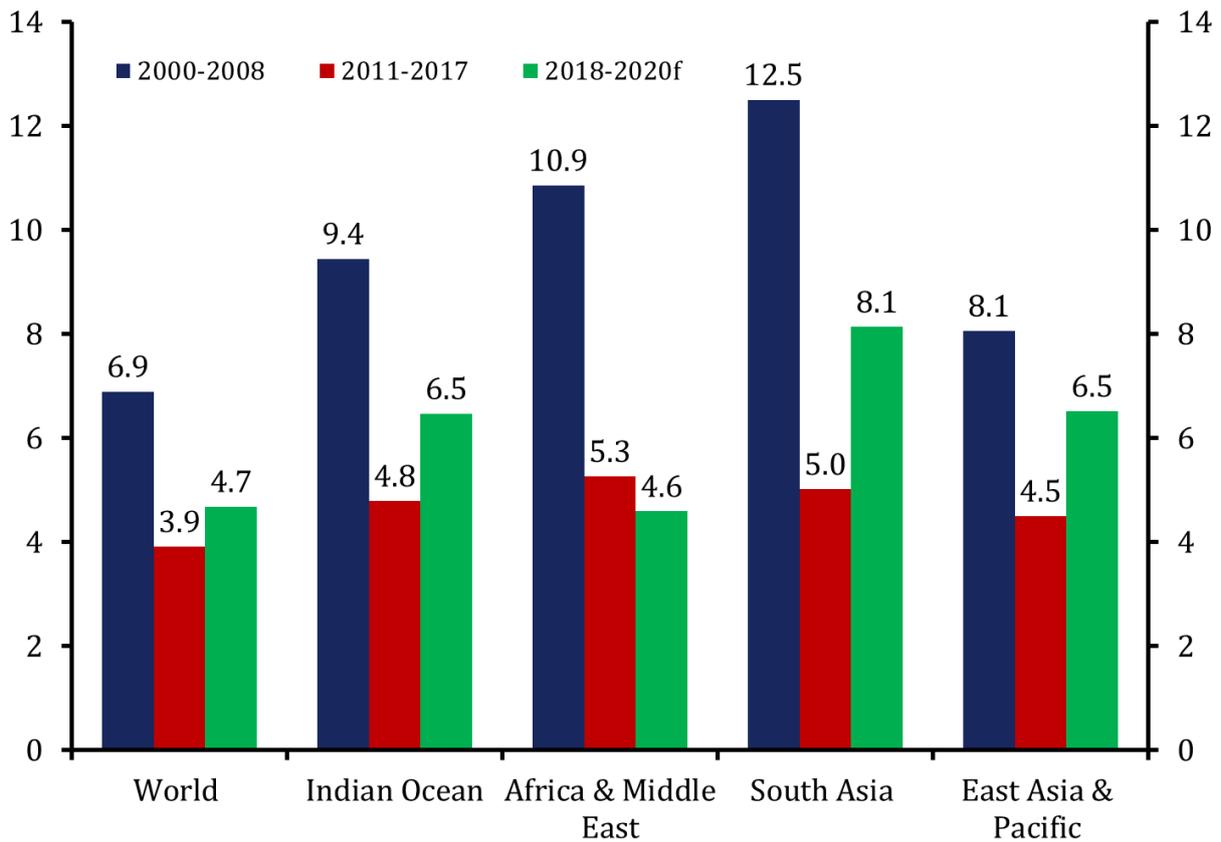
Some of this growth is linked to the growing role of trade in services. From a small base, the value of the Indian Ocean region's service exports increased five-fold from around USD 100 billion to over USD 500 billion between 2000 and 2017. Tourism and transport services earnings have grown, as has trade in IT and other business services. Nonetheless, services exports are concentrated in a few countries, notably Australia, India, and Singapore, and goods were still the source of around three-quarters of the region's total export revenues in 2017. Among these goods exports, machinery and electronics account for around 40% of total shipments while manufactured chemical and fuels account for a further 20%. Food and other primary commodities cover an additional 20% of total exports.

The Indian Ocean economy's trade growth is likely to increase to an average of 6.5% per year in 2018-2020, which would exceed expected average world trade growth of 4.7%. This could increase the value of the region's to around USD 7.2 trillion, equivalent to 13.8% of world trade. This is partly due to a cyclical pick up in investment, rising import demand from major developed markets, and increased intra-regional shipments across Asia. It is worth bearing in mind, however, that these assumptions may not be borne out and these forecasts do not incorporate the risk of increasing trade protectionism between the US and its major trade partners and a larger-than-expected slowdown in the Chinese economy.

Risks aside, there is a mixed picture of trade growth across the sub-regions. As Figure 4 shows, the robust annual trade volume growth in all three sub-regions during 2000-2008 slowed significantly during 2011-2017. In 2018-2020, South Asia and East Asia and the Pacific are expected to see a partial recovery in trade growth to 8.1% and 6.5% respectively. However, Africa and the Middle East may experience below par trade growth of 4.6%.

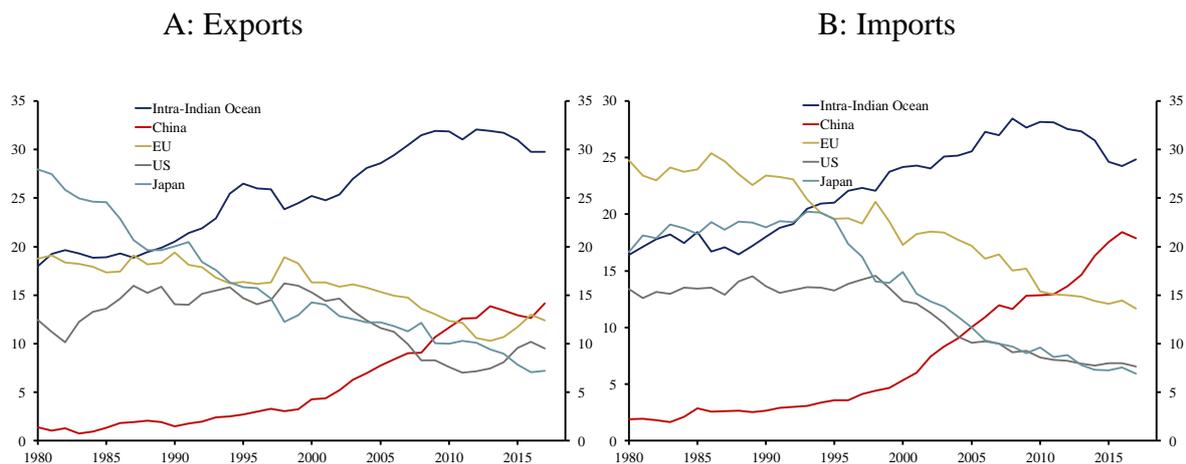
The single most important destination for the Indian Ocean region's goods exports is China, with around 14% of the region's total goods exports shipped there in 2017 (see Figure 5). The importance of China as a destination for the region's exports is a relatively recent phenomenon – only 4% of the region's exports were shipped there in 2000 – and the growth in its market share has come at the expense of major developed economies, notably the US, EU, and Japan. These economies were the destination for around 10% each of the Indian Ocean's exports in 2017. Of other major global powers, Russia and Brazil are the destination for less than 1% of the total exports each.

Figure 4: Indian Ocean Economy and Sub-Regional Trade Volume Growth (% y/y)



Sources: LKI calculations based on IMF, World Economic Outlook Database, Available at: <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx>, Accessed on June 2018

Figure 5: Goods Trade by Destination (% Share of Total)



Sources: LKI calculations based on IMF Direction of Trade Statistics, Available at: <http://data.imf.org/?sk=9D6028D4-F14A-464C-A2F2-59B2CD424B85>, Accessed August 2018

On the import side, the major players in Indian Ocean trade are much the same. China has become a much more important source for imports since 2000 and accounted for almost 18% of imported goods in 2017. In contrast, the EU, US, and Japan have become less important

though they are still significant with around 5-10% of the region's imports coming from each. Likewise, Russia and Brazil play a relatively unimportant role in terms of imports.

However, the importance of any major trading partners beyond the Indian Ocean, pales in comparison to the magnitude of trading within the region. Intra-regional trade accounted for 29.8% of the region's goods exports and 24.8% of goods imports in 2017. This level of intra-Indian Ocean trade compares favourably with other groupings in the region with formal trade agreements, such as ASEAN and SAARC, although it is still far behind the kind of deep trade links seen in the EU and NAFTA, where intra-regional trade exceeds 50% of total trade.

Moreover, there are significant variations in the extent of engagement in intra-regional trade within the Indian Ocean. The eastern edge of the region, which includes the South-East Asian states of Thailand, Malaysia, and Indonesia, as well as Australia, accounts for around 60% of intra-regional trade in terms of values. Of the intra-regional trade that the Indian Ocean's South Asian and Middle Eastern and African states account for, the majority of its trade with countries outside their sub-regions. This highlights that, while intra-regional trade is significant for the Indian Ocean as a whole, this does not reflect strong trading links between all the countries in the region.

### **4.3. Foreign Direct Investment**

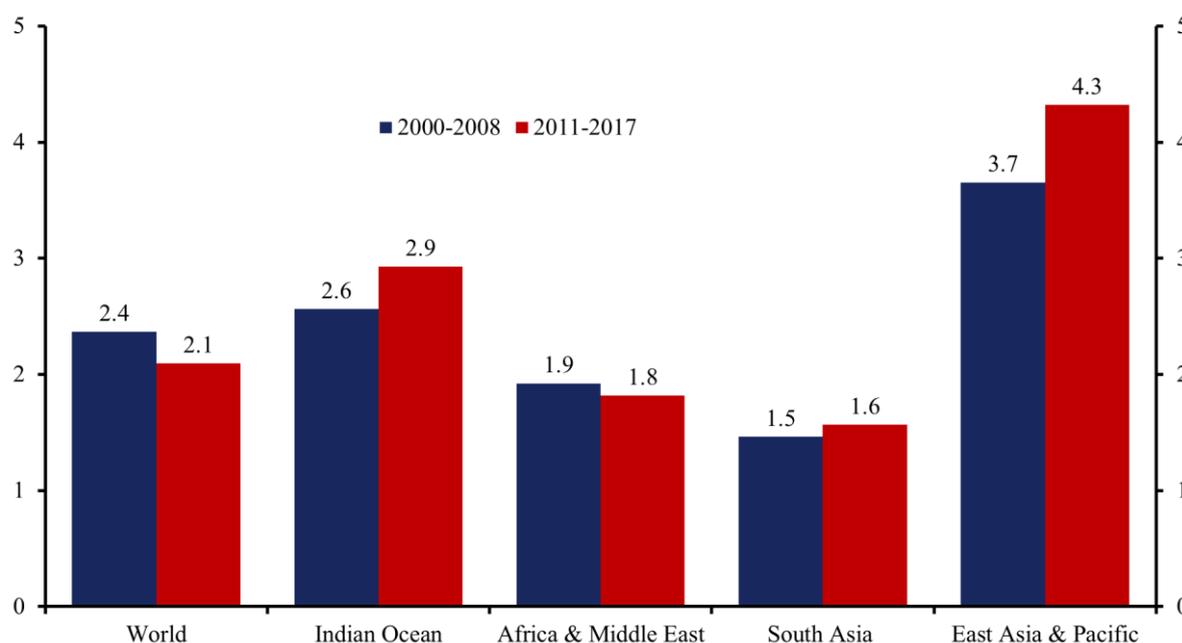
Increased trade flows in the Indian Ocean economy have been accompanied by rising foreign direct investment (FDI). FDI flows into the region rose from USD 44 billion in 2000 to USD 239 billion in 2017, which increased the region's share of global inward FDI from around 3% to almost 17%. As a share of Indian Ocean regional GDP, average FDI inflows rose from 2.6% of GDP during the period between 2000 and 2017, to 2.9% between 2011 and 2017, which compares favourably to the decline in world FDI flows as a share of GDP, from 2.4% to 2.1% (see Figure 6).

This improvement was driven by higher FDI inflows into East Asia and Pacific, which increased from an average of 3.7% of GDP in the period prior to the global financial crisis to 4.3% in the period since. In contrast, FDI inflows into the Middle East and Asia, and South Asia have remained stagnant at around 2.0% and 1.5% of GDP respectively. At a country level, the biggest destinations for FDI in the Indian Ocean are Singapore, Australia and India, which account for around 60% of the total value of FDI inflows into the Indian Ocean economy in 2017.

Outward FDI flows from the Indian Ocean are less significant, though they have also risen. FDI from Indian Ocean economies increased from USD 13 billion in 2000 to USD 92 billion by 2017. This was equivalent to an increase from around 1% of global outward FDI in 2000 to 6% in 2017. East Asia and the Pacific again dominate, accounting for USD 58 billion of the outward FDI in 2017, and at a country level Singapore, Thailand and the UAE accounted for 60% of the region's total FDI outflows in the same year.

While country-level forecasts for FDI flows are not widely available, global FDI flows are projected to rise in 2018 (UNCTAD, 2018, pp.14-19) based on the upswing in the global economy, stronger trade growth, and strong profits for multi-national enterprises. The region’s growing importance in global trade and substantial investment needs, both in infrastructure and productive capacity, means that it is likely to continue increasing its share of global investment inflows over the coming years. East Asia looks is set to continue dominating in this regard. Outward FDI flows from the region are likely to also increase, but will remain less significant than inward investment flows.

**Figure 6: Indian Ocean Sub-Regional FDI (% of GDP)**



Sources: LKI calculations based on UNCTAD Foreign Direct Investment Statistics, Available at: <http://unctadstat.unctad.org/EN/>, Accessed August 2018; IMF, World Economic Outlook Database, Available at: <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx>, Accessed on August 2018

#### 4.4. GDP Growth

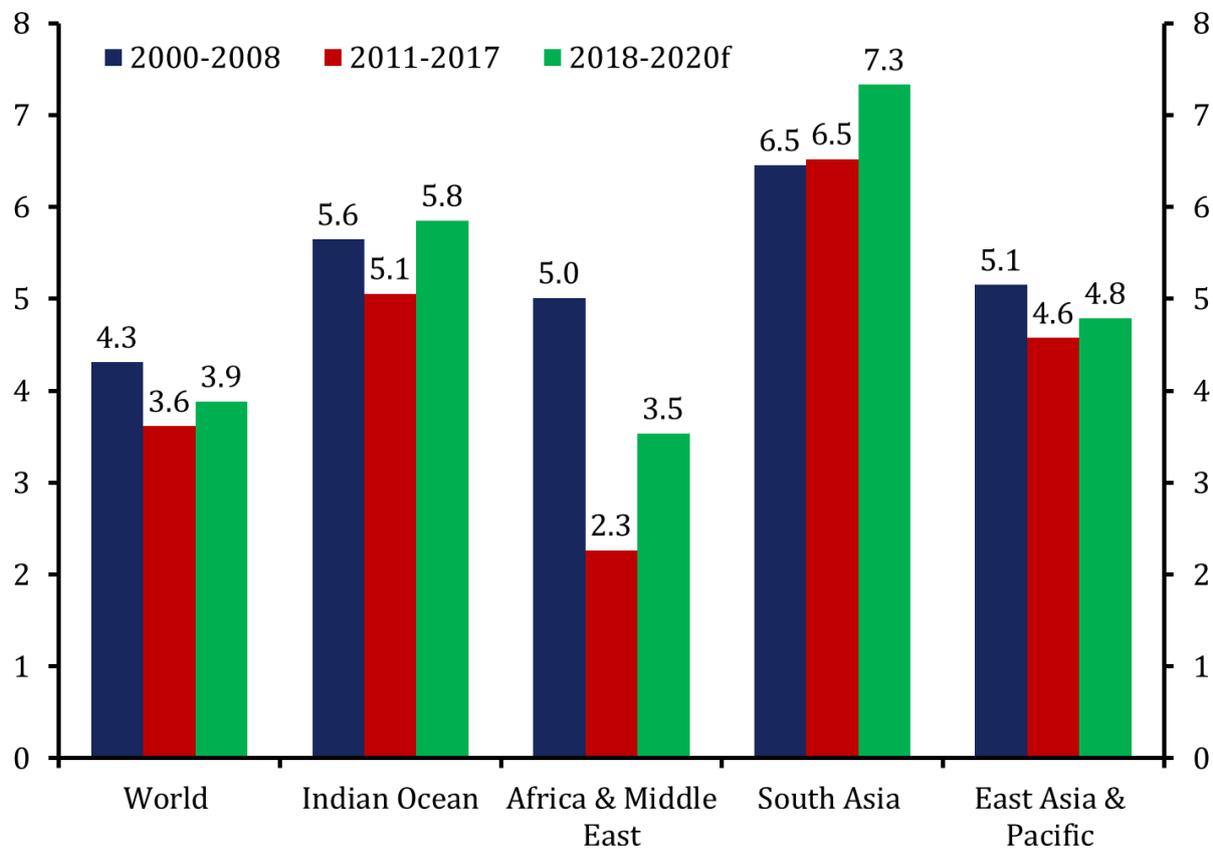
Regional growth has outperformed world growth since 2000 (see Figure 7). The Indian Ocean economy grew at 5.6% per year compared with 4.3% per year for the world economy during 2000-2008.<sup>11</sup> The region’s economy was less affected by the global financial crisis and recovered more quickly than the rest of the world. While world growth averaged just 3.6% annually between 2011-2017 due to slow recoveries in advanced economies and deep recessions in some major developing economies, notably Brazil and Russia, the Indian Ocean’s economy grew by a more impressive 5.1% during this same period. Regional economic growth

<sup>11</sup> The regional real GDP growth rate is based on national real GDP growth rates weighted by each country’s share of the regional economy, which was calculated using PPP exchange rates. The data for regional growth and world growth are from the IMF World Economic Outlook Database.

is expected to pick up to 5.8% in 2018-2020 – the strongest rate since 2010. This is partly due to rising global economic momentum, but these projections also outstrip the 3.9% average growth expected for the world economy. The major risks to this forecast include rising trade protectionism, tightening global financial conditions and higher oil prices, though these would affect countries in different ways.

South Asia—led by a robust India—has seen the fastest growth among the sub-regions in both 2000-2008 and 2011-2017. Meanwhile, East Asia and the Pacific and Africa and the Middle East experienced slower growth in 2011-2017 compared with 2000-2008. Growth is projected to be strongest in South Asia over 2018-2020, but it is also expected to pick up in those countries in East Asia as well as Africa and the Middle East.

**Figure 7: Indian Ocean Economy and Sub-Regional Real GDP Growth (% y/y)**



Sources: LKI calculations based on IMF, World Economic Outlook Database, Available at: <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx>, Accessed on June 2018

The observed decline in the gross income elasticity of trade—defined as the average growth rate of Indian Ocean trade divided by the average growth rate of Indian Ocean GDP—raises the issue whether the lacklustre trade growth represents a temporary cyclical deviation from trend or a longer-lasting movement reflecting major structural changes. The Indian Ocean economy’s gross income elasticity of trade nearly halved from 1.7 in 2000-2008 to 0.9 in 2011-2017 as a result of declining elasticities in South Asia, and East Asia and the Pacific (see Table

3) It is projected to be stable at around 1.1 in 2018-2020 in line with the gross elasticity of trade at the world level. Worryingly, it appears that trade is playing less of a role in driving regional growth than before the crisis.

Table 3: Gross Income Elasticity of Trade in the Indian Ocean

	<b>2000-2008</b>	<b>2011-2017</b>	<b>2018-2020</b>
<b>World</b>	<b>1.6</b>	<b>1.1</b>	<b>1.2</b>
<b>Indian Ocean</b>	<b>1.7</b>	<b>0.9</b>	<b>1.1</b>
<i>Middle East &amp; Africa</i>	2.2	2.3	1.3
<i>South Asia</i>	1.9	0.8	1.1
<i>East Asia &amp; Pacific</i>	1.6	1.0	1.4

Sources: LKI calculations based on data in figures 4 and 7.

## 5. Projecting the Indian Ocean Economy in 2025

Based on the continuation of the positive economic trends seen since 2000 and assuming no major downturn in the world economy, the Indian Ocean economy is likely to play an even larger role in the world economy by 2025 with improved prosperity. This ‘business as usual’ scenario is based on projections of four key indicators for the Indian Ocean economy:

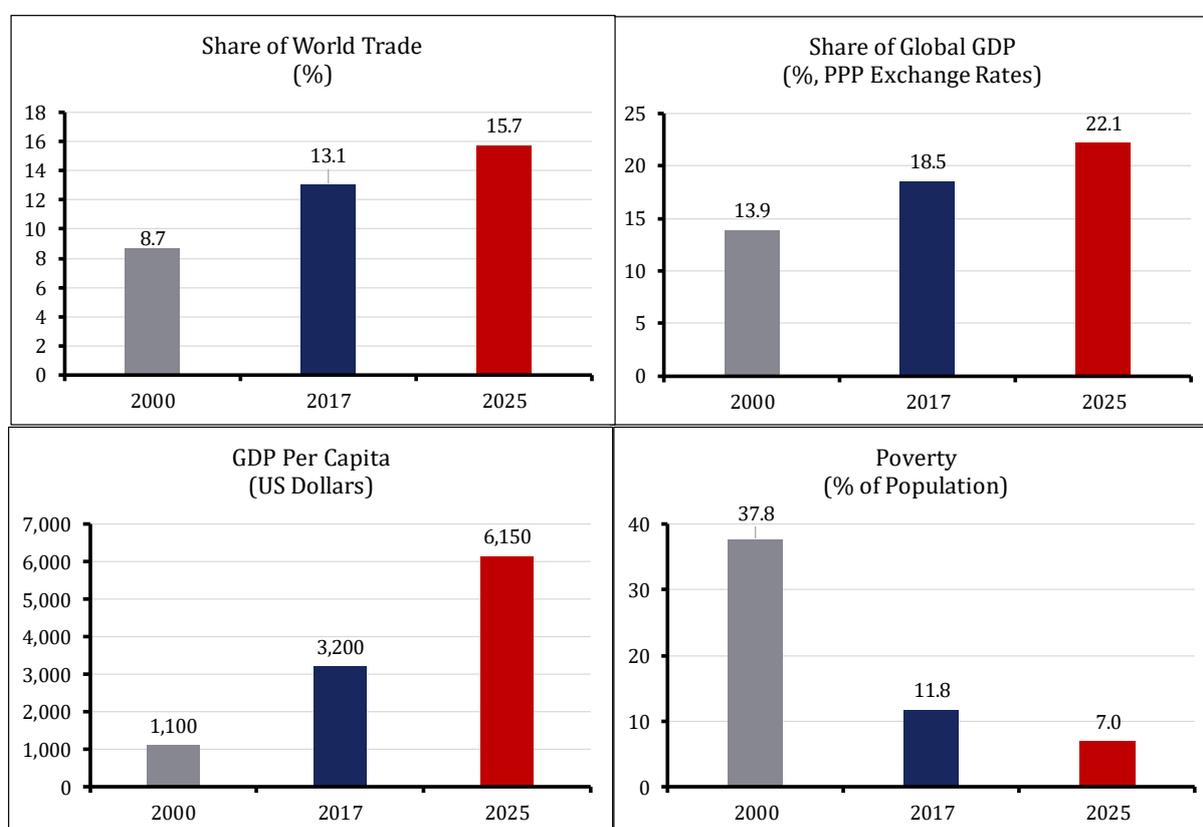
- (1) the share of regional trade in world trade,
- (2) the share of regional GDP in world GDP,
- (3) regional GDP per capita, and
- (4) share of the region’s population living in poverty.<sup>12</sup>

Using the available country-level forecasts for trade volume growth from the IMF’s World Economic Outlook Database April 2018 for the period between 2018 and 2023, and assuming that the trends implied in these forecasts continue to 2025, we estimate that the Indian Ocean economy’s share of world trade in goods and services is likely to rise from 13.1% to 15.7% between 2017 and 2025. In 2000, this figure was just under 9% (see Figure 8). While this makes the, admittedly heroic, assumption that the value and composition of the region’s exports does not change during this period, it is reflective of the fact that the trade volume growth in the Indian Ocean economy is expected to average around 6% during this period, compared to 4% for the world as a whole. At a sub-regional level, the rise in the Indian Ocean’s share of world trade will be driven East Asia and the Pacific. This region’s share of world trade is set to rise from 7.6% in 2017 to 9.2% by 2025. In contrast, South Asia’s share of world trade is expected to only edge up from 2.8% to 3.8% during this period, while the Middle East & Africa’s share of world trade is expected to remain unchanged. (See Table 4.).

<sup>12</sup> The forecasting methodology adopted here draws on AT Kearny (2015) and ADB and ADBI (2014).

To show the implications of growing trade for the Indian Ocean’s share of the world economy, the available forecasts for real GDP growth, the GDP deflator and PPP exchange rates from the IMF’s World Economic Outlook Database April 2018, were used to construct a forecast for the region’s nominal GDP in 2023. Assuming the continuation of the trends in the preceding forecast this share was then forecast to 2025 by the authors. Under this conservative scenario, the Indian Ocean economy’s share of global GDP (at PPP exchange rates) is expected to rise from 18.5% to 22.1% between 2017 and 2025. In 2000, the Indian Ocean economy accounted for 13.9% of world GDP. In 2025, the Indian Ocean economy’s share of the world economy will place it in the league of other major players such as China, the US and the EU. This reflects the growing importance of South Asia, and East Asia in the Pacific, in the global economy. The Middle East and Africa share of world GDP is expected to decline from 3.0% to 2.9% between 2017 and 2025.

**Figure 8: The Indian Ocean Economy in 2025**



Sources: LKI calculations based on World Bank, World Development Indicators Database, Available at: <https://data.worldbank.org/topic/poverty>. Accessed on July 2018; IMF, World Economic Outlook Database, Available at: <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx>, Accessed on July 2018.

Combining this with forecasts for the Indian Ocean’s population in 2025 from the United Nations Department for Economic and Social Affairs, implies that Indian Ocean Economy GDP per capita (current USD) will almost double from USD 3,200 to USD 6,150 between 2017 and 2025. It was USD 1,100 in 2000. This reflects strong income gains across the Indian

Ocean's sub-regions. Although the doubling in per capita incomes in South Asia from USD 1,900 in 2017 to USD 4,300 is particularly important as it is home to almost two-thirds of region's total population. Increasing income levels partly reflected the region 'catching up' up with developed countries.

Table 4: Indian Ocean Sub-Regions in 2025

	<b>2000</b>	<b>2017</b>	<b>2025 (Forecast)</b>
<b><u>Share of World Goods &amp; Services Trade (%)</u></b>			
<b>Indian Ocean</b>	<b>8.7</b>	<b>13.1</b>	<b>15.7</b>
<i>Africa &amp; Middle East</i>	<i>1.0</i>	<i>2.7</i>	<i>2.7</i>
<i>South Asia</i>	<i>1.1</i>	<i>2.8</i>	<i>3.8</i>
<i>East Asia &amp; Pacific</i>	<i>6.6</i>	<i>7.6</i>	<i>9.2</i>
<b><u>Share of Global GDP (% , PPP Exchange Rates)</u></b>			
<b>Indian Ocean</b>	<b>13.9</b>	<b>18.5</b>	<b>22.1</b>
<i>Africa &amp; Middle East</i>	<i>3.1</i>	<i>3.0</i>	<i>2.9</i>
<i>South Asia</i>	<i>5.4</i>	<i>9.0</i>	<i>12.1</i>
<i>East Asia &amp; Pacific</i>	<i>5.4</i>	<i>6.5</i>	<i>7.1</i>
<b><u>GDP Per Capita (current USD)</u></b>			
<b>Indian Ocean</b>	<b>1,100</b>	<b>3,200</b>	<b>6,150</b>
<i>Africa &amp; Middle East</i>	<i>2,750</i>	<i>6,800</i>	<i>10,700</i>
<i>South Asia</i>	<i>475</i>	<i>1,900</i>	<i>4,300</i>
<i>East Asia &amp; Pacific</i>	<i>2,050</i>	<i>6,800</i>	<i>10,700</i>

Sources: LKI calculations based on World Bank, World Development Indicators Database, Available at: <https://data.worldbank.org/topic/poverty>. Accessed on July 2018; IMF, World Economic Outlook Database, Available at: <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx>, Accessed on July 2018.

Rising incomes will also have a major impact on the prevalence of extreme poverty in the region. Based on the methodology described by Ram (2011, 2013) and historical data on Indian Ocean countries' poverty rates from the World Bank PovcalNet database,<sup>13</sup> the relationship between the region's real per capita GDP growth and changes in the share of the population living in poverty was calculated for the period between 1980 and 2013. This is also known as the growth elasticity of poverty and was then used to estimate the change in the share of the Indian Ocean economy living in poverty between 2017 and 2025 based on the forecasts for GDP per capita already derived. While this assumes that the rate of change in inequality in the Indian Ocean economy during this period is the same as it was during the sample period (1980-2013), it suggests that the share the region's population living on less than USD 1.90 per day will almost halve from 11.8% in 2017, to 7.0% by 2025. This is an enormous jump, considering that in 2000, 37.8% of the region was living in poverty.

<sup>13</sup> Note that no data for poverty rates was available for Brunei, Cambodia, Oman, Singapore, Somalia or the UAE.

As the growth elasticity of poverty was calculated at an Indian Ocean regional level, it is not possible to derive consistent sub-regional forecasts for the decline in poverty rates. That said, as the most recent data on poverty rates suggests that the South Asian sub-region accounts for around 70% of people in the Indian Ocean living in extreme poverty, the decline of poverty is in this region likely to be greatest in this sub-region.

## **6. Challenges to Trade-Led Growth**

However, the continued rise and economic dynamism of the Indian Ocean economy is not guaranteed. It could be affected by several challenges that could yet undermine the region's prosperity. At the very least, failing to address these issues will mean the region's economic potential is left underexploited. Dealing with all the challenges facing such a vast region, including issues as diverse as climate change, maritime security threats and poor national governance, is beyond the scope of this study. But in terms of trade-led growth—the key driver of regional prosperity—four challenges appear most pressing. These are: (1) port and customs quality, (2) barriers to trade and investment, (3) development gaps, and (4) nascent regional economic governance. Table 5 provides some indicators to compare trade-related infrastructure and trade barriers in the Indian Ocean economy against the OECD.<sup>14</sup>

### **6.1. Ports and Customs Quality**

Gaps in ports infrastructure and onerous customs procedures are an important barrier to maritime trade as they increase the cost of moving products across borders (De, 2009). However, inter-country comparisons of the quality of port infrastructure are difficult due to measurement problems, statistical gaps, and the inherently subjective nature of such evaluations. Table 5 provides one such evaluation from the World Economic Forum's Global Competitiveness report based on a survey of global business leaders' perceptions and available hard data indicators ports. A value of 7 in the scoring system used shows the best possible situation and 1 the worst. The data suggest that the average quality of ports in the Indian Ocean economy (4.2) typically lags behind that of the OECD (5.0). At a sub-regional level, the quality of ports in South Asia (4.2) and Africa and the Middle-East (4.2) are slightly ahead that of East Asia and the Pacific (4.1). As Figure 9 shows, there is considerable variation between Indian Ocean economies in this area too. More developed regional economies – such as Singapore, UAE, Malaysia, Australia and South Africa – have better ports than less developed economies, particularly in Africa.

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<sup>14</sup> Policy benchmarking is increasingly used in studies of regional integration. See ADB (2010) and Wignaraja (2014).

**Table 5: Trade-related Infrastructure and Trade Barriers in the Indian Ocean Economy**

	<b>Indian Ocean</b>	Africa and the Middle East	South Asia	East Asia and Pacific	<b>OECD</b>
<b>Quality of Port Infrastructure (2018) (Higher Number= Better Quality)</b>	4.2	4.2	4.2	4.1	5.0
<b>Trading Across Borders: Time to Export, Border Compliance - Average Hours (2017)</b>	65.4	62.3		65.3	11.0
<b>Weighted Average Tariff (2016)</b>	2.8	3.4	5.3	1.1	1.6
<b>Average No. of Non-Tariff Measures (2017)</b>	25	35	18	14	N.A
<b>Services Trade Restrictiveness Index (Higher Number = More Restrictive)</b>	36.7	32.4	44.1	38.3	19.5
<b>No. of Days to Start Business (Men, 2017)</b>	22	23	18	21	8

*Note: Simple averages for the region and sub-regions were calculated using national data divided by number of countries.*

*Sources: LKI calculations based on World Economic Forum, The Global Competitiveness Report 2017-2018, Available at <https://www.weforum.org/reports/the-global-competitiveness-report-2017-2018>, Accessed on July 2018; World Bank, Doing Business Database, Available at <http://www.doingbusiness.org/data/exploretopics/trading-across-borders>, Accessed August 2018; WTO, Trade and Tariff Database, Available at: [https://www.wto.org/english/res\\_e/statis\\_e/statis\\_e.htm](https://www.wto.org/english/res_e/statis_e/statis_e.htm), Accessed on July 2018; World Integrated Trade Solution (WITS), Available at: <https://wits.worldbank.org/>, Accessed on June 2018; World Bank, Services Trade Restrictions Database, Available at: <http://iresearch.worldbank.org/servicetrade/>, Accessed on June 2018.*

Figure 9: Quality of Port Infrastructure (Rated 1-7, 2017)



Sources: Compiled by LKI based World Economic Forum, *The Global Competitiveness Report 2017-2018*, Available at <https://www.weforum.org/reports/the-global-competitiveness-report-2017-2018>, Accessed on July 2018. Data not available for Comoros, Iran, Somalia and the Maldives.

A broader indicator of the barriers in maritime trade is the World Bank’s Logistics Performance Index, which incorporates a number of different aspects of trading across borders including infrastructure, customs and the quality of logistics providers. This is based on a worldwide survey of logistics operators, which asks them to score these different aspects logistics in the countries they work in on a scale of 1, the worst, to 5, the best. The result of this survey in Table 6 suggest that the average quality of overall logistics in the Indian Ocean (2.9) lags the OECD (3.6) by some margin, with the biggest discrepancy being related to infrastructure quality and the efficiency of customs procedures. Within the Indian Ocean, East Asia and the Pacific outperforms South Asia and the Middle East and Africa on all aspects of the index.

In specific relation to customs, the Trading Across Borders indicator compiled by the World Bank gives an idea of how many hours, on average a country takes for border compliance. In the Indian Ocean, it takes an average of 65 hours for border compliance (see Table 5). In terms of subregions, South Asia is the slowest, with an average of 73.2 hours while Africa and the Middle East is the fastest with an average of 62.3 hours.

Amidst fiscal constraints, many Indian Ocean economies need to undertake public investment in port development and customs modernisation. The emerging collection of mega-regional infrastructure initiatives - such as China’s BRI, Japan’s Partnership for Quality Infrastructure, the Africa-Asia Growth Corridor, the EU Investment Plan and ASEAN’s Master Plan for Connectivity – and international financial institutions can also facilitate investment in ports and trade facilitation. However, these competing large-scale initiatives and donor programmes

may also present some challenges to recipients, including a lack of coordination between competing donors, differing social and environmental standards, insufficient progress on the domestic regulatory reforms needed to maximise the benefits of new infrastructure and risks to debt sustainability in recipient economies (see Yoshimatsu, 2017; Hurley, Morris and Portelance, 2018).

**Table 6: Logistics Performance Index (Rated 1-5, Aggregate Score)**

	<b>Indian Ocean</b>	Africa and the Middle East	South Asia	East Asia & Pacific	<b>OECD</b>
<b><u>LPI Score</u></b>	<b>2.9</b>	<b>2.8</b>	<b>2.7</b>	<b>3.2</b>	<b>3.6</b>
Customs	2.7	2.6	2.5	3.0	3.5
Infrastructure	2.8	2.6	2.6	3.0	3.6
Intl. Shipments	2.9	2.8	2.8	3.1	3.4
Logis. Competence	2.9	2.7	2.7	3.1	3.6
Tracking & Tracing	2.9	2.8	2.8	3.2	3.7
Timeliness	3.3	3.1	3.1	3.6	4.0

*Note: Aggregated LPI score was used, which combines the four most recent LPI editions. This combines the scores of the six components across the 2012, 2014, 2016 and 2018 LPI surveys to generate a “big picture” to better indicate countries’ logistics performance. Simple averages for the region and sub-regions were calculated using national data divided by number of countries. No data was available for Seychelles and Timor Leste.*

*Sources: LKI calculation based on World Bank data. Available at:*

<https://lpi.worldbank.org/international/aggregated-ranking?sort=asc&order=Country#datatable>

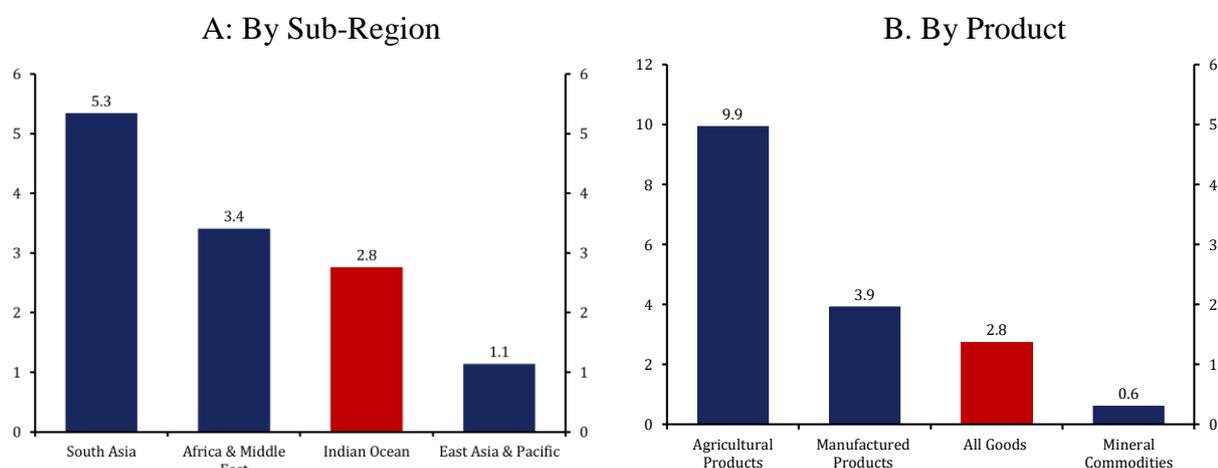
## **6.2. Barriers to Trade and Investment**

Import tariffs in the Indian Ocean economy have fallen significantly since the 1990s reflecting gradual liberalisation in major economies like India and the creation of the WTO, which contributed to falling tariffs globally. The simple average tariff rate<sup>15</sup> on imports into Indian Ocean economies fell to historic lows from 13.8% to 4.6% between 2000 and 2016. A greater fall from 7.6% to just 2.8% is visible when assessed using the weighted average tariff rate, which weights the tariff applied to each good by that particular product’s importance in trade flows.

<sup>15</sup> The simple average tariff level is the unweighted average of the effectively applied tariff rates for all products. LKI calculations based on UNCTAD Trade Analysis Information System (TRAINS), Available at <http://trains.unctad.org/Forms/TPPproject.aspx>, Accessed on June 2018; World Bank, World Integrated Trade Solution (WITS), Available at: <https://wits.worldbank.org/>, Accessed on June 2018

As Figure 10 shows, weighted tariffs are higher in South Asia than in the other two subregions. Similarly, the weighted tariffs are higher on agricultural goods than manufactures and minerals. However, the average effective tariff rate is generally below 10% across the board.

**Figure 10: Indian Ocean Weighted-Average Tariff Level (% , Ad Valorem, 2016)**



*Source: LKI calculations based on UNCTAD Trade Analysis Information System (TRAINS), Available at <http://trains.unctad.org/Forms/TPPproject.aspx>, Accessed on June 2018; World Bank, World Integrated Trade Solution (WITS), Available at: <https://wits.worldbank.org/>, Accessed on June 2018*

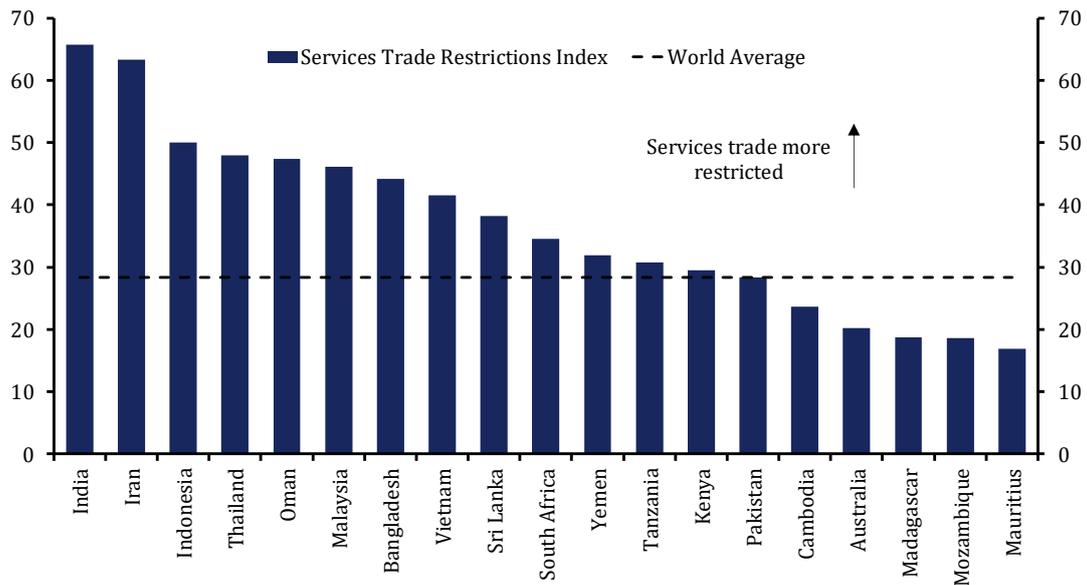
However, murky non-tariff measures (NTMs) do impede Indian Ocean trade. Data is problematic as economies fail to report NTMs to the WTO and difficulties exist in quantifying the relative significance of different NTMs. Nonetheless, the numbers of NTMs initiated and notified to the WTO by Indian Ocean economies increased steadily from 128 to 348 between 2000 and 2010 and still further to 686 in 2017.<sup>16</sup> The bulk of NTMs initiated in 2017 were technical barriers to trade (59.9%) and sanitary and phytosanitary measures (32.2%).

Assessing barriers to trade in services is more challenging than for goods. Services trade takes different forms, including selling a service across national boundaries, setting up a subsidiary, sending an employee overseas to provide a service, as well as tourism and educating foreign students.<sup>17</sup> Similarly, services trade barriers can range from licensing or accreditation to provide a service in a country, to restrictions on foreign companies in certain sectors or even tourist visa fees. While some economies are excluded, the World Bank’s Services Trade Restrictiveness Index suggests that services trade barriers in the Indian Ocean economy (36.7) are generally high relative the OECD (19.5), though there are variations between sub-regions and countries (see Table 5 and Figure 11).

<sup>16</sup> LKI calculations based on WTO, Trade and Tariff Database, Available at: [https://www.wto.org/english/res\\_e/statis\\_e/statis\\_e.htm](https://www.wto.org/english/res_e/statis_e/statis_e.htm), Accessed on July 2018

<sup>17</sup> [https://www.wto.org/english/tratop\\_e/serv\\_e/cbt\\_course\\_e/c1s3p1\\_e.htm](https://www.wto.org/english/tratop_e/serv_e/cbt_course_e/c1s3p1_e.htm)

Figure 11: Services Trade Restrictiveness Index



Sources: World Bank, Services Trade Restrictions Database, Available at: <http://iresearch.worldbank.org/servicetrade/>, Accessed on June 2018

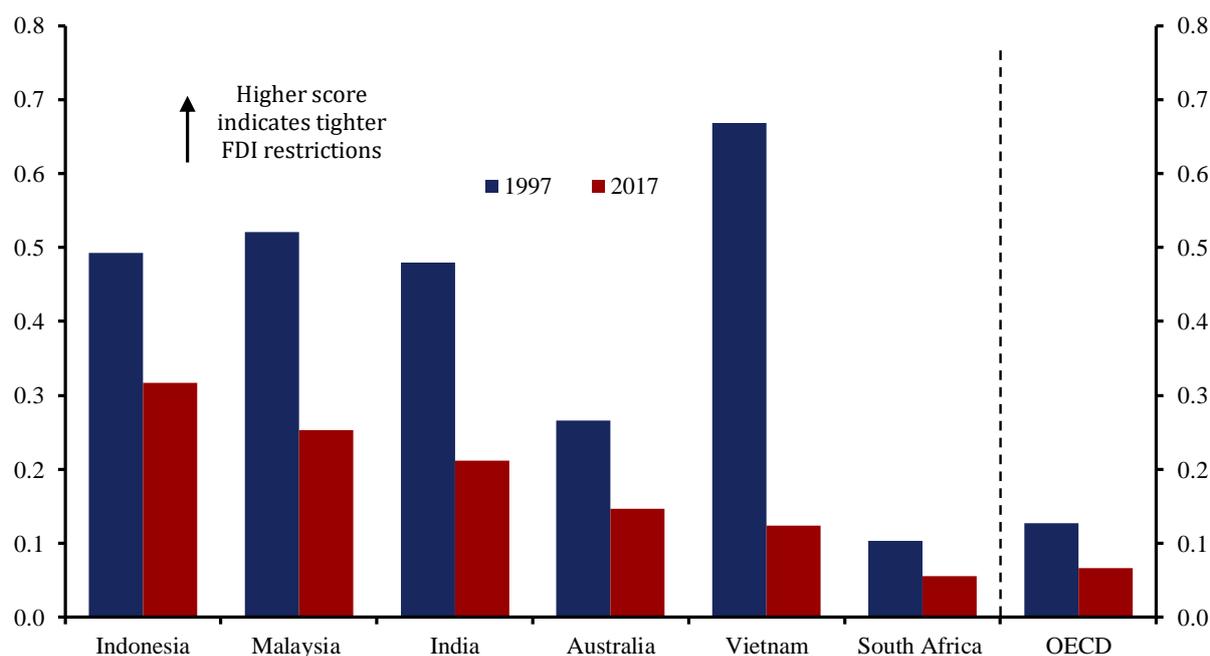
An additional complication is the border regulatory barriers affecting business and trade. For instance, it can take as much as 22 days on average to start a business in the Indian Ocean economy compared with only 8 days for the OECD (see Table 5). Africa and the Middle East (23 days) is the worst performing subregion.

These regulatory barriers also deter FDI, and add to a range of additional statutory restrictions on FDI in the Indian Ocean economies. These measures include limits on the share of a local company that a foreign entity can own, screening requirements for foreign investment or restrictions on foreign employment. Unfortunately, a consistent indicator – the OECD FDI Restrictiveness Index<sup>18</sup> – is only available for a few Indian Ocean economies. On this limited basis it appears that FDI restrictions have fallen since 1997 but they remain more stringent than those in OECD economies (see Figure 12).

Gradually reducing barriers to trade and investment would support trade-led growth in the Indian Ocean. However, to benefit from liberalisation, factors of production need to be reallocated between and within sectors. This structural change is a key source of gains from trade but brings with it costs of adjustment (Francois, Jansen and Peters, 2011). Some workers face temporary unemployment and income losses through lost jobs to international competition. Accordingly, the speed, stages and sequencing of trade and investment reforms need to be tailored to individual national circumstances and be accompanied by suitable trade adjustment programmes to retrain workers in sectors displaced by foreign competition and provide better financial access for small and medium enterprises (SMEs).

<sup>18</sup> OECD, FDI Restrictiveness Index, Available at: <http://www.oecd.org/investment/fdiindex.htm>, Accessed on July 2018

Figure 12: FDI Regulatory Restrictiveness Index



Sources: OECD Stat, Available at: <https://stats.oecd.org/Index.aspx?datasetcode=FDIINDEX#> Accessed on August 2018

### 6.3. Development Gaps

Significant economic progress over recent decades notwithstanding, development disparities and capacity gaps remain between Indian Ocean economies (see Figure 13). In March 2018, The UN classified ten regional economies across the three subregions as less developed economies (LDC) including Bangladesh, Cambodia Comoros, Madagascar, Mozambique, Myanmar, Somalia, Tanzania, Timor-Leste and Yemen.<sup>19</sup> LDCs face significant structural impediments to sustainable development and typically have lower per capita incomes than other regional economies. LDCs are thought to be vulnerable to economic and environmental shocks and have low levels of human development. Poverty rates – the share of the population living on less than USD 1.90 per day – are relatively high in LDCs and income inequality is rising.

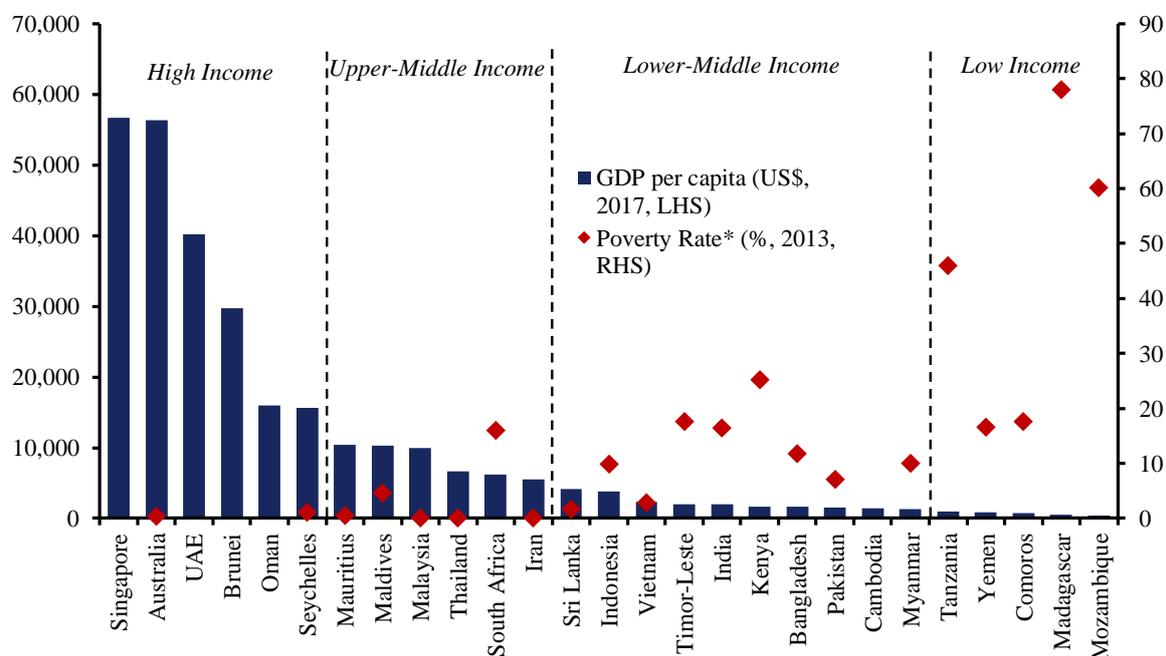
While the diversity of the region presents an opportunity for mutually-beneficial trade based on each country's comparative advantage, development gaps impede LDCs from fully engaging in trade-led growth. Financial constraints in LDCs restrict national investments in port and logistics infrastructure that improve their quality and reduce trade costs. LDCs also rely on trade-related taxes for a larger share of their revenue as limitations in tax administration capacity and large informal sectors undermine the efficacy of other forms of taxation (Burgess and Stern, 1993), which further raises their trade costs. Moreover, small and medium enterprises (SMEs) located in LDCs lack international competitiveness and the ability to join

<sup>19</sup> <https://www.un.org/development/desa/dpad/least-developed-country-category/lpcs-at-a-glance.html>

global value chains (GVCs). More fundamentally, skills deficits and difficult business environments deter export-oriented FDI that would allow LDCs to engage in trade in higher value-added sectors.

Total foreign aid to Indian Ocean economies as a group, doubled from USD 12.4 billion to USD 25.1 billion between 2000 and 2016.<sup>20</sup> Encouragingly, the share of aid to LDCs increased from 37.5% to 50.2% over the same period. However, the bulk of such aid is concentrated in three LDCs – Myanmar, Somalia, Yemen. It is notably lower in other economies which have significant trade-related needs and high poverty. For instance, it is below USD100 per person even in Mozambique where the poverty rate is around 60% (see Figure 13). Accordingly, there have been high-level political calls by Sri Lanka’s Prime Minister for the establishment of an Indian Ocean Development Fund (IODF) to enhance economic development in regional economies (Wickremesinghe, 2016). In our view, this fund could usefully complement existing national and donor efforts in the sphere of trade-related development in the region’s LDCs and middle-income countries (MICs). It could also give special priority to projects which foster regional integration efforts between one or more economies across the Indian Ocean’s three sub-regions (for instance, projects between African and South Asia economies). The IODF’s mandate, financing, governance, staffing, and project activities should be guided by best international practices in regional development banks. Further research by think tanks seems warranted on the feasibility and terms of reference of the IODF.

Figure 13: GDP Per Capita & Poverty Rates in IOR Countries Source: LKI calculations based on



World Bank, *Poverty and Equity Database*, Available at: <https://data.worldbank.org/topic/poverty>. Accessed on July 2018; IMF, *World Economic Outlook Database*, and Available at: <http://www.imf.org/external/pubs/ft/weo/2018/01/weodata/index.aspx>, Accessed on July 2018.

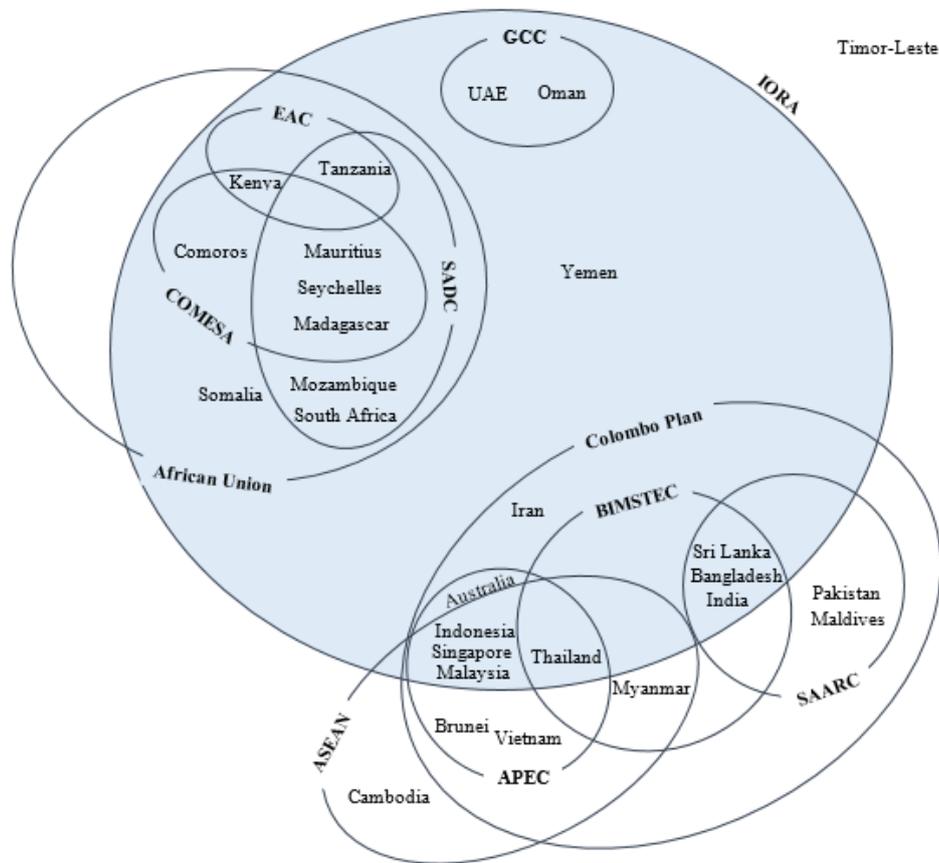
<sup>20</sup> This accounted for 15.9% of world ODA flows in 2016, but is less than US\$10 per person.

An additional issue is the risk of some middle-income countries (MICs) confronting situations of rising inequality as growth has not always been pro-poor and external shocks remain problematic. These countries could find themselves stuck in the ‘missing middle’ of development finance, when total resources available fall as the country moves from low- until well into middle-income status (Wignaraja et al., 2018). Some MICs also lack the requisite technical knowledge to build institutions for fostering trade-led growth such as world class ports and bodies for negotiating comprehensive free trade agreements (FTAs). A case thus exists for external development assistance and knowledge transfer to support the middle-income transition in the Indian Ocean economy. Fostering public private sector partnerships (PPPs) for port development and better targeting to countries with rising inequality and fragile situations are essential to more effectively utilising scarce external assistance.

#### **6.4. Nascent Regional Economic Governance**

A classic hub and spoke network of some 11 regional institutions and FTAs are involved in governing the Indian Ocean economy and furthering regional economic integration. Figure 14 depicts the hub of the network as the Indian Ocean Rim Association (IORA) which covers the majority of the Indian Ocean economies. The multiple spokes include several mostly smaller sub-regional institutions which count Indian Ocean economies among their membership. This includes the Association of South-East Asian Nations (ASEAN), the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), the South Asian Association for Regional Cooperation (SAARC), the Gulf Cooperation Council (GCC), and the Southern African Development Community (SADC). A few Indian Ocean countries are also included in cross-regional institutions like Asia-Pacific Economic Cooperation (APEC).

Figure 14: Network of Regional Institutions governing the Indian Ocean



Source: Compiled using information available on official websites of these respective institutions.

Table A1 maps the available details of these regional institutions. It suggests that the network of regional institutions covering the Indian Ocean is at a nascent stage of institutional development compared to those in the Americas or Europe. These inter-governmental institutions have limited powers delegated by members, lack formal rules or legal structures, have inadequate financial resources and lack permanent secretariats. While the stated objectives of institutions all make some reference to pursuing economic prosperity, in practice these institutions have overlapping agendas with differing emphasis on promoting regional economic integration. Of the 11 regional institutions, only six have a trade agreement in force<sup>21</sup> and the scope and ambition of these agreements vary significantly. They range from the Gulf Cooperation Council's customs union, which removes all internal tariff barriers and imposes a common external tariff, to the South Asian Free Trade Agreement between SAARC members, which originally only covered goods and allowed members states to maintain large negative lists that exclude products from tariff reductions (UNESCAP, 2017, p.6).

Furthermore, while IORA and regional institutions without a trade agreement, promote cooperation on trade facilitation and other forms of technical cooperation, multiple priority areas and limited resources mean the scope of these activities varies significantly. For example,

<sup>21</sup> Notified as in force to the World Trade Organization and included in its Regional Trade Agreement database; available online: <http://rtais.wto.org>

IORA’s secretariat has less than 20 staff members working on six priority areas, of which promoting trade and investment is just one (Waidyatilake, 2017) while the ASEAN’s secretariat has approximately 300 staff working on three pillars of the ASEAN community.<sup>22</sup> Annual budgets also range from less than USD 0.5 million for the Colombo Plan to over USD 400 million for the African Union.

Adding to this tangle of regional institutions are about ten bilateral FTAs that involve Indian Ocean economies. Ten bilateral FTAs between Indian Ocean countries, which are exclusively between countries in the South Asian, and East Asian and Pacific sub-regions of the Indian Ocean (see Table 7). The scope of trade liberalisation among these FTAs also varies significantly, with some covering only goods, while others also incorporate rules on trade in services and investment. Further complicating matters, 52 bilateral investment treaties between countries in the Indian Ocean formalise rules for bilateral investment, as well six additional bilateral FTAs or economic cooperation agreements that contain investment provisions.<sup>23</sup>

Table 7: Bilateral Free Trade Agreements Between Indian Ocean Countries

<b>Free Trade Agreement</b>	<b>Date Implemented</b>
India-Sri Lanka	December 2001
Singapore-Australia	July 2003
India-Thailand	September 2004
Thailand-Australia	January 2005
Pakistan-Sri Lanka	June 2005
India-Singapore	August 2005
Mauritius-Pakistan	November 2007
Malaysia-Pakistan	January 2008
India-Malaysia	July 2011
Malaysia-Australia	January 2013
Singapore-Sri Lanka	January 2018

*Source: Asia Regional Integration Centre, Free Trade Agreement Database, Available at <https://aric.adb.org/database/fta> and Accessed on July 2018*

Given the diversity of the Indian Ocean economies, it is perhaps inevitable that the quest for Indian Ocean economic regionalism is likely to remain ‘institution light’ for the foreseeable future. However, the Indian Ocean’s existing hub and spoke network of regional institutions and FTAs could be strengthened. One step would be to undertake the appointment of an Eminent Persons Group (EPG) from member states tasked with developing a plan to strengthen IORA’s role in regional economic governance. The EPG’s review should provide a vision for IORA’s role in regional economic governance as well as delegated powers from members, formal rules and legal structures, financial resources and a permanent secretariat.

<sup>22</sup> ASEAN Political-Security Community, ASEAN, Economic Community and ASEAN Socio-Cultural Community.

<sup>23</sup> Based on UNCTAD’s international investment agreement database. Available online: <http://investmentpolicyhub.unctad.org/>

Another step would be to encourage linking the various sub-regional and bilateral FTAs in the region to a mega-regional trade agreement with common trade rules and standards. This would increase market access, reduce trade barriers and facilitate regulatory coherence. It would also help to insure against rising protectionist tendencies internationally, as well as strengthen global and regional value chains. Asia's mega-regional trade agreement – the Regional Comprehensive Economic Partnership (RCEP) - seems a reasonable candidate (Wignaraja, 2018). This agreement is currently under negotiation among 16 Asia-Pacific economies including important Indian Ocean economies like Australia, Cambodia, India, Indonesia, Malaysia, Singapore and Vietnam. RCEP has an open accession clause which means other economies can join the agreement at a later date. Furthermore, RCEP addresses the special needs of less-developed ASEAN economies through early elimination of tariffs on products of interest to them, and through the provision of development assistance to narrow development gaps.

## **7. Conclusion**

This paper examines the economic outlook for the Indian Ocean economy in an attempt to address whether the regional economy could become a global growth pole. This appears to be the first attempt to prepare a regional economic outlook for this unique collection of economies spread across three sub-regions in a vast ocean. The exercise examined the region's initial conditions, trends in trade-led growth, the near and medium-term context and policy challenges.

The Indian Ocean economy does seem to be emerging as a new global growth pole. Continuing the pre-crisis trend, the region's trade and growth have grown faster than the global economy since the crisis. Furthermore, based on reasonable assumptions, our projections suggest that the Indian Ocean economy is likely to play a larger role in the world economy with rising prosperity in 2025. The region is could account for around 20% of world GDP in 2025 and its per capita incomes may double to USD 6,150 between 2017 and 2025. Furthermore, the share of population in poverty is likely to halve to 7% by 2025.

The Indian Ocean's initial conditions were broadly supportive of trade-led growth. While covering a diverse set of economies spread over a large sea and land area which raises trade costs, the region's rich factor endowment provides the bedrock for a dynamic regional trading economy. This endowment includes large global shares of oil and gas reserves, mineral reserves and fish stocks. The demographics also favour the region with a large share of the world's working population albeit with varying levels of productivity and wages.

The Indian Ocean economy has been fundamentally shaped by trade throughout history, but this has been especially true since the turn of the 21<sup>st</sup> century. Container traffic through the region's ports has expanded significantly. The region hosts a fifth of the world's top 100 container ports with East Asian and Pacific ports dominating container traffic. Goods and services trade links within the region and beyond have deepened to an unprecedented extent. South Asia, led by India has the brightest outlook for trade volume growth in the short term.

China is emerging as the most important trading partner for the region. A trade upswing has driven rapid economic growth that has reduced poverty and increased per capita incomes.

The global financial crisis has marked a watershed in Indian Ocean's economic performance. The pace of the region's container traffic and its goods and services trade have slowed since the crisis. With trade playing a lesser role in economic activity than before, regional economic growth has also slowed. Only time will tell whether this is a blip in an upswing growth cycle or a longer lasting change leading to new normal growth. New global and regional risks are clouding the region's economic horizon which are likely to impinge on the near-term economic outlook.

Looking ahead, the Indian Ocean's positioning as a global growth pole is also susceptible to several challenges that could yet undermine the region's prosperity. Gaps in port infrastructure and customs procedures in some economies are an important barrier to maritime trade as they raise the cost of moving goods across borders. Tariffs have fallen significantly but non-tariff measures, barriers to services trade and restrictions on FDI are problematic. Significant economic progress notwithstanding, development disparities and capacity gaps remain. Ten regional economies are classified as LDCs and some middle-income countries risk confronting situations of rising inequality and weaknesses in institutions to facilitate trade-led growth. Regional economic governance is at a nascent stage compared to those in the Americas or Europe. The array of inter-governmental institutions suffers from limited delegated powers from members, inadequate financial resources and lack permanent secretariats.

Tackling these challenges requires a combination of coherent national and regional policy measures. Key actions would include (1) investing in port development and customs modernisation through national and mega-regional initiatives, (2) gradually reducing in barriers to trade and investment, (3) setting up an Indian Ocean Development Fund to support LDC participation in trade-led growth and to facilitate knowledge transfers to middle income countries, and (4) strengthening regional economic governance through appointing an Eminent Persons Group on IORA and linking sub-regional and bilateral FTAs to the RCEP.

Table A1: Regional Organisations in the Indian Ocean Region

<b>Name of Institution</b>	<b>Indian Ocean Economy Members</b>	<b>Date Established</b>	<b>Annual Budget (USD)</b>	<b>Information on Secretariat</b>	<b>Objective/Trade Agreements</b>
<b>Association of Southeast Asian Nations ( ASEAN)</b>	Brunei, Cambodia, Indonesia, Malaysia, Singapore, Thailand, Vietnam, Myanmar	August 1967	N/A	Located in Indonesia	Ensure economic growth, social progress and cultural development through regional collaboration.  The AFTA agreement was signed in January 1992.
<b>Asia-Pacific Economic Cooperation (APEC)</b>	Australia, Brunei, Indonesia, Malaysia, Singapore, Thailand, Vietnam	November 1989	Annual member contributions total USD 5Mn, presently.	Located in Singapore with a minimum of 57 staff members	To strengthen the multilateral trading system by reducing barriers in order to facilitate cross border trade and business.  FTAAP was endorsed in November 2014.
<b>Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC)</b>	Sri Lanka, India, Bangladesh, Thailand, Myanmar	June 1997	N/A	Located in Bangladesh with a minimum staff of 24	To utilise the synergies among members to collaborate on sub regional projects and support national development plans.
<b>Indian Ocean Rim Association (IORA)</b>	Australia Bangladesh, Comoros, India, Indonesia, Iran, Kenya, Madagascar, Malaysia, Mauritius, Mozambique, Oman, Seychelles, Singapore, Somalia, South Africa, Sri Lanka, Tanzania, Thailand, UAE, Yemen	March 1997	N/A	Located in Mauritius with a minimum staff of 17	To facilitate discussions and provide support in policy implementation in maritime safety and security related fields and the 'Blue Economy.'

<b>Southern African Development Community (SADC)</b>	Madagascar, Mauritius, Mozambique, Seychelles, South Africa, Tanzania,	August 1992	USD72 Mn. 2016/2017	Located in Botswana.	To achieve development, economic growth and alleviate poverty while encouraging sustainable use of resources and strengthening historic ties between members. The SADC FTA was enforced in August 2008.
<b>Gulf Cooperation Council (GCC)</b>	UAE and Oman	May 1981	N/A	Located in Saudi Arabia	To formulate regulations for various fields such as economic and financial affairs, education and culture and stimulate scientific and technological progress within the region The GCC Customs Union was enforced in January 2015.
<b>South Asian Association for Regional Cooperation (SAARC)</b>	Bangladesh, India, Maldives, Pakistan Sri Lanka	December 1985	N/A	Located in Nepal, 61 staff members roughly	To improve the standard of living and promote the welfare of people, through regional economic integration and cooperation.  SAFTA was enforced in January 2004.
<b>African Union</b>	Comoros, Kenya, Madagascar, Somali Mauritius, Mozambique, Seychelles, South Africa, Tanzania	May 2011	USD 417 Mn. 2016	Located in Ethiopia	To promote sustainable development at the economic, social and cultural levels as well as the integration of African economies.  AfCFTA was signed in March 2018.
<b>Colombo Plan</b>	Australia, Bangladesh, Brunei, India, Indonesia, Iran, Malaysia, Maldives, Pakistan, Singapore, Sri Lanka, Thailand, Vietnam Myanmar	July 1951	USD 442,381 Budget for 2014/2015	Located in Sri Lanka	To encourage technical cooperation and assist in the sharing and transfer of technology among member countries.

<b>Common Market for Eastern and Southern Africa (COMESA)</b>	Comoros, Kenya, Madagascar, Mauritius, Seychelles,	December 1994	USD 42 Million in 2017	Zambia	To promote economic activity and the adoption of suitable macro-economic policies and programmes; to raise the standard of living of its peoples, and to foster closer relations among its member States; COMESA FTA was launched in October 2000.
<b>East African Community</b>	Kenya, Tanzania	July 2000	USD 110 Million in 2017/2018	Located in Tanzania	To widen and deepen co-operation in, among others, political, economic and social fields. EAC Customs Union was put in place in January 2005.
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Sources: Compiled using information available on official websites of these respective institutions

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