# SOUTH ASIAN FREE TRADE AGREEMENT: PROSPECTS OF SHALLOW REGIONAL INTEGRATION

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# South Asian Free Trade Agreement: Prospects of Shallow Regional Integration

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**Abstract:**
This paper essentially focuses on the belated regionalization attempts of the South Asian economies and myriad of problems that are coming in their way to forming a smoothly functioning free trade area and regional integration agreement. Notwithstanding their efforts, progress so far has been tardy. Although South Asian economies took several liberalization measures during the 1990-2005 period, this group of economies was the most highly protected group in the global economy in 2005. It lagged behind in opening its domestic economy to global competition as well as in attracting FDI. Furthermore, evidence of trade complementarity in South Asian economies is mixed so far, which made creation of an FTA a weak proposition. However, this paper recommends that despite lack of success, South Asian economies should continue their endeavors to regionalize. At present, these economies are at a low level of per capita income and economic development. As they move up their respective growth trajectories, they are likely to develop complementaries. If these economies continue to grapple with their current hurdles to regionalization, in the medium-term South Asian economies stand to gain in welfare terms even if they succeed in shallow regional integration.

**Keywords:**
Globalisation, free trade, SAFTA, South Asia, economic integration

**Contents:**



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# SOUTH ASIAN FREE TRADE AGREEMENT:
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## 1. Introduction

This paper is an attempt to understand the incentives for and progress towards greater economic integration in South Asia. This sub-region comprises seven economies, namely, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan and Sri Lanka, which are members of South Asian Association for Regional Cooperation (SAARC). The first concrete proposal for establishing a framework for regional cooperation in South Asia was made by the former president of Bangladesh, Ziaur Rahman, in May, 1980. It was promptly endorsed by Nepal, Sri Lanka, the Maldives and Bhutan but India and Pakistan were initially skeptical. Their acceptance of the SAARC concept was slow, hesitant and delayed. Its charter was accepted by all the seven members in mid-1985. Success of similar regional trade and economic integration groups in other parts of the globe had impressed the members. Therefore, they created it primarily for holding consultations on regional issues of mutual interest as well as collaborating in international fora for mutual benefit. Regional cooperation that SAARC initially emphasized was on the political level, for which the foreign ministers of the seven countries met. Members also intended to explore the possibilities of cooperation on economic and social issues, but that was secondary.

Due to the legacy of conflicts, the member countries of the SAARC were initially tentative in coming together. Lack of enthusiasm, poor understanding of benefits of regional integration and overly cautious conduct made the process of formulating regional integration-related agreements and implementing them in an effective and efficacious manner a time-consuming and difficult one. SAARC often gave an impression of being a forum where the member countries met to carry on discussions and organize seminars and conferences, rather than thoughtfully devise pragmatic sub-regional economic integration policies for the common good of them all and implement them in a methodical manner so that their GDP growth and intra-regional trade and investment can be accelerated and poverty ameliorated (Katzenstein, 2000).

India is by far the largest SAARC economy, while Pakistan and Bangladesh are the second and the third largest (Table 1). These three economies are of crucial importance for any sub-regional integration and cooperation plan to operate successfully, albeit India and Pakistan would be the dominant constituents of any formal regional integration agreement. The size of the GNP and per capita income of the seven South Asian economies according to the latest available data are as follows:

Table 1

Gross National Income (GNI) in 2004

| | GNI in Billions of dollars | GNI Per Capita In dollars |
|---|---|---|
| 1. Bangladesh | 61.3 | 440 |
| 2. Bhutan | 0.70 | 760 |
| 3. India | 673.2 | 620 |
| 4. Pakistan | 90.7 | 600 |
| 5. Nepal | 6.6 | 250 |
| 6. The Maldives | NA | 2,300 |
| 7. Sri Lanka | 19.5 | 1,010 |

Source: The World Bank. 2006. *World Development Indicators.* Washington DC. Table 1.1.

Bhutan and the Maldives are two tiny economies of the sub-region. The former is a land-locked country, while the latter is water-locked. Of these seven, three economies, namely Bangladesh, Bhutan, the Maldives and Nepal, come under the UN designated category of the least-developed countries (LDCs). The Maldives and Sri Lanka come under the World Bank category of lower-middle income (LMI) countries and India and Pakistan come under the category of low income countries (LIC). South Asia is one of the poorest regions in the world. More than a-fifth (22 percent) of the global population lives in this sub-region, although it accounts for merely 2 percent of the global GDP. A large number of absolute poor inhabit this sub-region, which is world's mostly populated.

If per capita GNI is taken as a measure, Sri Lanka is the second most prosperous sub-regional economy (Table 1). The island country of the Maldives has the highest per capita GNI. It is made up of 1,190 coral reef islands, having 26 major atolls. Only 200 islands are inhabited and 44 of them have been skillfully adapted for modern tourism. Due to its prosperous tourism-based economy, the Maldives is the growth champion of South Asia. It leases out numerous islands to expert tour operators, who run the industry in a highly professional manner. Hiring of expatriate professionals in tourism-related businesses is a common practice. So are imports of all the inputs needed by the tourism industry. Its average annual GDP growth rate for the last two decades (1985-2005) was 10 percent and per capita GDP $2,300. Fisheries and trade follow closely behind tourism. The economy is regarded as exemplary in the region and welcomes foreign direct investment (FDI).

The tiny Himalayan Kingdom of Bhutan is one of smallest and least developed economies in the world. Agriculture is the mainstay of the economy and a large proportion (85 percent) of population depends on it. Animal husbandry and forestry are of the other economic activities. Due to high and rugged mountainous terrain building roads and other infrastructure is difficult and expensive. The economy is closely aligned with that of India, through close trade and monetary links. Although the industrial sector is small and technologically backward, Bhutan has high hydropower potential. It has also become an attractive tourist destination in the recent years. Its per capita income was $760, higher than many of its larger sub-regional neighbors.

## 2. Liberalizing Protectionist Regimes

During the post-World War II period, the South Asian economies had adopted the strategy of import-substituting industrialization (ISI). The supporting policies that went with the ISI included a massive public sector and a control-ridden private sector, that existed at the periphery of the economy, and a strong anti-export bias. The ISI strategy effectively worked towards limiting trade, including intra-regional trade. Its influence was asymmetric towards restraining the latter. High level of protectionism was an integral part of the ISI strategy.

Tariff levels in Bangladesh, India and Pakistan were exceedingly high until 1990. In the early 1990s, more South Asian economies changed course and began liberalizing their domestic trade regimes by slashing tariffs. Both India and Bangladesh began liberalizing trade policies and cutting tariff rates in the early 1990s. It continued gradual tariff reduction during the 1990s and the early 2000s. Nepal and Pakistan began liberalization and slashing of tariff rates in 1997. Bangladesh's tariffs were the highest in the region but the government began to slash them. Consequently, during the 1990s the South Asian economies succeeded in moving away from the stringently protectionist quasi-autarkic regimes of the past and in increasing their trade with the global economy. However, it must be pointed out that, first, this evolution was slow, much slower than that in China. There was backtracking on tariff reforms in Bangladesh and India during 1997-2001 period. Second, trade liberalization in the sub-region was far from uniform, with Bangladesh, India and Pakistan still adhering to several interventionist policies.

As set out above, while considerable tariff liberalization occurred in the South Asian economies, they continue to be among the most highly protected in the world, after the socialist economies. Table 2 shows this clearly:

Table 2

Tariff Rates in the South Asian Economies

(In Percent)

| Economy | Year | Simple Average | Weighted Average | Standard Deviation |
|---|---|---|---|---|
| Bangladesh | 2004 | 18.42 | 15.87 | 10.2 |
| Bhutan | 2002 | 16.61 | 18.18 | 10.9 |
| India | 2001 | 32.32 | 26.50 | 13.0 |
| The Maldives | 2003 | 20.21 | 20.68 | 13.2 |
| Nepal | 2003 | 13.61 | 16.80 | 10.9 |
| Pakistan | 2003 | 17.1 | 14.46 | 10.9 |
| Sri Lanka | 2001 | 9.25 | 6.68 | 9.3 |

Source: Computed from COMTRADE Database of the United Nations by Mukherji (2005).

In the sub-region, the simple and weighted average tariffs were highest in India and lowest in Sri Lanka. The levels of average applied tariffs were also the highest for this sub-group of economies. In 1989-90 applied average unweighted tariffs for the South Asian economies were 76 percent. Comparable figure for the East Asian economy was 20 percent.[1] The South Asian economies labored under the ISI regime for decades. In terms of growth and industrialization, they not only failed to keep pace with the dynamic economies of East Asia but also

[1] The source of these statistical data is the World Bank, *Global Economic Prospects*, 2005.

did not learn the modus operandi of brisk real GDP growth from them until recently (Das, 2005a).

Non-tariff barriers (NTBs) and para-tariff barriers (PTBs) also present serious problems in sub-regional integration. In April 2006, trade ministers of the seven countries met in Dhaka to identify and review the NTBs and PTBs and plan a strategy to restrain them. To this end, the SAFTA Committee of Experts (SCOE) was established, which will meet twice a year.

Macroeconomic reforms and liberalization were adopted by the South Asian economies due to general disenchantment with the socialistic-style economic management under the ISI regime, in which large and intrusive government systems excessively intervened in the economic life. A segment of the policy-making community in these economies felt that their countries have been missing out on the growth and development opportunities that East and Southeast Asian economies enjoyed. South Asian economies, except Sri Lanka, did not adopt liberalization of trade and foreign investment until the early 1990s. Sri Lanka undertook significant reform and liberalization measures towards the end of the 1970s and during the 1980s, and was the pioneer in the sub-region. The reforms that were implemented paid off and their consequence is reflected in Sri Lanka’s relatively higher per capita GNI in South Asia (Table 1).

Trade policy liberalization and reduction of border tariff measure were an integral part of the macroeconomic and structural reforms programs launched by these economies. Under these programs the South Asian economies also undertook considerable industrial deregulation. The reform and restructuring measures were both much-needed and long-awaited. Public policy mandarins were slow to realize the error of their ways. The business community and a segment of the policy-making community belatedly began to recognize how critical the external sector can be for economic growth and poverty alleviation. Even the incomplete reform measures have strengthened the poverty alleviation efforts in South Asia.

Poverty gap index for this sub-group of economies was 16.06 percent in 1981, it declined to 11.00 percent in 1990, and further down to 6.37 in 2001 (Chen and Ravallion, 2004).[2] Belatedly they became cognizant of the fact that external sector can become an effective locomotive for GDP growth.[3]

Financial sector liberalization was to be adopted next. India and Sri Lanka began deregulation of interest rates and permitted private sector banking to grow in the mid-1990s. Nepal and Pakistan followed with identical measures in the late 1990s. Majority of the South Asian economies followed prudent fiscal and monetary policies. The exceptions in this regard were India and Sri Lanka. These two economies were known for fiscal profligacy, with large budget deficits, in the vicinity of 10 percent of the GDP.

Economic and structural reforms in these economies were not only launched after long procrastination but are also incomplete. There is a pressing need to implement further reforms, unleash the market forces, reduce the high level of governmental intervention in the economy and address the rigidities that the economic structures of South Asian economies are presently facing so that they could achieve trade-induced growth exemplified by the East Asian economies in the near-term. These measures are sure to benefits the absolute poor.[4]

## 3. Consequences of Reforms and Restructuring

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[2] See Chen and Ravallion, 2004, Table 4.

[3] This argument does not necessarily conflict with the fact that poverty amelioration in India during the 1980s was greater than in the 1990s, although growth performance in the 1980s was relatively weaker. The reason is that the poverty elasticity of economic growth in India fell over this period. Poverty elasticity implies how much is the poverty reduction caused by 1 percent GDP growth rate.

[4] The definition of absolute poor is based on subsistence, the minimum standard needed to live. Robert McNamara who coined this term defined it as "a condition of life beneath any reasonable standard of human dignity." There has been a long drawn debate in the discipline regarding whether income or consumption poverty lines should be defined in absolute or relative terms. Most international organizations define the poverty line in an absolute way as the "level of income necessary for people to buy the goods necessary to their survival." In keeping with this concept, the dollar-a-day line, at 1985 purchasing power parity, is being extensively used in academic researches and by policy makers (Bourgignon, 1999). However, broader definition of poverty is the general lack of capabilities that enables a person to live a life he or she values, encompassing such domains as income, health, education, empowerment and human rights.

Numerous cross-country and panel regressions found evidence of "outwardness", or "outer-orientation" or "openness" being strongly linked to faster economic growth. This relationship held irrespective of the fact whether openness is measured in terms of a country's trade policies, that is, by the level of tariff and the non-tariff barriers (NTBs), or as a policy outcome, that is, the ratio of trade (exports plus imports) to GDP (Das, 2007).[5] During the decade of 1990s, outer-oriented,[6] or export-led, growth become a key strategic thrust in each one of the South Asian economies. It was evidenced by the gradually increasing integration of each individual economy with the global economy. One of the statistical measures of this trend is the significantly increasing merchandise trade to GDP ratios for the South Asian economies.

The effect of partial reforms was reflected in the gradual firming up of real GDP growth rate in this group of economies during the decade of 1990s, which in turn contributed to an impressive reduction in poverty. Three countries that demonstrated the most impressive results were Nepal, India and Bangladesh, in that order. They recorded poverty reduction by 11 percent, 10 percent and 9 percent, respectively, during the period under consideration. In Sri Lanka poverty declined by 6 percentage points. However, Pakistan went against the grain and recorded an 8 percentage point increase in poverty. The reason was economic stagnation during the 1990s. This occurred in the backdrop of rapid economic expansion during the decade of 1980s, which had contributed a 12 percentage point reduction in poverty reduction in Pakistan.[7]

These traditionally slow-growing economies also began turning in superior economic performances. Over the 2000-05 period, Bangladesh, Bhutan, India, the Maldives and Pakistan recorded quinquennial average GDP growth rate of 5 percent or above. The two economies that lagged were Sri Lanka (4.7 percent)

[5] See Das (2007), chapter 1 for a detailed exposition.
[6] The term outer-oriented was first used by Anne O. Krueger and it came into currency after that. See Krueger (1980) and (2000).
[7] The statistical data cited here comes from Devarajan and Nabi (2006).

and Nepal (2.5 percent). In 2005, the year for which *World Development Indicators 2006* provides statistical data, GDP growth rate for all the South Asian economies crossed 5 percent. India and Pakistan turned in stellar performance with annual GDP growth rates of 8.5 percent and 7.8 percent, respectively.

Since 2000, this group of economies, particularly Bangladesh, India, Pakistan and Sri Lanka recorded brisker export growth than in the past. Their exports to the industrial economies, particularly to the European Union (EU) and the United States (US), picked up significant momentum. That being said, trade expansion in South Asia started from a small base. If trade as a percentage of GDP is taken as a measure of openness of the economy, in 2004 the Maldives was the most open economy in South Asia (178 percent), followed by Sri Lanka (82 percent) and Bhutan (65 percent). Pakistan (31 percent) and Bangladesh (36 percent) were at the other extreme. India (42 percent) and Nepal (49 percent) were better than their protectionist past but did not open much.[8] Performances of the Maldives, Sri Lanka and the tiny economy of Bhutan were an exception to the rule. Notwithstanding the endeavors and improvements of the 1990s and early 2000, South Asian economies still have the lowest trade to GDP share of any country group in the global economy.

## 4. More than Incomplete Reform Programs

Although slow and incomplete reform implementation has continued in the South Asian economies, they ushered in improvements in the GDP growth rate and export performance. This raises a valid question regarding the rationale behind brisker growth rate. The South Asian economies were, and still are, in the grips of several growth-impeding forces. For instance, the larger South Asian economies were, and still are, known to be having a great deal of governance

[8] The source of these statistical data is *World Development Indicators*, 2006, annually published by the World Bank.

related problems. This was their Achilles heel. Transparency International,[9] the global organization that computes the annual Corruption Perception Index (CPI) of countries, placed Bangladesh at the bottom of its list in its 2005 rankings, for having the highest level of corruption in the world. On a 1 to 10 scale, where 10 stood for no corruption, Bangladesh scored 1.7. As Table 3 shows that other South Asian countries for which this index was computed did little better.

Table 3

Corruption Perception Index (CPI)

| Country | Rank in the World | CPI Score |
|---|---|---|
| 1. Bangladesh | 158 | 1.7 |
| 2. Pakistan | 144 | 2.1 |
| 3. Nepal | 117 | 2.5 |
| 4. India | 88 | 2.9 |
| 5. Sri Lanka | 78 | 3.2 |

Source: Transparency International, Berlin, Germany.

Until the time of writing (late 2006) these economies continued to suffer from macroeconomic, financial and governance related constraints. All these flaws coalesced to retard productivity growth rate and rein in competitiveness of export sectors. Private sector economic activity was critically constricted by serious infrastructural bottlenecks, poor economic governance, serious constraints in labor and land markets, and inadequate development and deficient performance of the financial markets. Some of the most conspicuous economic constraints have been created by power shortage and inland road and rail transport

[9] Transparency International is the leading global non-governmental organization devoted to combating corruption. Its mission is to *create change* towards a world free of corruption. It is based in Berlin, Germany, having chapters in all the large countries.

constraints, archaic labor laws and inefficient trade infrastructure, particularly customs procedures and regulations. Business enterprises, particularly small and medium ones, frequently face problem in accessing finance from the organized financial sector. While property rights are properly defined, implementation is arbitrary. Stifling red tape and rent-seeking practices in the government system increase the transaction costs enormously. These economies have a long way to go in, first, completing their reform and restructuring process and, second, addressing the limitations enumerated in this paragraph.

There were several well-known long-standing social malaise that exacerbated the economic difficulties in this sub-region. Principal among them were the presence of corruption, inefficient government systems, incompetent bureaucracies in the larger South Asian economies, environment of domestic (Nepal and Sri Lanka) and mutual (between India and Pakistan) conflicts. In spite of following the ISI strategy in the past and incomplete reforms in the present, one is intrigued by the question about what factors could possibly be responsible for recent pick up in the GDP growth rate and trade performance in the South Asian economies.

One plausible answer could be institutional development, which helped make the payoff from the partial macroeconomic reform program superior to what can be normally expected. Democratic environment, which contributed to democratic institutional development and free press in this country group were responsible for slow progress of reforms on the one hand, were also responsible for improved outcomes of the partial reform process on the other hand. Second, it seems that incomplete reforms helped in diminishing or removal of the most egregious forms of anti-export bias that these economies had suffered from in the past. Gradual domestic policy reforms improved export performance over the 1990-2000 period, which was reflected in improvement in the trade to GDP ratio. Third, Devarajan and Nabi (2006) posited that external financial flows were the other factor that helped South Asian economies in surpassing the trend growth rates.

After September 11, 2001, external debt burden of Pakistan declined sharply. A significant source of external finance for the South Asian economies was remittances from abroad, which have been on an increase. A good number of nationals from the large South Asian countries live and work abroad and repatriate their savings. In 2005 they received inflows of repatriated income of $22 billion, which helped keep their balance of payments situation stable.

In addition, agriculture in South Asia is largely monsoon fed. Therefore, weather conditions are of material importance and influences annual GDP growth rates significantly. Over the last several years, these countries benefited from adequate and spread out monsoons. They contribute to bountiful harvest, which firmed up the GDP growth performance. Also, a long spell of low interest rates in the industrial economies resulted in larger capital flows into the stock markets of some of the South Asian economies than was possible under normal circumstances. India benefited most from this kind of external capital flows. Other countries were able to borrow large amounts from the global capital markets in this environment of low interest rates. This development was responsible for an up tick in investment in the South Asian economies.

## 5. Intra-Trade and Regional Integration Initiatives

Intra-regional trade is not a novel concept for the South Asian economies. That being said, they are indeed new to the concepts of regionalism and regionalization.[10] Around the time of their independence (in 1948) almost a-fifth (19 percent) of their total trade was intra-regional. This was the period when their tariff barriers and NTBs were yet to be raised and as legacy of the Great Depression of the 1930s the tariff barriers and NTBs in the industrial economies were high. Historically, this was the high point of intra-regional trade in South Asia. After this point it went into a monotonic decline; it was 4 percent of their total trade in 1960 and 2 percent in 1970. With minor fluctuations, it continued to remain by and large at this level (2.4 percent) until 1990. As a proportion of total

[10] See Das (2005b) for a distinction between regionalism and regionalization.

trade it began to rise slowly to reach approximately 4 percent in 1999 (Pursell and Pitigala, 2001).

As elucidated in Section 2, during the post-War era South Asian economies adopted the growth strategy of ISI with heavy anti-export bias and high protectionism. This policy regime did not allow any plan of regional integration to be conceived. During the three waves of regionalism in the global economy, this country group remained passive during the first and minimally active in the second.[11] The concept of regional integration had little relevance or appeal for these economies. However, these economies that were indifferent to the concept of regional integration in the past began to notice growing regionalism in other parts of the global economy and comprehend its benefits and warmed up to the concept of regionalism as well as regionalization. By taking initiatives and making the agreements enumerated below, South Asian economies entered the primary stage of economic unification. In the past, this sub-group was regarded as laggards in this respect, but it participated in the third wave of regionalism. After 2000, South Asian economies displayed eagerness to participate in the regional economic dynamism and be part of regional agreements in other parts of Asia and the global economy.

Since the Uruguay Round (1986-94) of Multilateral trade negotiations (MTNs) India and during the Doha Round (2001-2006)[12] of MTNs Bangladesh and Pakistan begun participating in the multilateral trade negotiation with some zeal. During the Doha Round negotiations of the World Trade Organization (WTO), India was one of the leaders of the Group-of-Twenty (G-20) economies, which represented the medium and large developing economies and influenced the rule-making process of the multilateral trade regime. Similarly, Bangladesh played an effective role on behalf of the LDCs in the Doha Round (Das, 2007). Intra-regional trade and regional integration endeavors in South Asian economies

[11] See Das (2004) for a detailed discussion on the three waves of regionalism.
[12] Due to serious disagreements among the participating members and differences in negotiating positions the Doha Round of MTNs was formally suspended on July 24, 2006.

continued to be very low even during the Uruguay Round, albeit they picked up markedly during the Doha Round.

Notwithstanding the liberalization measures of the 1990-2005 period, this group of economies was still the most highly protected group in the global economy in 2005 (Das, 2006). It lagged behind in opening its domestic economy to global competition as well as in attracting FDI. The Maldives was an exception in this regard and was able to attract notable amount of FDI in its tourism-related industries. Although FDI inflows to this sub-region have improved since 2000, South Asian economies were regarded as unattractive by the global investing community and FDI inflows in general remained weak. Notwithstanding recent improvements, regionalism and regionalization in this group of economies has still not made much headway. In the recent past intra-regional trade increased from 2.4 percent in 1990 to 4.0 percent in 2000. However, at the time of writing intra-regional trade accounted for merely 5 percent of the total merchandise trade of this sub-group of economies. As indicated below (Table 4), intra-regional trade as a share of GDP was also the lowest for the South Asian economies.

Table 4

Intra-Regional Trade as Share of GDP (2004)

(Percent)

| Region | Intra-Regional Trade |
|---|---|
| 1. East Asia and Pacific | 26.5 |
| 2. Europe and Central Asia | 15.3 |
| 3. Latin America | 6.4 |
| 4. Sub-Saharan Africa and | 5.3 |
| 5. Middle East and North Africa | 3.5 |

| | |
|---|---|
| 6. South Asia | 0.8 |

Source: World Bank. *Global Economic Prospects 2005,* Washington DC. p. 43.

Why is 95 percent of the trade of South-Asian economies with the extra-regional economies? A close scrutiny of trade statistics and direction of trade of this country-group reveals that their intra-regional trade was heavily concentrated on a small number of traditional markets in the sub-region. This trend was determined by historical developments in their trade. These economies completely ignored to expand their intra-regional markets during the post-War period. Trade expansion in the other member countries of the sub-region had a low priority for these economies. In addition, persistent protectionist trade regimes, discrimination of trade with larger neighbors, long-running conflicting relations among the larger countries and constraints emanating from transport and trade facilitation were the principal inhibiting factors. History of ignoring the sub-regional markets and the inhibiting intra-trading environment coalesced to keep the intra-regional trade to such a measly level in South Asia.

Multifarious feuds among the South Asian economies was one of the reasons they did not think of forming an economic union of any kind for a long while. Confrontations among them during the post-War period made economic cooperation difficult. Moving belatedly on the sub-regional economic integration front, the seven South Asian economies signed an agreement to form the South Asian Preferential Trade Area (SAPTA) in 1993; it came into effect in December 1995. Although three rounds of preference exchange negotiations took place, the exchange of preferences among members under SAPTA obstinately remained exceedingly low. Lack of success of SAPTA was caused by the well known drawbacks, namely, persistence of high level of protection in the member countries, lack of any meaningful offers for tariff reduction, outright exclusion of several large sectors of trade from tariff reduction, domestic political problems, and tense relations among some member countries of SAPTA became an unviable proposition. Furthermore, India had a ban on imports of consumer products from the SAPTA countries until 1998 and from the rest of the world until 2001, which also became a hurdle in the way to having a robust SAPTA. It took off to an exceedingly poor start and gave an impression of initially existing merely on paper, thereafter it stagnated.

Product coverage under SAPTA remained limited. SAPTA's implementation in terms of tariff liberalization was lethargic primarily because of the adoption of the product-by-product approach. An analysis of the top 20 export commodities of the member countries revealed that the SAPTA resulted in significant preferences for only the LDC members of SAPTA. It could not be regarded as a successful regional trade-promoting body. The ultimate objective of the member countries was to build on SAPTA and turn the sub-region into a full-fledged free trade area (FTA). An Inter-Governmental Expert Group was set up in 1996 to propose the necessary steps to proceed towards an FTA. Turning SAPTA into a South Asian Free Trade Agreement (SAFTA) was originally planned to be completed by 2001, but little progress occurred in this direction.

After ten years of prolonged discussions, deliberations and negotiations, the SAFTA agreement was signed in January 2004, for which the internal liberalization was scheduled to begin on January 1, 2006, in a phased manner. In an obvious move to higher level of trade and economic cooperation, the 25-article SAFTA replaced the SAPTA. It was the most significant sub-regional economic initiative since the formation of SAARC. Members agreed to give themselves ten years for progressive liberalization of tariffs. Complete trade liberalization is to take place by 2016. Tariff cuts would proceed in two stages but at a different pace for the LDC member states and the non-LDC members of SAFTA. For the LDC members in the sub-region, India, Pakistan and Sri Lanka agreed to bring down the tariffs by January 2009. That is, in the WTO parlance, LDCs would benefit from "early harvest". As a gesture of goodwill the LDC members would also benefit from additional measures under the special and differential treatment accorded to them in the SAFTA.

SAFTA gives an impression of being a rhetorically ambitious organization. Still its negotiations have a narrow base and were limited to trade in goods. They did not cover services, investment, and other non-border market access issues. In addition, SAFTA ignored negotiations on the rules of origin (ROO), which can be a complex issue for any free trade agreement (Sally, 2006). Although SAFTA does not hold out a promise of fundamentally transforming the economies of one of the largest and most economically challenged and crowded regions of the global economy, it can deliver substantially increased intra-trade and investment in the sub-region.

Notwithstanding the recent regionalization initiatives leading to some improvement in the recent past, sub-regional economies still maintain fairly high level of protection. This sub-group of economies needs to set a high objective for regional integration and earnestly work towards achieving it. As any group of regionally integrating economies, they should first endeavor to increase intra-regional trade in goods and services. Second, they need to encourage cross border investment. To this end, creation of a supportive policy structure and attractive investment environment are indispensable. Third, equally important is the development of supply chains. In this area, South Asian economies can take a lesson from the East Asian economies and China, which have recorded impressive success in supply chain development and management. Furthermore, cooperation in the area of harmonization of product standards, customs procedures and other regulations would certainly help achieve the objectives of expansion of sub-regional trade, investment and supply chain development.

Multilateral trade negotiations (MTNs) under the Doha Round had stagnated since the very beginning. Divergence in positions of developing and industrial economies had existed on several significant issues in the Doha Round and the gap was not bridged even during the fifth biennial Ministerial Conference, held in Cancún, Mexico, during 10-14 September 2003. The number of participating economies in this Conference was 146. The principal bones of contention were agricultural trade reforms, an age old chestnut, and the so-called Singapore issues. Due to serious, albeit avoidable, errors of judgment, the dissension in negotiating stands taken by the large-trading WTO members and poor conference management wheels did come off the cart of the multilateral trading system and the Cancún Ministerial Conference collapsed ignominiously (Das, 2003). This failure of MTNs provided an impetus to formation of bilateral trade agreements (BTAs). In South Asia possibilities of BTAs were being discussed between three pairs of economies: Pakistan and Sri Lanka, Bangladesh and India and Bangladesh and Sri Lanka. This was in the background of India's bilateral agreements with Bhutan, Nepal and Sri Lanka. Similar endeavors were made between South Asian economies and those outside the sub-region. India and Thailand signed a framework agreement for negotiating an FTA. India was also forming similar BTA with Singapore. In addition, a joint study group was set up by China and India for studying the feasibility of an FTA. Moving faster than India, Pakistan signed a limited trade pact with China, also known as an "Early Harvest" agreement. It became operational in 2006 and is to be expanded into a full-fledged FTA by 2009. Pakistan signed a trade and investment framework agreement (TIFA) with the US in 2005, which is planned to become an FTA in the future. BTA discussions were in progress between Pakistan and several ASEAN economies, which included Indonesia, Laos, Singapore and Thailand. Sri Lanka signed a TIFA with the US, with plans to convert it into a full-fledged FTA in the short-term.

Thus viewed, the post-2000 scenario in South Asia has undergone a marked transformation. The series of recent regional and bilateral agreements—albeit slow to come about—portend to an alteration in the mindset of the policy mandarins in South Asia. They also presage the probability of creation of a large integrated economic region in the foreseeable future stretching beyond South

Asia. Asian political leaders have talked of visions of a prosperous Asia, stretching between Korea in the East and Pakistan in the West.

6. India's Unique Position

Being the largest sub-regional economy, India could potentially emerge as the unquestioned economic leader. It did not happen because India has had disharmonious relations with some of its neighbors, particularly the large ones. Experiences of the last two decades (1985-2005) show that it is difficult to have a reasonable economic integration between the members of the SAARC without proper resolutions of political conflicts between the members, particularly between India and Pakistan. Their mutual relations have never been devoid of distrust.[13] Being land-locked small economies, Bhutan and Nepal have strong trade links with India. Their trade share with India is disproportionately large, which is an exception to the general rule of low shares of intra-regional trade for the SAARC members.

That being said, what happens to the Indian economy influences the other sub-regional economies. Until the early 1990s, India was neither regarded as a rapidly growing economy nor a successful trader. Its export structure was dominated by simple and undifferentiated products, in which the comparative advantage lay in labor-intensive, low-skill and technologically simple products. This languid and dispirited performance of the Indian economy adversely affected the other sub-regional economies. However, with a pick up in Indian economic performance in the 1990s, this scenario began to undergo a transformation. Since 2000, several macroeconomic and financial indicators have recorded a marked improvement. India has a booming stock market, whose

[13] Disagreements between India and Pakistan on SAFTA-related issues persisted even in 2006. In November 2006 India claimed that Pakistan was deviating from the SAFTA Agreement and was refusing to implement it in letter and spirit. While the Indian Minister of External Affairs suggested that unless Pakistan implemented SAFTA Agreement earnestly, it will be difficult to operationalize SAFTA. While Pakistan had expanded the basket of tradable goods under the positive list by 78 items, obstructions to trade continued. He accused Pakistan of applying conditions to trade with India under SAFTA, which was against the essence of the agreement. India launched a formal complain to the SAARC Council of Ministers.

capitalization grew at a heady pace. Recent rankings show India as one of the three most favored destinations of FDI. These positive features have indeed attracted the global and regional attention. Indian economy can now impart its dynamism to the sub-regional economies.

One of the most striking and noteworthy development in this regard is that the growth rate of India's trade with the two sub-regions, East and Southeast Asia, particularly China, has accelerated significantly after the Asian crisis of 1997-98. Between 1997 and 2004, India's merchandise trade volume with East and Southeast Asia more than doubled. India's trade expansion with China contributed to this sharp increase in its intra-regional trade. In the recent past, the large Association of South East Asian Nations (ASEAN) economies (namely, Indonesia, Malaysia, the Philippines, Singapore and Thailand) have become more important trading partners of India than they ever were. However, Japan recorded a reversal of this trend and its trade with India declined in absolute terms over the same period.

Another noteworthy feature is the new trend in the intra-regional FDI flows. The volume of FDI flows between ASEAN and India has started expanding recently. Malaysia and Singapore have emerged as significant investors in India. Infrastructure sector in India has been attracting a lot of ASEAN capital. As Indian reforms and liberalization endeavors pick up momentum, FDI inflows are expected to increase. Indian companies are making large investments in the ASEAN economies and China, particularly in the services sectors and labor-intensive manufacturing. Information and communications technology (ICT) and pharmaceuticals are their other favorite areas of investment (Sally and Sen, 2005). Since 2000, both China and India have significantly increased their FDI in each other's economy. This trend is expected to accelerate in the near future (Das, 2006)[14]. Strengthening trade and investment relationship is integrating

[14] See Das (2006), Chapter 5.

Indian economy with the rest of Asia, which in turn will have a favorable indirect influence over South Asia's integration with the rest of Asia.

## 7. Mixed Evidence of Complementarity

In comparison to the other regions of the global economy, South Asia's exports are unusually concentrated on labor-intensive manufactures. This distinctive export structure was largely due to South Asia's distinctive combination of resources and factor endowment. In comparison to other regions South Asian economies have a lower level of education and fewer natural resources relative to supply of labor. Any future trade and development policy design must take these realities into account (Mayer and Wood, 2001).

The evidence of trade complementarity in South Asia is mixed, in that India's and Pakistan's exports are complementary to the import of some South Asian economies, particularly those of Bangladesh and Sri Lanka. Other economies show efficiency in only a small number of export areas and cannot be considered complementary to India's imports, or any other country's imports. Mirroring a lack of complementarity in trade, South Asian economies compete in their export markets in a narrow range of products—particularly in textiles and apparel and other light manufactured goods. Prospects of sub-regional integration are seriously inhabited by this trade structure.

As this sub-group of economies has comparative advantage in labor-intensive manufactured goods, they compete against each other in this category of exports in the rest-of-the-world (ROW) markets. Intra-sub-regional trade in this category has not increased because the sub-regional economies have not created any such opportunities. If anything, many South Asian economies, including India, had extensive quantitative restrictions against the imports of this category until late 1990s. For most manufactured consumer goods imports were nearly banned in India. In the absence of such restrictions, it was possible that some of these labor-intensive manufactured goods could be imported by India from the other sub-regional economies. As South Asia's trade pattern tends to conform to Heckscher-Ohlin model of trade, it is plausible "that the highest gains are likely to continue to accrue in those sectors and markets for which South Asia has a high differential in factor endowment, that is, vis-à-vis industrial countries" (Pitigala, 2005). This trade structure is sure to create hurdles in rapid and successful implementation of SAFTA in future.

## 8. Assessing the Economic Case for SAFTA

Intra-trade statistical data (Section 5) shows steady declined in the intra-regional trade in South Asia during the post-War period. By the mid-1960s, it had declined to 2 percent of the total trade of the Sub-regional economies. While small increase has been observed in the recent years, intra-trade is still less than 5 percent of the total trade (Section 5). This decline is an indicator of a low possibility of the sub-region coming together as a cohesive trading bloc in the short-term. Secondly, direction of import and export of the SAFTA member countries can also be revealing in providing an indication of possibility of emergence of a cohesive trading bloc in future. Baysan *et al* (2006) found that the member countries tended to trade far more intensively with the industrial economies, that is, the EU and the US, than with the neighboring sub-regional economies. This could be due to differences in factor endowments with the large industrial economies. A glance at the trade statistics of South Asian economies demonstrated that their exports to the industrial economies were far higher than those to other South Asian economies. India and Pakistan imported far more from the industrial economies as well. Bangladesh and Sri Lanka were different in this respect and imported 20 percent and 15 percent, respectively, of their total imports from the South Asian sources, essentially from India. However, their imports volumes were a small part of total Indian exports. Indian exports to neighboring sub-regional economies recorded a small increase during the 1990s, from 3 percent of the total in 1990 to 5 percent in 2002. Unilateral non-discriminatory liberalization of tariffs on most-favored-nation (MFN) basis was responsible for this increase.

Above evidence portends to a feeble future possibility of emergence of a robust, cohesive and profitable FTA in South Asia in the short-term. There are three essential factors that contributed to this weakness in the sub-region which made an FTA economically unattractive. First, the regional economies are small in terms of the size of the GDPs, per capita incomes and trade volumes. Consequently, the present market size in the sub-region is small. An FTA would therefore be essentially trade diverting, not trade creating. However, as the population is large, if and when the GDP and per capita income in the sub-regional economies increases to the level of middle-income developing economies, the aggregate demand would rise. This would increase the market size in the future as well as possibilities of an FTA that could be trade creating, not trade diverting.

Second factor that works against a successful FTA formation is the high level of protection that still prevails in the South Asian economies, particularly in Bangladesh, India and Pakistan. If the level of protection is in the SAARC member economies is brought down and the economies are relatively open, possibilities of trade diversion decline.

Third reason that weakens the economic case for SAFTA is the strong tendency among the members to exclude sectors from the FTA. When this proclivity is strong, the member countries are quick to exclude sectors from tariff reduction in which domestic lobbies are muscular, or when a domestic industry is uncompetitive. Also, stringent ROO can be used as potential barriers in sectors where domestic industry cannot compete with the union partners. This kind of barrier creation was observed in the India-Sri Lanka FTA. There is a possibility of this tendency being repeated in SAFTA.

## 9. Estimates of Benefits from Quantitative Studies

Quantitative estimates of gains from the formation of SAFTA can either be made by using the popular gravity model, or by computable general equilibrium (CGE) models. These modeling exercises make predictions with varying degree of accuracy.

9.1 Evidence from Gravity Model

In its basic form, the gravity model postulates that the trade between country *a* and country *b* is directly proportional to the product of GDPs of country *a* and country *b*, and inversely proportional to the distance between the two countries. Tinbergen (1962) was the first to conceive the gravity model in its simple form, while Poyhonen (1963) was the second. Numerous adjustments, additions and modifications were made in the gravity model since then. It became popular for modeling trade flows. Many studies have shown that it has a high degree of utility of the gravity model (Eichengreen and Irwin, 1998; Feenstra, 1998). However, there are some limits to it. For instance, a gravity equation can not predict the welfare effect of an FTA.

Using 1997 statistical series Hassan (2001) found that the seven SAARC economies not only reduced trade among themselves but also with the ROW. Given the traditional weak trading performance of the SAARC economies, particularly the large ones, this conclusion did not seem counterintuitive or incongruous. Hirantha (2004) used both panel and cross sectional data for 1996-2002 period to estimate trade creation and trade diversion effects under the present SAFTA regime, using the gravity model. Unlike Hassan (2001), Hirantha (2004) found evidence of trade creation among the SAARC member countries, without any trade diversion with the ROW. As the SAARC members are dependent on the ROW for their import needs, increase in intra-regional trade goes hand in hand with increasing trade with the ROW. As creation of SAFTA went beyond mere reduction of tariffs and NTBs and included liberalization of barriers to intra-regional investment, the conclusion of trade creation was a significant one. Intra-regional trade expansion due to the creation of SAFTA may well entail the externality of trade expansion with the ROW.

## 9.2 Evidence from CGE Models

The computable general equilibrium (CGE) models have the advantage of providing estimates of future consumption pattern, production pattern and trade at sector level. They can also predict the welfare effect of SAFTA formation. The flip side of this coin is that the reliability of predictions is not high. As the CGE model use data for the base year, which is one specific year, the predictive power of the CGE modeling is not comparable to that of econometric models and often open to question.

Of the two empirical studies that utilized CGE model to estimate the welfare effect of SAFTA, one is a little dated. Pigato *et al* (1997) employed the popular Global Trade Analysis Project (GTAP) data base and model. This study concluded that while SAFTA resulted in welfare gains to the member countries. These gains were larger when liberalization took place unilaterally, in a non-discriminatory manner. Another CGE modeling exercise by Bandara and Yu (2003) which employed a different version of GTAP data base estimated that real income gains for India would be 0.21 percent and for Sri Lanka 0.03 percent. According to this exercise, Bangladesh would suffer a real income loss of 0.10 percent, while the other members of SAFTA would gain by 0.08 percent. This study also concluded that the South Asian economies stand to gain more from unilateral non-discriminatory liberalization and multilateral liberalization than from the formation of SAFTA. None of the empirical studies predicted robust welfare gains from the formation of an FTA in South Asia.

## 10. So Why SAFTA?

The foregoing exposition convincingly demonstrated that the economic case for SAFTA in the short-term is weak. In the short-term, it is not likely to emerge as an instrument of strong and cohesive regional trade and economic integration in

South Asia. In the medium-term, with increasing income and expanding GDP and markets, the feasibility of a successfully operating FTA is likely to improve. An FTA may emerge as a strong instrument of trade expansion and economic integration in the sub-region.

If so, is it worth pursuing the strategy of regional integration in South Asia? Baysan *et al* (2006) noted that while case for an FTA in the present circumstances is not a persuasive one, but it can still be helpful. The sub-regional economies have a tradition of large informal and unrecorded trade. Also, a great deal of trade between India and Pakistan takes place via Dubai and Singapore. Through official channels annual trade between India and Pakistan was in the region of $200 million, but through third countries (Dubai and Singapore) its volume was $1.5 billion a year. The third channel of trade is illegal trade or smuggling via long and porous Indo-Pak borders. The third-country trade channel considerably increased the transaction cost of sub-regional trade. Creation of SAFTA will have the immediate benefit of a decline, even elimination, in transaction cost and increase in sub-regional trade volume.

Secondly, as all the economies in the world (except Mongolia) are now members of one kind of regional trade and integration arrangement or the other, South Asian economies have become laggards in following a global economic trend. Policy-makers in these economies may well be interested in keeping up with a global trend. Thirdly, with so many FTAs in the global economy, particularly in the parts where South Asian economies have their major trading partners, this sub-group realizes that is has begun to suffer from trade diversion. Forming an FTA with the economies in their own sub-region may well be a balancing measure against such trade diversion for the South Asian economies.

While not a convincing economic proposition at the present stage, SAFTA is here to stay. To maximize its potential benefits the seven member countries can take several pragmatic policy measures—preferably in the short-term—which can include: bringing down the tariff barriers and NTBs steadily to promote sub-regional trade in keeping with the comparative advantage and factor endowment of the individual member economy, gradually eliminating sectoral and product exclusion from the FTA, making ROO requirements reasonable, simple and minimal and keeping them constant for all products, and have clear rules regarding tariff-rate quotas, which may be eliminated as soon as feasible. Implementing these basic SAFTA-strengthening measures can be made into an efficient and phased plan by the member economies. The earlier these measures are implemented the earlier they would provide externalities like creation of regionally competitive firms in South Asia.

To achieve the SAFTA objectives of enhancement of intra-trade, intra-regional investment, economic cooperation and sub-regional integration in South Asia, it is indispensable for the member countries to let the past be the past and put behind the tarnished legacy of mistrust and tensions. The present generation of policy mandarins needs to approach SAFTA with a fresh mindset. Without a change in the mindset of the policymakers, regional integration may well remain a pipe dream for a long time to come. In an era of on-going economic and financial global integration, there is an imperious need to pragmatically take the necessary economic policy measures to achieve mutually beneficial goals of regionalization, which in turn could be a building block for onward move towards future globalization.

## 11. Summary and Conclusions

During the post-World War II period, the South Asian economies had adopted the strategy of ISI. The supporting policies that went with the ISI included a strong anti-export bias. The ISI strategy effectively worked towards limiting trade, including intra-regional trade. Its influence was asymmetric towards restraining the latter. High level of protectionism was an integral part of the ISI strategy, therefore South Asian economies remained among the most highly protected in the world for decades. Macroeconomic reforms and trade policy liberalization were launched by Sri Lanka in the late 1970s and the other South Asian economies in the 1990s. Reduction of border tariff measure were an integral part of the macroeconomic and structural reforms programs launched by these economies. These reforms are so far incomplete. The effect of partial reforms was reflected in the gradual firming up of real GDP growth rate in this group of economies during the decade of 1990s, which in turn contributed to an impressive reduction in poverty. Notwithstanding the liberalization measures of the 1990-2005 period, this group of economies was still the most highly protected group in the global economy in 2005. It lagged behind in opening its domestic economy to global competition as well as in attracting FDI.

The concept of SAARC was slow, hesitant and delayed in acceptance by the seven South Asian economies. Moving belatedly on the sub-regional economic integration front, the seven South Asian economies signed an agreement to form the SAPTA in 1993; it came into effect in December 1995. SAPTA could not be regarded as a successful regional trade-promoting body. SAFTA was created on the base of SAPTA. This agreement was signed in January 2004, for which the internal liberalization was scheduled to begin in 2006, in a phased manner. The intention of the member countries was to move to higher level of trade and economic cooperation

At this point in time, for the South Asian economies, the economic case for launching an FTA is weak. Prospects of SAFTA leading to a deep of sub-regional integration in South Asian economies are also weak in the short term. Evidence of trade complementarity in South Asian economies is mixed, which made creation of an FTA a weak proposition. The lack of complementarity is reflected in a strong penchant of the larger South Asian economies towards trading with the principal industrial economies. Empirical studies that tried to estimate income and welfare gains from an FTA in South Asia did not find a robust evidence of large gains for the South Asian economies. In addition, a legacy of mistrust and tension has made the members excessively cautious in taking meaningful policy measures towards economic cooperation. Thus viewed, a lot of economic and political factors add up to make a negative case for an FTA in the short-term. That being said, there is a reasonable case for the creation and gradual strengthening SAFTA.

However, at present, the SAFTA member economies are at a low level of per capita income and economic development. As they move up their respective growth trajectories, they are likely to develop complementaries. If this sub-group of economies continues to grapple with its present hurdles and take small and measured steps, in the medium-term South Asian economies stand to gain in welfare terms even from shallow regional integration. The emerging complementarities—and reduced mutual distrust—are sure to lead to growth of symbiotic relationship among them. In addition, there is a political economy argument of SAFTA increasing bargaining power of this sub-group of economies in trade negotiations with the rest of the world.

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