South Asia: Does Preferential Trade Liberalization Make Sense?

Arvind Panagariya*

*Professor of Economic and Co-director, Center for International Economics, Department of Economics University of Maryland, College Park, MD 20742-7211. Email: panagari@econo.umd.edu.

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Evaluating Preferential Trade Liberalization in South Asia

Arvind Panagariya

1. Introduction

The early history of preferential trading within the South Asian Association of Regional Cooperation (SAARC) closely paralleled that within the Association for South East Asian Nations (ASEAN). ASEAN was founded in 1967 but the ASEAN Preferential Trade Area was launched only twelve years later in 1977. Even then, the effective sharing of trade preferences remained negligible. In the same vein, SAARC was founded in 1985 and had little success in promoting trade preferences among its members during the first decade of its existence. Though the plans to create the South Asian Preferential Trade Area (SAPTA) were announced in 1993, the actual exchange of preferences remained extremely limited.

Reacting to the negotiations for the North American Free Trade Agreement (NAFTA), the ASEAN members signed the ASEAN Free Trade Area (AFTA) agreement in 1992. Though the objective of the AFTA agreement is to create a free trade area among member countries by the year 2003, to-date the exchange of preferences has been minimal. Much of the liberalization by AFTA members has proceeded along nondiscriminatory lines. The SAARC members, on the other hand, now appear poised for a serious exchange of trade preferences. India and Sri Lanka have recently signed a free trade area agreement and there is talk of a similar agreement between India and Bangladesh. Since politics has driven this change in the approach, disappointingly little effort has been made to evaluate the economic impact of these agreements and the general desirability of preferential trade liberalization in the region relative to alternatives, which include maintaining the status quo.

The purpose of this paper, therefore, is to systematically address the issue of trade liberalization in the region and offer a qualitative assessment of alternative approaches. I compare two broad approaches to trade liberalization: nondiscriminatory and preferential. The former approach can be pursued on a unilateral basis by each country in the region, on a concerted basis by the countries in the region, or multilateral basis under the auspices of the WTO. The latter approach can take the form of crisscrossing bilateral free trade areas between various countries in the region or a region-wide free trade area.

The view I take in the paper is that the move towards preferential trading is a mistake, at least from the viewpoint of India. India continues to have very high trade barriers so that the scope for trade diversion and the losses accompanying it are likely to be considerable. Business lobbies being relatively powerful in most of the countries in the region, they are likely to exploit the rules of origin and sectoral exceptions in these arrangements in ways that will maximize trade diversion and minimize trade creation. In as much as the rules of origin give bureaucrats power, employment and opportunities to share in the rents created by tariff preferences, they too will become active parties to the diversionary tactics of business lobbies. Therefore, the member countries are better advised to proceed along nondiscriminatory lines in achieving further liberalization. To the extent that coordination among the regional partners may help speed up such liberalization and assist in moderating the adjustment costs, a concerted approach may be a useful complement to unilateral and multilateral liberalization. From India's viewpoint, status quo is preferred to preferential liberalization.

The focus of the paper is largely on the examination of the case for preferential trading. This is done systematically in Section 2. In Section 2.1, I show that the small

volumes of intra-regional trade observed until recently resulted from highly protectionist trade regimes in the region rather than due to any lack of trade preferences. In Section 2.2, I outline the economics of FTAs and demonstrate that high-tariff countries such as India stand to lose from such arrangements with low-tariff countries such as Sri Lanka. Moreover, the potential for the union as a whole experiencing a reduction in welfare is also very large. In Section 2.3, I discuss how the rules of origin may make FTAs even less desirable from the welfare standpoint. I pay special attention to the role of politics in determining the likely shape of FTAs. I conclude the paper in Section 3 with the argument that the countries in the region will be better off using the SAARC to launch concerted non-discriminatory liberalization.

2. A Critical Examination the Case for Preferential Trade

There are several aspects of preferential trading in South Asia region that must be addressed. I consider them in succession in this section.

2.1 Low Intra-regional Trade

It is sometimes argued that countries within the SAARC region trade "too little" with one another in relation to what one would predict on the basis of their proximity and income levels. If one looks at the official trade data until late eighties or early nineties, it does appear that the countries in South Asia do not trade as much with one another as other countries with similar income levels and proximity do.[1]

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[1] For example, based on the gravity equation, Frankel and Wei (1997) find the coefficient of their South Asia bloc (defined as including India and Pakistan) variable to be negative. This means that *ceteris paribus* a country within South Asia trades less with a trading partner in South Asia than with an outside partner. Likewise, Dhar and Panagariya (1995) found the coefficient of the variable

There are three reasons why this line of reasoning supporting the promotion of trade preferences within the region must be dismissed. First, the low level of trade has been essentially the result of autarkic policies in the region. In the extreme case, Bangladesh would not be able to export to India very much if India's trade barriers were virtually prohibitive. The same applies to India's exports to Bangladesh. The reason for the low level of intra-regional trade until recently was not the absence of trade preferences but the absence of liberal trade policies in general. Pitigala, Pursell and Baysen (2000) have recently documented this fact systematically. Among other things, they show that once the countries in the region began to liberalize, their intra-regional trade expanded rapidly. The effect of trade liberalization by India, which is by far the largest country in the region, is especially pronounced.

Thus, consider Table 1, taken from Pitigala et al. With one exception, Bangladesh, intra-regional trade as a proportion of total trade had bottomed out in 1990. Even for Bangladesh, the figure in that year at 5.8 percent was only a tiny bit higher than that in 1981, 5.4 percent. The decade of 1990s was a period of very substantial liberalization on a nondiscriminatory basis by the countries in the region.[2] Correspondingly, intra-regional trade expanded rapidly and demonstrated an upward trend for every country in the region. For India, it more than doubled from 1.4 percent in 1990 to 3.2 percent in 1998. Given India's weight in the region, the total intra-regional trade also more than doubled from 2.4 percent to 4.9 percent. With the region's share at less than 1 percent in the world GDP and

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representing common border to be negative in the gravity equation for India. Given the scope for misspecification in the gravity equation, one must take any analysis based on the gravity equation with some grain of salt. Nevertheless, there is little disagreement on the finding that until 1980s and perhaps early 1990s, the countries in South Asia traded too little with one another.

[2] See Panagariya (1999) for documentation.

the countries having comparative advantage in similar products, intra-regional trade would no longer appear to be "too low."

The second reason why the argument of low intra-regional trade must be treated with some caution is that official trade figures understate the extent intra-regional trade even in the years of heavy protection in India and elsewhere in the region. According to some of the recent studies, there has been considerable amount of so-called "informal" trade among member countries of the region. This was not only to evade the high tariffs that must be paid on official trade but also to carry out some trade that would have not been permitted at all. For example, Pitigala et al. (2000) report that once we add the informal trade, intra-regional trade of Bangladesh in 1995 jumps from 17.7 to 21.8 percent. For Sri Lanka, the jump is from 11.4 to 14.4 percent in the same year. These data reinforce the previous argument.

Table 1. Officially recorded regional trade as a share of total trade

(Percent)

Country	Regional Imports				Regional Exports				Total Regional Trade			
	1981	1990	1995	1998	1981	1990	1995	1998	1981	1990	1995	1998
India	1.3	0.4	0.6	1.1	2.9	2.7	5.1	5.6	1.8	1.4	2.7	3.2
Pakistan	1.9	1.6	1.5	2.4	5.5	4.0	3.2	4.9	3.1	2.7	2.2	3.6
Bangladesh	4.7	7.0	17.7	17.5	7.9	3.1	2.3	2.7	5.4	5.8	12.7	12.4
Sri Lanka	5.2	7.0	11.4	12.9	8.8	3.7	2.7	2.4	6.5	5.6	7.5	8.2
Nepal	-	13.4	17.5	31.7	63.8	7.7	9.2	36.2	47.4	11.9	15.0	32.8
Maldives	6.0	7.4	4.5	7.7	22.3	13.8	22.5	16.6	9.4	9.2	6.7	9.4
SOUTH ASIA	**2.4**	**2.0**	**3.8**	**4.3**	**4.8**	**3.1**	**4.3**	**7.3**	**3.2**	**2.4**	**4.1**	**4.9**
MERCOSUR		14.5	18.1		8.9	8.9	20.5		10.7	14.0	21.3	
ANDEAN COMMUNITY		6.4	12.6	12.0		4.1	11.8	11.9		7.9		
ASEAN	13.2	14.6	16.9	20.9	17.2	18.2	23.4	19.8	15.2	16.3	20.0	20.3

* Shares are in current US$

Note. Data for Bhutan is unavailable Oil imports are excluded for developing countries in South Asia

Sources: IMF Direction of Trade Statistics. [Taken from Pitigala et al. 2000).]

Finally, there is nothing in economic theory that says that preferential trade between countries with low existing levels of trade is beneficial. Many economists have (erroneously) argued just the opposite to defend and promote PTAs between countries that already trade a lot with each other.[3] They argue that if two countries trade a lot with each other, they are "natural trading partners" and trade diversion due to tariff preferences between them is not of serious concern. In Bhagwati and Panagariya (1996), we have offered a systematic analysis of why one cannot infer anything as regards the welfare implications of tariff preferences from the existing levels of intra-union trade, whether high or low. Economists have now generally accepted our critique and the blanket assertions that high initial volumes of intra-regional trade make PTAs more likely to be welfare improving are no longer common.

2.2 Trade Creation, Trade Diversion and revenue Transfer

Given that South Asia accounts for less than one percent of the world production and that tariffs in the region are high, the risk of trade diversion from preferential trade liberalization is high. With 99 percent of the world production outside the region, the likelihood that the most efficient and competitive producers of the large majority of the products are within the region is very low. This means that the scope for trade diversion is substantial.

To understand the welfare effects of preferential trade liberalization on union members, consider two potential union partners, India and Sri Lanka. Assume the initial

[3] For example, see Krugman (1991), Summers (1991) and Frankel, Stein and Wei (1995).

tariff on the product under consideration is higher in India than Sri Lanka. Depending on the demand and supply conditions, there are three analytically distinct possibilities: (i) total supply by the two countries falls short of the demand in the high-tariff country in the post-FTA equilibrium; (ii) total supply by the two countries exceeds the demand in the high-tariff country but the two countries together remain net importers from the rest of the world; and (iii) the two countries together are net exporters of the product in the post-union equilibrium.

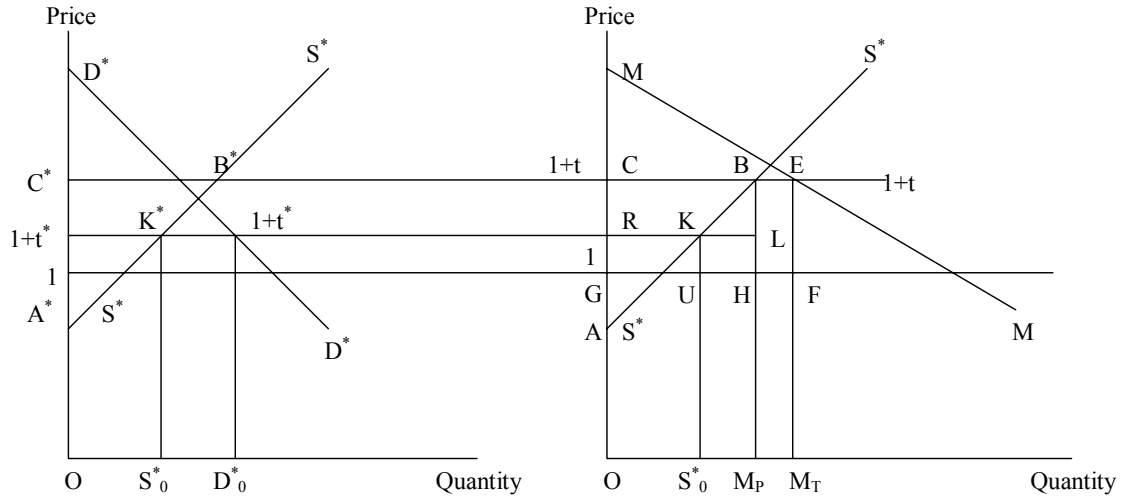

Figure 1: Welfare Effects when Imports into the High-tariff Country (India) from Outside do not Cease in the Post-FAT Equilibrium

(i) Within-union Supply Falls Short of the Demand in the High-Tariff Country in the Post-FTA Equilibrium

In Figure 1, the left-hand panel represents the market in Sri Lanka and the right-hand panel the import market in India. We distinguish the symbols and variables associated with Sri Lanka by an asterisk. Thus, D^*D^* and S^*S^* represent the demand and supply curves,

respectively, in Sri Lanka. Initially, the country levies a nondiscriminatory tariff at rate t^*. By appropriate choice of units, we set the world price of the product at unity. This allows us to represent the domestic price in Sri Lanka by $1+t^*$. Imports amount to quantity $D^*_0S^*_0$.

In the right-hand panel, MM represents the import demand for the product in India. This curve is obtained by subtracting India's supply curve from its demand curve in the background. Initially, India levies a nondiscriminatory tariff at rate t and imports quantity OM_T. Its customs authorities collect rectangle CEFG in tariff revenue (ignore curve S^*S^* for now).

Suppose now that India and Sri Lanka form an FTA, eliminating tariffs on each other but keeping it on the imports from third countries. As long as any imports from third countries continue to come into each country, the price cannot fall below $1+t^*$ in Sri Lanka and 1+t in India. Given this price pattern, Sri Lanka will sell its *entire* quantity in India and import the product from outside to satisfy its domestic demand. Thus, in Figure 1, Sri Lanka diverts its entire supply, shown by S^*S^* in the right-hand panel, to India and imports quantity OD_0 in the left-hand panel from outside countries to satisfy the domestic demand.

In the right-hand panel, observe that India's imports from outside decline from OM_T to M_PM_T. The quantity OM_P now comes from the union partner. Since Sri Lanka's imports have gone up by OS^*_0, combined imports of the union from outside have declined by $S^*_0M_P$. This quantity measures the extent of trade diversion, which imposes a welfare cost on the union as a whole of trapezium BHUK.

Trapezium BHUK does not fully measure the loss to India from trade diversion, however. The loss to India, equaling the tariff revenues loss measured by rectangle CBHG is much larger. Recall that in the post FTA equilibrium, India does not collect any revenue

on the imports from Sri Lanka. Moreover, since the FTA results in no decline in the price of the product, there is no efficiency gain. Hence, the entire revenue loss is a net loss to India. Of this, CBKR becomes extra profit for the exporters in Sri Lanka, BHUK pays for the deadweight loss from trade diversion, and RKUG effectively becomes the extra tariff revenue for Sri Lanka's customs authorities.[4] Thus, Sri Lanka's net gain from the FTA is CBKR+RKUG, which equals India's tariff-revenue loss minus the deadweight loss due to trade diversion (=CBHG-BHUK).

This analysis has two main implications in the case when the within-union total supply of the product is too small to supply the entire market in the high-tariff country. First, the net loss to the union can be measured by trapezium BHUK whose parallel sides equal per-unit tariff rates in the partner countries and the base equals the extent of trade diversion. Second, the net loss to the high-tariff country equals the tariff revenue lost in the post-FTA equilibrium. Finally, the benefit to the low-tariff country equals the difference between tariff revenue loss of the high-tariff country and the deadweight loss from trade diversion.

Note that Figure 1 assumes that both union partners import the product under consideration in the pre-FTA equilibrium. But the conclusions we have derived remain entirely valid even if one of the countries exports the good in the pre-FTA equilibrium provided we also assume that the tariff in that country is zero. Within the theoretical

[4] Purely in an accounting sense, area RKUG also goes to the exporters in Sri Lanka. But since they were facing the price $1+t^*$ in the pre-FTA equilibrium, this area is not a *net* addition to their profits. Instead, since they earn this profit in the Indian market in the post-FTA equilibrium, customs authorities in Sri Lanka are able to collect an equivalent area as extra tariff revenue on the new imports, OS^*_0.

context, the assumption of zero tariffs on a good when it is exported is a reasonable one but in practice this may not be true. If so, the analysis must be slightly modified.

Thus, suppose the demand curve in the left-hand panel of Figure 1 is sufficiently to the left that it crosses the supply curve below the world price of 1. In this case, Sri Lanka exports the product in the initial equilibrium and its internal price is 1. The formation of the FTA leads to the same effects in the right-hand panel as before but the effects in the left-hand panel are different. Once all of Sri Lanka's supply is diverted to India as a result of the FTA, the tariff t^*, which was dormant in the pre-FTA equilibrium, becomes effective. Whereas in the pre-FTA equilibrium, the price in Sri Lanka was 1, in the post-FTA equilibrium, it becomes $1+t^*$. This leads to a deadweight loss measured by the triangle under the demand curve between price lines $1+t^*$ and 1. The gain to the firms in Sri Lanka is larger now since the price facing them rises to 1+t from 1 rather than $1+t^*$ in the previous case. Correspondingly, consumers in Sri Lanka make a net loss due to the price rise. Thus, there is a transfer in this case from consumers in Sri Lanka to producers, which did not exist in the previous case.

(ii) *The High-tariff Country Ceases to Import from Outside while the Low-tariff Country does not sell any of its Output in its own Market*

This case is shown in Figure 2. The initial tariffs are as in the previous case. India imports OM_T and collects CBFG in tariff revenue. The formation of FTA leads Sri Lanka to divert its entire supply once again to India. But this time, its supply at 1+t exceeds the demand in India. As a result, the price in India declines. But as long as the price remains higher than 1+t*, Sri Lanka has no incentive to sell any of its supply in its own market. As drawn in Figure 2, this being the case, the equilibrium in India settles at point E. The price in India

declines and total imports expand by M_TM_F. The outside country is eliminated entirely as a source of supply. Of the total quantity diverted, Sri Lanka supplies HF by *expanding* its output and incurs a cost higher than previously incurred by the rest of the world. This leads to a deadweight loss of trapezium LFUK. At the same time, the FTA generates new trade in the amount M_TM_F, which gives rise to the net gain of triangle BEK. The net effect of the FTA on the joint welfare is positive, zero or negative as triangle BEK exceeds, equals or is exceeded by trapezium LFUK.

Taken by itself, India gains triangle BEL on the new trade but loses LFGR on the old trade. The loss arises from tariff-revenue loss, which amounts to BUGC in total. But of this, CBLR is redistribution to India's own consumers on account of lower price of the product. The net effect on India is ambiguous now, though as drawn in Figure 2, area LUGR being larger than BEL, India loses.

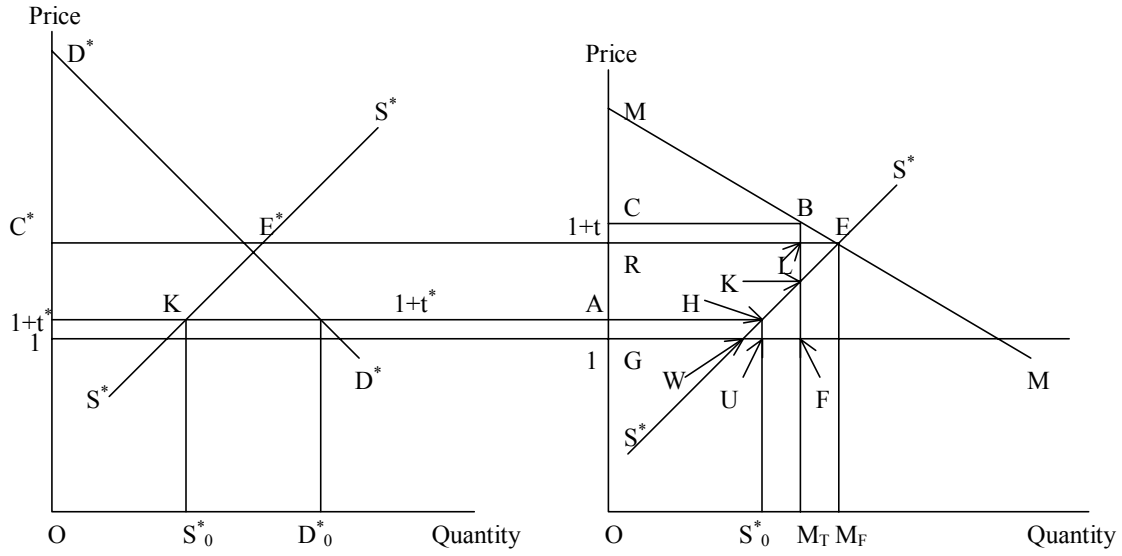

Figure 2: Welfare Effects when Imports into the High-tariff Country from Outside Cease Completely and the Partner Satisfies the Entire Internal Demand from Purchases Outside

As in case 1, Sri Lanka continues to benefit from the FTA. It expands its supply of the product from point H to E along its supply curve and makes a net gain of area REHA. In addition, Sri Lanka benefits from generating additional tariff revenue since it imports all of its domestic consumption now. This gain equals AHUG in the right-hand panel of Figure 2. Thus, of the total tariff revenue transferred from India to Sri Lanka, RLFG, area RLKHA adds to the profits of Sri Lanka's exporters, LFUK pays for the deadweight loss due to trade diversion (or higher production cost in Sri Lanka) and AHUG the tariff revenue collected by Sri Lanka.

(iii) High-tariff Country Ceases to Import from Outside and the Low-tariff Country Sells Part of its Output in its Own Market

In this case, Sri Lanka's supply is sufficiently large that in the post-FTA equilibrium, the price in India drops down to 1+t*. Sri Lanka now sells a part of its supply in its own domestic market as well. If it continues to import a part of its supply from outside, the price stays at 1+t* in both countries. If no imports come from outside price drops below 1+t* with 1+t* serving as the borderline case in which internal supply is exactly equal to the internal demand at 1+t*.

In this case, price does not rise for producers and consumers in Sri Lanka and falls that facing producers and consumers in India. Therefore, the union's joint welfare necessarily rises. Distributional effects are still present, however, so that India could still lose while Sri Lanka necessarily benefits. This is shown in Figure 3.

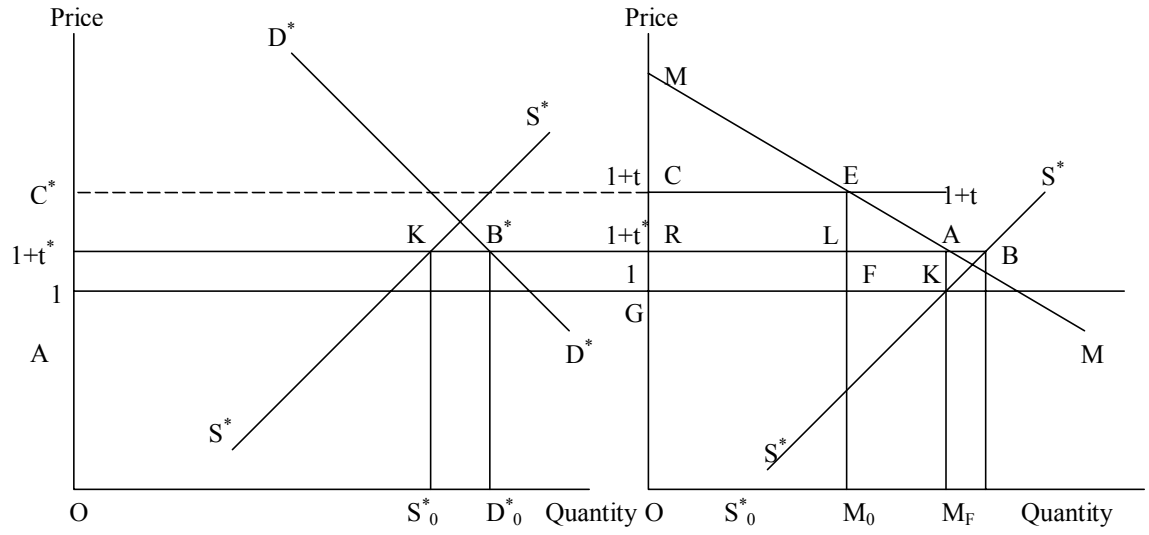

Figure 3: High-tariff Country Ceases to Import from Outside and the Low-tariff Country Sells Part of its Output in its Own Market

Initially, India buys all its imports from outside. Under the FTA, the price drops to 1+t* and all imports switch to Sri Lanka. The price in Sri Lanka remains unchanged at 1+t* with its own producers selling quantity AB there. The remaining demand in Sri Lanka is satisfied by imports from outside. India's total imports rise from M_0 to M_F. This new trade generates the total gain of area EAKF of which FLA accrues to India and LAKF to Sri Lanka. At the same time, India loses all tariff revenue (CEFG) of which RLFG transfers to the exporting firms from Sri Lanka. Sri Lanka's total gain equals RAKG.

In Figures 1-3, it has been assumed that in the initial equilibrium, both Sri Lanka and India are importers of the product under consideration. The case when one of them is an exporter and the other an importer is readily analyzed. Thus, suppose that Sri Lanka is an exporter of the product. Since the price received on exports is the world price, the logical assumption in this case is that the internal price in Sri Lanka equals the world price. Therefore, when the FTA is formed and India's higher internal price becomes available, as

in Figures 1-3, Sri Lanka's entire supply will still be diverted to India. We will still obtain the three cases discussed above and essentially the same analysis will apply.

A key implication of case (i) is that as long as the imports of a product from outside into the country with higher tariff are not eliminated, joint welfare of the union declines relative to the initial equilibrium with nondiscriminatory tariffs. Moreover, the country with higher tariffs loses while the country with lower tariff benefits from the FTA. Given the current tariff structure in India and Sri Lanka and the likelihood that imports from outside are unlikely to be eliminated by the FTA, this analysis suggests that the FTA between India and Sri Lanka will hurt the former, benefit the latter and hurt them jointly.

In some products, the equilibrium may correspond to Figure 3 or some variation thereof such that at least the joint welfare of the union rises. Even then, there are two qualifications. First, the country with higher tariff is still likely to lose in the absence of transfers from the low tariff country. And second, politics is likely to work against the benefits arising in products such as those depicted in case (iii). Whereas the internal price in the importing country in case (i) is unchanged, the same is not true in cases (ii) and (iii). In both of these latter cases, internal price of the product in India declines. Producers within India are likely to demand exclusion of precisely those sectors that generate new trade and hence offer benefits from trade creation. My conjecture is that a close look at sectoral exclusions from the FTA will reveal that these sectors are predominantly those in which trade creation was likely to occur.

2.3 Rules of Origin

My discussion so far is based on the assumption that there are no traded inputs. In reality, few goods are produced wholly in one place. Goods exported by a country often

contain components imported from elsewhere. This fact opens the door to the rules of origin (ROOs) within FTAs. These rules usually specify a certain proportion of the value added that must have within-union origin to qualify for duty-free status in the FTA.

The economics of the rules of origin has been carefully developed in the recent work of Duttagupta (2000) and Duttagupta and Panagariya (2001).[5] The effects of ROOs are complicated due to the fact that they impact trade in both inputs and final goods using these inputs. Let us consider each of these in turn within the context of a model in which there is one traded input and one final good using this input. Call the final good shirt and intermediate input fabric.

To get a fix on some of the effects, assume that Sri Lanka exports shirts while India exports fabric in the initial equilibrium. A reasonable assumption in this situation is that the tariff is zero on shirts in Sri Lanka and on fabric in India.[6] Therefore, in the absence of a ROO, all within-union output shirts is sold in India while that of fabric in Sri Lanka. Letting t be the tariff on shirts in India and t_m^* that on fabric in Sri Lanka and choosing units such that the world price of each good is 1, the upper limit on the price of shirts is 1+t and on the fabric $1+t_m^*$.

Assume further that within-union supply of fabric in this equilibrium is insufficient to satisfy the total demand for it by shirt manufacturers in Sri Lanka. Therefore, they import a part of their fabric from outside countries and the price of fabric settles at $1+t_m^*$. Fabric sellers from India also receives the price of $1+t_m^*$, which is higher than1, the price they receive in the world market.

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[5] Also see Ju and Krishna (1998).

[6] We could work with the less restrictive assumption that the tariff on the final good is lower in Sri Lanka and that on the input in India. But this introduces some additional complications.

Now suppose we introduce a ROO that allows duty free sales shirts by manufacturers in Sri Lanka only if they use a pre-specified proportion of fabric of within-union origin. If this proportion is set at a level higher than the proportion of within-union fabric supply in the total fabric used by shirt manufacturers in Sri Lanka in the absence of the ROO, the demand for within-union fabric will rise. This will raise the price of within-union fabric above $1+t_m^*$. In effect, protection to within-union fabric will rise over and above that provided by the tariff on fabric imports in Sri Lanka. Even if the initial equilibrium was similar to Figure 3 so that the FTA without ROO had given rise to a net welfare gain for the union as a whole in fabric, the contribution of ROO will be negative. To measure this loss precisely, we must solve endogenously for the price of the fabric made within the union (see Duttagupta and Panagariya, 2001). We must then measure the impact of this change on the output and calculate the associated deadweight losses in both India and Sri Lanka.

In addition to this primary effect in the fabric sector, a binding ROO gives rise to a secondary effect in the final-good sector. The ROO increases the price of within-union fabric, which lowers the profitability of shirts exported by firms in Sri Lanka. The expansion of exports of shirts from Sri Lanka is less than what it would have been in the absence of ROOs. If the FTA without ROO had produced a purely trade diverting outcome such as that in case (i) above, depicted in Figure 1, the secondary effect of the ROO proves beneficial since it reverses some of the harmful trade diversion in the shirt market. If, instead, the FTA without ROO had led to a welfare-enhancing outcome such as that in case (iii), shown in Figure 3, the secondary effect of the ROO is harmful since it reverses the beneficial trade creation in the shirt market.

Similar to sectoral exceptions, ROOs may be manipulated so as to minimize the beneficial effects of the FTA. Observe that if the outcome in shirts in the absence of a ROO resembles case (i), depicted in Figure 1, the FTA enhances protection to producers in Sri Lanka without reducing protection to producers in India. Moreover, the ROO does not give rise to increased protection for them. Therefore, shirt producers in India do not have an incentive to lobby for a strict ROO while shirt producers in Sri Lanka definitely oppose it. In contrast, in case (iii), shown in Figure 3, the FTA reduces protection for shirt manufacturers in India and a binding ROO works to restore it. Therefore, they have an incentive to lobby for the ROO. Thus, if lobbying determines ROOs, they will be set at a high level when the FTA without ROO leads to trade creation in final goods sectors using the input. Alternatively, they will be set at non-binding levels when the FTA without ROO leads to leads to trade diversion in final goods sectors using the input.

3. Conclusion: Concerted, Non-discriminatory Liberalization

The above analysis suggests that forming a South Asian FTA will probably prove harmful overall, with a low-tariff country such as Sri Lanka benefiting and high-tariff country such as India hurting. At least on economic grounds, a persuasive case for the FTA cannot be made.

Instead, all trade diversion can be avoided if the countries in the region were to liberalize on a non-discriminatory basis. Some years ago when the reaction to NAFTA in East Asia was leading to calls for the formation of trade blocs in that region, I had argued (Panagariya 1994) that the region choose to liberalize on a non-discriminatory basis in a concerted fashion through the Asia Pacific Economic Cooperation (APEC) forum instrumentality. The case I made applies with even greater force to South Asia. All

countries within the region are small in relation to the rest of the world. Therefore, the risk of the deterioration of the terms of trade from liberalization is virtually absent. To the extent that many of the countries in the region share a common border, coordination of external trade policy may help discourage costly trade deflection. At present, there is much incentive for goods to be imported into Sri Lanka at low duties and them smuggled into India. India could greatly benefit from bringing its tariff rates down rapidly to match those of Sri Lanka.

In this respect, it is worth noting that despite much talk of FTA, the members of the Association of South East Asian Nations (ASEAN) have undertaken virtually all liberalization on a non-discriminatory basis. There is even a formal provision in the ASEAN FTA (AFTA) Agreement encouraging the member countries to extend whatever liberalization they undertake as a part of their AFTA obligation to the rest of the world. The countries in South Asia will be well advised to take a similar approach to regional liberalization.

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