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Trading Choices of South Asia

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Trade economists have identified three main avenues to trade liberalization: unilateral, multilateral and bilateral. Unilateral liberalization refers to a country going on its own, removing trade barriers without waiting for its trading partners to do the same. Unlike unilateral disarmament, unilateral trade liberalization is in a country’s own interest since it promotes specialization in products of its comparative advantage and allows imports to come from the most efficient source abroad. Much of India’s liberalization that began in the late seventies with the re-introduction of the open general licensing and was considerably accelerated in the early nineties falls into this category.

Multilateral liberalization refers to liberalization under the auspices of the World Trade Organization (WTO) and is generally a response to the liberalization by the country’s trading partners. This avenue seeks reciprocity from other WTO members. The last round of such liberalization took place under the Uruguay Round (UR) Agreement that led to the establishment of the World Trade Organization. Currently, the Doha Development Round is pushing the multilateral liberalization frontier further out.

Finally, the bilateral (or plurilateral) route manifests itself in what trade economists have come to call preferential trade areas (PTAs) in which two or more countries reciprocally liberalize trade with each other but not the rest of the world. The Sri Lanka-India Free Trade Area (SIFTA) and South Asian Free Trade Area (SAFTA) are both examples of PTAs. When the member countries go so far as to eliminate all trade barriers among them, as is the case with the North American Free Trade Agreement (NAFTA), the arrangement is called a free trade area (FTA). If, in addition, the countries also adopt a common external tariff as with the European Union (EU), the arrangement becomes a customs union (CU).

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An important characteristic shared by unilateral and multilateral liberalizations is that they are both non-discriminatory: trade barriers are removed with respect to all trading partners. These forms of liberalization, thus, adhere to the fundamental Most Favored Nation (MFN) principle of the WTO that requires each member to treat all other members with equal favor. In contrast, bilateral liberalization removes trade barriers preferentially, discriminating in favor of union members and against non-members. Trade barriers are removed only against goods imported from union members, with non-members continuing to pay the higher MFN duties.

While trade economists generally favor unilateral and multilateral trade liberalization, they are less sanguine about preferential trade liberalization because of its discriminatory nature, the fragmentation of the trading system such discrimination entails, and the ambiguous welfare effects it engenders. Indeed, in recent years, trade economists have increasingly turned against such liberalization leading Pascal Lamy, the then EU Trade Commissioner and now WTO Director General, to remark that half of the world's economists now oppose bilateral free trade arrangements. PTAs have, nevertheless, proliferated because potential exporters like them due to the protected access they provide them to the partner country market. For example, when Singapore forms an FTA with India, its exporters of steel get to sell steel duty free in the Indian market that is otherwise protected by high duties. PTAs have also acquired a life of their own because all others are doing them and they offer the leaders of the country opportunities to hold summits, stay virtually continuously in the limelight and make political statements to the effect that they too are fellow travelers in pursuit of free trade.

Therefore, in thinking about trading choices of South Asia, the issue whether the countries in the region should liberalize unilaterally or multilaterally is not a difficult one, at least for a trade economist. The experience of the countries themselves during the past two decades testifies to the benefits such liberalization confers. The critical and controversial question, instead, is whether the region should promote preferential trade liberalization among its members and with other countries.

In this paper, I argue against expending scarce political capital on turning the South Asia region into an FTA. This should not surprise the readers familiar with my writings on PTAs in general and SAFTA in particular. The new element here is to bring the evidence from SIFTA to bear on the argument. I then argue that if the countries in the region want to seriously pursue the option to form a trade bloc,

they must look towards an Asia wide bloc. Though I have generally opposed PTAs because they fragment the world trading system and throw barriers in the path of nondiscriminatory liberalization at the national as well as multilateral level, proliferation of PTAs already in place has taken the teeth out of this argument. The world trading system is now hugely fragmented with a “spaghetti bowl” of tariffs characterizing the global trade regime. The only effective solution to it will be the eventual worldwide free trade under the WTO auspices. In the meantime, having been subject to huge discrimination in North American and European markets by the numerous PTAs in those regions, Asia perhaps needs to strategically respond with a bloc of its own and force those blocs to open up. I argue that the starting point for an Asia wide bloc is an India-China FTA, however, not SAFTA.

I begin in Section 1 by recalling the success of unilateral and multilateral liberalization in the region during the past two decades. In Section 2, I subject the case for PTAs within the South Asia region. I carefully examine the experience with the Sri Lanka-India FTA to argue that economic benefits of such arrangements are likely to be offset by costs. In Section 3, I briefly examine SAFTA and suggest that the useful components of it can be pursued outside of a PTA. In Section 4, I argue the case for an India-China FTA as a stepping-stone to an Asia wide trade bloc.

TRIUMPH OF TRADE LIBERALIZATION

After more than three decades of near stagnation in per-capita incomes during 1950-80, South Asia showed signs of growth beginning in the 1980s that accelerated in the 1990s and beyond. Table 1 summarizes the growth rates in GDP in Bangladesh, India, Pakistan and Sri Lanka during 1981-04. Throughout the period, the region has grown at rates nearly twice those of the world economy. Because India accounts for more than three quarters of the region’s GDP, its growth has decisive impact on the overall regional growth. India grew 3.2 percent during 1965-81, shifted up to 5.1 percent during 1981-87 and then to 6.0 percent rate during 1987-04.¹ It is this steady rise of the Indian economy, especially since the late 1980s, which has attracted the world’s attention to the region.

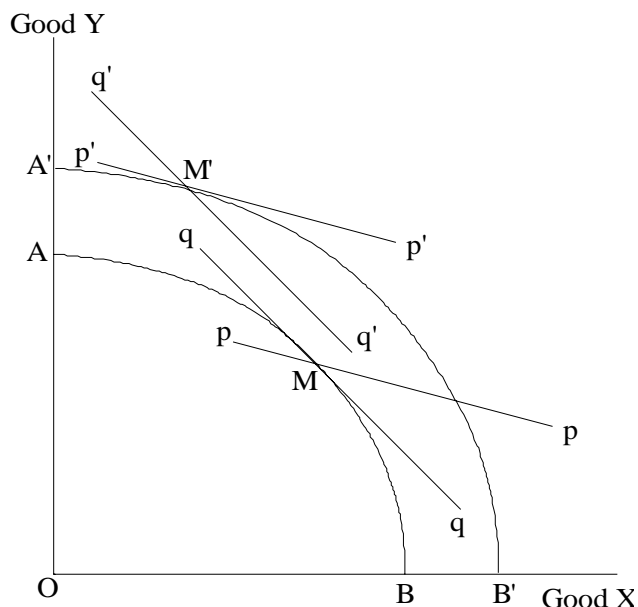
¹ During 1988-90, India grew 7.4 percent, which is the reason why the average growth rate during 1981-90 appears as high as during 1991-04. Once we separate 1988-90 from the remaining years in the 1980s, the two periods are no longer comparable. Growth during 1988-04 was distinctly higher than during 1981-87.

This acceleration in growth has taken place in an environment of declining trade barriers in the entire region. The recent comprehensive regional study by the World Bank (2004) offers an excellent documentation of this liberalization.² Rather than repeat it here, I present exports and imports of goods and services as proportions of the GDP in Table 2. According to this table, both ratios rose in all four SAARC countries shown between 1990 and 2000 except the imports/GDP ratio in Pakistan. In India, exports/GDP ratio rose from 7.1 percent to 15.3 percent and imports/GDP ratio from 8.6 to 14.6 percent. Likewise, in Bangladesh, exports rose from 6.1 percent of the GDP in 1990 to 14 percent in 2000 while imports rose from 13.7 percent to 19.2 percent over the same period. Thus, the shift in the growth rate has clearly happened in a more open trading environment.

There are at least two reasons why the GDP growth actually understates the actual gains from liberalization. First, in so far as opening to trade better aligns the domestic prices with the world prices, the measurement of the GDP at domestic prices understates the true value of output that must be measured at the world prices. This is readily seen from Figure 1. Thus, suppose AB in Figure 1 gives the economy's initial production possibilities frontier and good X is the import competing good. Though the slope of pp represents the world price, protection to good X establishes the price shown by qq in the domestic market. Production takes place at M and the GDP is given by line qq. Suppose next that the economy frees up trade fully and simultaneously the production possibilities frontier shifts to A'B'. Because producers now face the world price shown by p'p', production moves to M'. But if we continue to measure the GDP at the old protection-ridden domestic price, qq, GDP would be given by line q'q'. When growth is computed as the proportionate change between qq and q'q', it will turn out to be less than when measured as the proportionate change between pp and p'p'. From the welfare standpoint, the latter rather than the former measures growth accurately

² Earlier accounts of trade policies for the major countries of the region can be found in Panagariya (1999) and for India in Panagariya (2004).

Figure 1: Measuring GDP at Pre-liberalization Domestic Prices Understates Growth.



The second reason why GDP even if measured at post-liberalization prices would understate growth is the appearance of many new and higher-quality products not previously available. To a consumer in India, these benefits of liberalization are obvious today. Many of the top quality computers, electronic equipment, cell phones, automobiles, clothing and even fruits available today would not have existed under a protected regime. Even when the final assembly of these products is done at home, it is safe to say that the components used to produce them would not be available in the absence of relatively free trade. While economists have increasingly recognized the gains from trade liberalization along the new variety and quality dimension, traditional GDP figures still fail to capture them.

Given that liberalization has so far been good for growth and welfare, the obvious question to ask is how best to proceed further. Specifically, should PTAs be a part of the future trade liberalization strategy? Answering this question requires a critical look at the efforts to promote PTAs within the South Asia region. I begin with some history of PTAs followed by their critical examination.

PREFERENTIAL TRADING IN SOUTH ASIA: A BRIEF HISTORICAL BACKGROUND

During the first three years of their independence, intra-regional trade among India, Pakistan and Sri Lanka as a percentage of their total trade was in the double digits (World Bank 2004, chapter 5). In part, this large proportion reflected the relatively protectionist trade regime in developed countries that had come to exist in the

1930s and 1940s. But it also reflected low barriers to trade within the subcontinent. In the subsequent years, while the developed countries opened their markets, thus, opening the door to trade between them and other countries including those in South Asia wider, the latter themselves turned inward. Import-substituting industrialization, with massive public-sector participation in the production activity and tight control of the private sector, became the cornerstone of the development strategy pursued in the region.

The import-substitution policies worked towards limiting not just total trade but in some ways asymmetrically towards limiting intra-regional trade. Once boundaries had been drawn between India and Pakistan, they deliberately attempted to replace imports from across the new borders. For example, before independence, the region that became East Pakistan had grown most of Bengal's jute textile mills in Calcutta processed it. After 1947, India protected and promoted jute farming by restricting the imports that had traditionally come from the East, while East Pakistan imposed restrictions on imports of processed jute established from India and established its own jute textile mills to process jute. Similarly, India restricted imports of raw rubber from Sri Lanka (and Malaysia) to promote the development of a rubber industry in Kerala.

After Bangladesh emerged as an independent country in 1971, it chose to follow the same essential road. Nepal and Bhutan, both landlocked, had more open trade relations with their dominant neighbor, India, but they too followed similarly restrictive policies with respect to the rest of the world. Consequently, though they came to trade more intensively with India, like other countries in the region, they too remained relatively closed with respect to the outside world. The only exception to this general pattern in South Asian was the Maldives, a tiny island state in the Indian Ocean.

With the possible exception of Sri Lanka that had undertaken significant liberalization in the late 1970s, anti-trade policies remained dominant in the region for nearly four decades. The collapse of the Soviet Union and the success of China under outward-oriented policies finally convinced the policy makers in the region that rapid growth could not be achieved without wholesale opening of their trade regimes. As noted above, unilateral trade liberalization policies, which had begun to be introduced in the second half of the 1980s, were introduced on a more systematic basis in the 1990s. The change contributed to a more rapid expansion of trade of India, Pakistan, Bangladesh, and Nepal not only with the outside world but with one another as well.

Quite apart from the general opening up, the countries in the region also began to see increased cooperation and trade among them as a key objective. This was reflected partially in the founding of the South Asian Association of Regional Cooperation (SAARC) in 1985 to promote dialogue and cooperation. In 1993, the member nations of SAARC went on to sign an agreement to forge the South Asian Preferential Trade Area (SAPTA), which became operational in December 1995. Though the actual exchange of preferences remained extremely limited, the process of negotiation kept the dialogue among the member countries alive.

But the worldwide proliferation of preferential trade arrangements in the last decade has now led to a change in thinking in the region, especially India, which has begun to negotiate a series of preferential trade agreements of its own. Within the region, this has recently led to the signing of the South Asian Free Trade Area (SAFTA) with the ultimate objective of turning South Asia into a full-fledged FTA with the internal liberalization beginning in 2006. This agreement has come in the wake of a bilateral FTA agreement between India and Sri Lanka in 1998 that became operational on March 1, 2000. In addition, India has also had prior trade agreements involving an FTA with Bhutan and substantial one-way preference to Nepal.

SAFTA: A CRITICAL EXAMINATION

Like 180 other existing PTAs notified to the WTO and in force as of July 8, 2005, SAFTA also adds to the fragmentation of the global trading system. But it would be wrong to judge the arrangement on this basis since the responsibility for the maintenance of a sound global trading system must rest with the larger, developed countries. If these latter countries abdicate their responsibility, the smaller countries can scarcely be blamed for putting the self-interest ahead of the public good. Therefore, SAFTA must be judged not by what harm it inflicts on the global trading system but by what benefits it confers on its member countries.

In his pioneering analysis, Jacon Viner (1950) noted that PTAs that are predominantly trade creating make its members better off whereas those that are trade diverting make them worse off. Thus, for example, when Bangladesh allows Indian cement to be imported duty free and this leads the more efficient Indian cement industry to out compete the less efficient Bangladesh cement industry, we have what Viner called trade creation: increased imports into Bangladesh represent a shift from high cost Bangladeshi producers to low-cost Indian producers. On the other hand, if duty free access to Indian computers into Bangladesh allow the less efficient Indian computer manufacturers to displace more efficient Korean suppliers who remain subject to the duty, we have what Viner called trade

diversion: increased imports from India in this case represent a switch from low-cost outside sources to the high-cost within-union sources of supply.

Therefore, the critical factor in determining whether SAFTA would raise or lower the real incomes of the member countries depends on whether it will be predominantly trade creating or trade diverting. Many analysts have suggested using the share of intra-regional trade in total trade as a measure of potential trade creation by an FTA. It is claimed that the larger this trade, the more “natural” the union. Bhagwati and Panagariya (1996) have systematically shown, however, that the extent of intra-regional trade has little bearing on whether the union is beneficial or harmful in welfare terms. The reason is that the change in intra-regional trade due to a tariff preference *at the margin* bears no obvious relationship to the *existing* volume of intra-regional trade. Depending on the precise structure of the model, it is entirely possible that when intra-regional trade is small, its further expansion does not lead to the diversion of trade from extra-regional partners.

Nevertheless, since intra-regional trade remains a key target of PTAs, let me briefly describe its evolution without any suggestion that its existing level has a bearing on the likelihood of either trade creation or trade diversion dominating upon the formation of the union. Figure 1, taken from World Bank (2004), shows the evolution of the total intra-regional trade in South Asia since the end of the British rule in the region. Until 1951, this trade as a percentage of the region’s total trade was in the double digits. As note in the previous section, this pattern reflected two facts: the world markets were relatively closed and South Asia was relatively open. In the years that followed, the two trade regimes exchanged places: the world markets opened up while South Asian borders became progressively closed. Moreover, in the case of India and Pakistan, political tensions virtually closed official international trade between them. By 1967, intra-regional trade had already fallen to just 2 percent of the region’s total trade. It recovered briefly in the early 1970s but declined steadily thereafter until 1990 when it fell back to the 1967 level of 2 percent of total trade. The share began to recover again only when the region, especially India, began to open its trade regime in the 1990s, reaching 4.2 percent in 1999.

Tables 3 and 4 show country-level data on the direction of exports and imports, respectively. The pattern at the country level essentially mirrors that at the aggregate level. On the exports side, the countries trade mainly with developed countries and relatively little with South Asian partners. For India and Pakistan, this fact also holds true on the imports side. But Bangladesh and Sri Lanka import

as much as 20 and 15 percent of their respective total imports from South Asian sources, mainly India. These volumes remain relatively small proportion of the total Indian exports, however. What remains true is that even Indian exports to the South Asian partners have expanded significantly during the 1990s rising from 3 percent in 1990 to 5 percent in 2002. The change has come about mainly due to liberalization of the MFN tariffs in the region.

Against this background, we see three important features of the South Asian economies that make an FTA among them *economically* unattractive.³ First, the economies are relatively small in relation to the world both in terms of the GDP and trade flows. Table 5 shows the population, GDP and the volume of trade in the SAARC-5 (Bangladesh, India, Nepal, Pakistan and Sri Lanka) in the year 2001. In terms of population, the region is substantial: one fifth of the world. This clearly indicates the future potential of the market if per-capita incomes reach the levels prevailing currently in the ASEAN economies. But the current per-capita incomes are tiny in relation to the latter so that the economic size of the region remains small: less than one twentieth of the world in terms of the GDP. And if we take India out of the picture, this proportion drops to 0.4 percent. The probability that the most efficient suppliers of the member countries are within the region is slim. Correspondingly, the probability that the FTA is likely to be largely trade diverting is quite high.

Trade-related indicators reinforce this conclusion. Thus, the last column of Table 5 shows the share of SAARC countries in the world trade (exports plus imports). Together, the countries in the region account for only 1.1 percent of the world trade. Again, if India is excluded, the proportion drops to 0.4 percent. The scope for trade diversion due to tariff preferences is indeed very large.

The second reason for why *prima facie* the economic case for SAFTA is weak relates to the relatively high level of protection among the SAARC economies. If the country participating in a regional arrangement were itself open, it would not suffer from trade diversion even if it were tiny. For example, Singapore does not have to fear trade diversion in its own market since its union partners must compete with the outside union countries on equal footing: everyone faces near zero tariffs in Singapore. In an India-Singapore FTA, it is India that must suffer all the negative consequences of trade diversion. Against this background, it is useful to consider the existing trade barriers in the SAARC countries. This is done in

³ Some of these concerns are discussed in greater detail with the associated analytics in Panagariya (2003).

Table 6. It is evident that the level of protection within the SAARC region remains high in all countries except, arguably, Sri Lanka. The simple average of the applied duties in non-agricultural goods ranges from 10 percent in Sri Lanka to 21 percent in Bangladesh. In India, this tariff is approximately 20 percent. In agriculture, the level of protection is even higher and ranges from 25 percent in Pakistan to 100 percent in India.

The third and final reason that makes the economic case for SAFTA weak concerns the political economy of the selection of excluded sectors and rules of origin. When countries are allowed to choose sectors that can be excluded from tariff preference of free trade, domestic lobbies make sure that the sectors in which they may not withstand competition from the union partner are the ones that get excluded. On the other hand, lobbies go along with free trade in the sectors in which they are competitive and the preference will threaten the imports from outside countries. In the same vein, lobbies tend to go for tight rules of origin or outright quantitative restrictions in precisely those sectors in which they fear the competition from the partner most. On the other hand, when the threat is mainly to the imports from outside countries, they are willing to accept greater liberalization. The rules of origin can also be subject to abuse by the bureaucrat administering them. In cases where imports from the partner may be threatening an inefficient domestic competitor, bureaucratic discretion may be employed to block entry of the imports.

A common argument advanced in favor of SAFTA is that there is a substantial informal trade among the countries of the region (Table 7) and that this trade involves large real costs. For example, the bulk of India-Pakistan trade is routed through Dubai, which is costly. An FTA may help eliminate these costs. There are three issues relating to this argument that must be examined critically. First, in so far as the illegal trade between India and Pakistan is concerned, it is important to find out what part of it is due to the restrictions that preclude trade at the MFN terms and what part tries to evade even the MFN tariff. Second, is it possible that informal trade is largely driven by considerations other than the evasion of tariffs? A recent paper by Taneja, Sarvanathan and Pohit (2003) studies the transacting environments in the formal and informal trading between India and Sri Lanka. They find that the transaction cost in formal trading in India as well as in Sri Lanka is significantly higher than in informal trading.⁴ Thus, the presence of informal

⁴ This is analogous to the international financial transactions. Despite the adoption of the current-account convertibility by India, many traders continue to prefer moving funds through Hawala because of the lower transactions costs and its substantially more rapid transmission mechanism.

trade may simply reflect excessive transactions cost of passing the goods across the border through formal channels. An FTA will likely add to this cost, especially for small and medium firms, by adding the costs of complying with the rules of origin. Therefore, paradoxically, the FTA might divert trade from the low- to high-transactions cost channel. Finally, even if the real costs associated with informal trade are higher (contrary to what the Taneja et al. study shows), benefits from such cost savings through the FTA must be weighed against the costs of trade diversion.

Given this pessimistic economic assessment, one may ask why has the move towards SAFTA gathered momentum. We suggest that the answer to this question is rooted in politics. First, with most countries in the world moving forward with more and more PTAs, there is a clear sense in the region that it may be falling behind in this race. In the absence of hardnosed economic analysis, the view that ‘if all others are doing it, it must be good’ dominates. Second, the region has definitely suffered from the trade diversion generated by the many FTAs in the Americas and EU and its neighbors. The leaders in the region may therefore see a strategic advantage in forging ahead with as many of their own FTAs as possible in response. Third, politicians do not seem to distinguish between discriminatory and nondiscriminatory liberalization as sharply as economists do. As a result they see bilateral agreements as one of the instruments of liberalizing trade. Sometimes they even see it as a superior instrument because it leads to reciprocal liberalization in the partner countries. Finally, SAFTA is also seen as a vehicle of promoting better political ties among neighbors, especially India and Pakistan that have had a long history of rivalry. The common example the proponents of this argument have in mind is that of the European Economic Community (EEC) which is claimed to have joined France and Germany into a tight economic union and made future conflicts between them very costly.⁵

In the context of SAFTA, this last argument has its limitations. For example, one may argue whether SAFTA is itself feasible in the absence of political harmony between India and Pakistan. The case of France and Germany involved a victorious power and a vanquished one and the military presence of an outside superpower that made compliance feasible. The circumstances facing India and

⁵ This argument, while quite fashionable, is not without flaws. For one thing, it was the military presence of the United States in both Germany and Japan that ensured peace in the respective regions. If the PTA was such a potent force, why is it that the U.S. military presence continued in Germany? Indeed, no FTA or customs union was formed in the Far East and yet a lasting peace could be established there because the U.S. military was present in Japan. Moreover, even without any regional arrangement, the Far Eastern economies have come to be as integrated economically as those in Europe.

Pakistan are altogether different. With an ongoing conflict and closed borders, they effectively deny the Most Favored Nation (MFN) status to each other.

But even if feasibility can be persuasively argued, one must ask whether SAFTA is the first-best instrument of promoting peace between India and Pakistan. For example, trade between them would likely grow substantially if they were to just open the borders to each other on a genuine MFN basis, which is a precondition for SAFTA in any case. Moreover, even if preferential trade is an essential aspect of the promotion of peace, can this not be accomplished more directly by an India-Pakistan bilateral FTA? Or will the promotion of cultural ties through the movement of people across the border not be a more direct means of achieving the objective? These are the tough questions that the proponents of the “peace argument” have not confronted to-date.

SRI LANKA-INDIA FTA: SECTORAL EXCEPTIONS AND RULES OF ORIGIN

The reservations to the SAFTA based on sectoral exceptions and rules of origin expressed in the previous section have been found to apply to SIFTA in a recent study by Baysan, Panagariya, and Pitigala (2004). Without providing full details of the study, let me offer below some of its key observations.

SIFTA made generous use of sectoral exceptions. For example, top 20 exports of Sri Lanka (to the world and not just India) at the 6-digit HS level accounted for 46 percent of Sri Lanka’s total exports in 1999. India subjects 15 out of these 20 products to either a tariff rate quota (meaning the tariff preference applies only up to a pre-specified quantity of imports) or negative-list exception. Thus, the exclusionary policies applied with potency to products in which Sri Lanka showed the greatest comparative advantage.

The rules of origin and rules of destination requirements further restrict the exports. For example, apparel exports from Sri Lanka are not only subject to the tariff rate quota of 8 million pieces but at least 6 million of these pieces should be manufactured from fabrics of Indian origin exported to Sri Lanka from India. Likewise, exports of tea from Sri Lanka at the preferential tariff are not to exceed 12.5 million kilograms within a calendar year. Both products are also subject to a uniquely South Asian restriction we may call the rule of destination: the preference applies only if the products enter through specific Indian ports.

Similar observations apply to preferences given by Sri Lanka to India. As Weerakoon (2001) points out in her excellent paper, at the time the lists of

concessions were finalized, of the 319 items on which Sri Lanka offered zero duty to India, the latter exported only three to the former. Looked another way, of the 2,907 products exported by India to Sri Lanka, only 21 percent received any tariff preference at all. Conversely, of the 1,351 items in the zero-tariff list of India, Sri Lanka exported only 68 items to the former. Of the 380 items exported by Sri Lanka to India, 50 were on the Indian negative list, 44 received a 25 percent tariff preference, 218 received a 90 percent preference (expanded to 100 percent as of March 1, 2003) and 68 received a 100 percent preference.

THE WAY FORWARD: AN ASIAN BLOC VIA INDIA-CHINA FTA

There is surely scope for cooperation within South Asia on a project-by-project basis in areas such as infrastructure and trade facilitation. SAFTA itself contains a host of worthwhile areas of cooperation. But it has been a mistake to put these non-trade issues into SAFTA since there is no reason to hold progress in one area hostage to progress in the other areas.

But in so far as the promotion of PTAs is concerned, as the largest country in the region, India needs to think big and focus its efforts on forging an India-China FTA with the eventual goal of creating an Asia wide FTA. More than ten years ago, I wrote arguing against an East Asian discriminatory trade bloc (Panagariya 1994). But the circumstances have changed considerably since then requiring reevaluation.

In particular, since the conclusion of the NAFTA, PTAs have proliferated in North America, Latin America and Asia. Whereas as of 1990, only 32 such agreements notified to the General Agreement on Tariffs and Trade (GATT) were still in force, they had gone up to 170 by January 1, 2005.⁶ There is no member of the World Trade Organization (WTO) that does not belong to at least one PTA today and some belong to as many as 20!⁷ More than 70 agreements are being negotiated or signed that have not yet been notified to the WTO.

This proliferation of trade blocs has created very substantial discrimination against Asian exports in North America, Europe and Latin America. Of course, it will be

⁶ The total number of agreements notified to the GATT and World Trade Organization (WTO) as of January 1, 2005 was 312. But only 170 of them were still in force with the rest having either lapsed or been superseded by new agreements. Of the 124 agreements notified to the GATT during 1948-94 before it was replaced by the WTO on January 1, 1995, only 32 are in force currently. See Crawford and Fiorentino (2005) for further details.

⁷ See http://www.wto.org/english/tratop_e/region_e/regfac_e.htm.

best if the Doha Round would bring about free trade in industrial products and substantial liberalization in agriculture and services. In that case, discrimination faced by Asian goods in these markets will end at the source since preferences against zero tariffs are also zero. But the ground reality is that the Doha Round will not eliminate trade barriers entirely even in industrial products let alone agriculture and services. Therefore, the current discrimination is likely to persist.

Against this background, a strategic argument can perhaps be made for an Asia wide trade bloc that would provide the leverage necessary to pry open the North American and European trade blocs. If one accepts this argument, an India-China FTA is probably the best starting point for such an Asian bloc. For example, an alternative route would be the development of such a bloc around the Association of Southeast Asian Nations (ASEAN). Currently, both India and China have framework agreements to form FTAs with the members of ASEAN and they could proceed with turning those into real FTAs. But a truly credible movement towards an Asian bloc would eventually require an FTA between these two countries. Rather than take this alternative route, if India and China were to sign an agreement, chances are much greater that the remaining countries in Asia (and outside) will rush to sign agreements with them. Presently, the ASEAN is driving the integration process in Asia but with the emergence of India and China as major economic powerhouses and the relative stagnation faced by the most populous ASEAN country, Indonesia, its ability to serve as the engine of the Asian integration has substantially diminished.

An India-China FTA also has the advantage that it will help promote an alternative FTA template that focuses on trade integration rather than non-trade subjects including labor standards, intellectual property rights and even restrictions on the use of capital controls. These subjects are integral parts of the US FTA template that the US may eventually want to turn into the WTO template. An Asian bloc that relies on a “trade only” template will be an effective instrument of countering the US template in the future WTO negotiations. With their vast pools of labor supply, India and China have the greatest interest in ensuring that market access does not get linked to labor and environmental standards.

Internally, India can surely benefit from cooperation with China in shaping its labor-intensive industry. In particular, direct competition with China may help push some of the key reforms necessary to stimulate the expansion of the labor-intensive industry. With the wages in China now rising, the time for India could not be more opportune for moving in a big way into such labor-intensive sectors as apparel, footwear and toys. Likewise, China could gain from increased interaction with India in the information technology sector.

Criticisms of preferential trade liberalization I offered in the context of SAFTA apply to India-China FTA as well though with less potency since China is a large player in the world market and a super-efficient producer of many goods. The latter fact means that the scope for trade creation is greater with the benefits of trade preference translating into lower prices for consumers. Nonetheless, as long as India continues to have substantially higher tariffs than China, the danger of potential losses from trade diversion reflected in the transfer of tariff revenue to the Chinese firms in the form of higher profits remains. As such, in thinking of such an FTA, one must assume that India would remain committed to its current non-discriminatory liberalization and bring the external tariffs down to the Chinese levels in two or three years' time.

Objections to an India-China FTA in India are principally grounded in the fear that Indian entrepreneurs will be unable to withstand competition from the super-efficient Chinese firms. There are two responses to this argument. First, competition is what trade liberalization is all about. Benefits from liberalization accrue precisely from competing against the best in world. India will not produce top class cricket players if it were to we ban its players from playing in the test cricket. Its top class software engineers will also fail to achieve their full potential if they were restricted to use their skills for domestic industry alone. In terms of trade creation and trade diversion, the more efficient the trading partner, the less fear that the FTA will result in trade diversion.

The second reason why this fear is misplaced is that India's own experience during the last two decades demonstrates that Indian entrepreneurs are perfectly capable of competing with the best in the world. From a regime with strict import licensing and more than 100 percent average tariff rate in 1991, India has moved to a regime with free imports with the highest tariff of 15 percent (with some exceptions) on industrial products. This transition has not slowed down industrial growth in India. On the contrary, Indian industry today is perhaps much more efficient than 20 years ago. Though more progress is required, its specialization is also closer to its comparative advantage than 20 years ago.

These arguments are reinforced by the fact that India-China trade has been one of the most rapidly growing bilateral trade relationships in he last ten years. And while the bilateral balance remains in favor of China, rapid growth has taken place in both directions with concomitant benefits to both countries. According to the Indian Commerce Ministry data, India's exports to China rose from a paltry \$18 million in 1990-91 to approximately \$4.6 billion in 2004-05. India's imports from

China expanded equally rapidly, from \$35 million to \$6.7 billion over the same period. While China is now the largest source of India's imports, it is also the second largest destination of its exports (not counting UAE, which is only a way station for Indian exports).

CONCLUDING REMARKS

In this paper, I have argued that the case for the SAFTA on both economic and political grounds is not especially persuasive. Economically, the region is small in relations to the outside world and remains heavily protected. *Prima facie*, these features imply that trade preferences to regional partners will likely be trade diverting rather than trade creating. Based on the experience with the Sri Lanka-India FTA, the rules of origin and sectoral exceptions are more likely to restrict the expansion of intra-regional trade in precisely those sectors in which the countries have comparative advantage, that is, the sectors in which trade creation is more likely.

A political case for the SAFTA is sometimes asserted by appeal to the experience of France and Germany but to-date I have not seen it clearly articulated. The circumstances of France and Germany after Germany had been decisively defeated and the U.S. military forces occupied Germany were quite different from those of India and Pakistan. Border hostility and dispute between these nations are ongoing and unresolved. This difference raises serious doubts about successful implementation of the SAFTA. On the other hand, if the arrangement is implemented, it is not going to result in the kind of integration and impact observed among the member states of the European Economic Community. The latter was a much larger market to begin with and chose the instrumentality of a customs union that eventually aimed to even introduce factor mobility. In contrast, so far SAFTA can only be seen as intended to promote selective trade preferences with even the goal of a full-fledged FTA five to seven years having limited credibility. Finally, it remains to be argued persuasively that the SAFTA is the best means to break the hostility between India and Pakistan.

Therefore, it stands to reason that the instrumentality of SAARC be deployed not in promoting SAFTA but project-by-project cooperation in areas of mutual interest. Projects in areas of infrastructure, energy and trade facilitation are clearly good candidates for such cooperation.

In so far as preferential trading is concerned, I have argued that its goal should be an Asia wide trade bloc for which the best starting point is an India-China FTA.

These are growing economies and together reasonably large. Because of the highly competitive nature of China's firms in many products on the worldwide scale, risks of trade diversion for India are much lower than in SAFTA. An India-China FTA also offers the best prospects for forging the Asia wide FTA eventually.

A final word must be said in support of a successful completion of the Doha Round, of course. Developing countries have the greatest stake in bringing this round to a successful end. The negotiations are now largely limited to trade liberalization, which offers win-win bargains. Since India has the most trade concessions to give due to its high level of protection, it has a pivotal role to play. Its importance in the negotiations is perhaps next only to that of the European Union.

Fig 1: South Asia's Intra-regional Trade as a Share of Total Trade, 1948-99

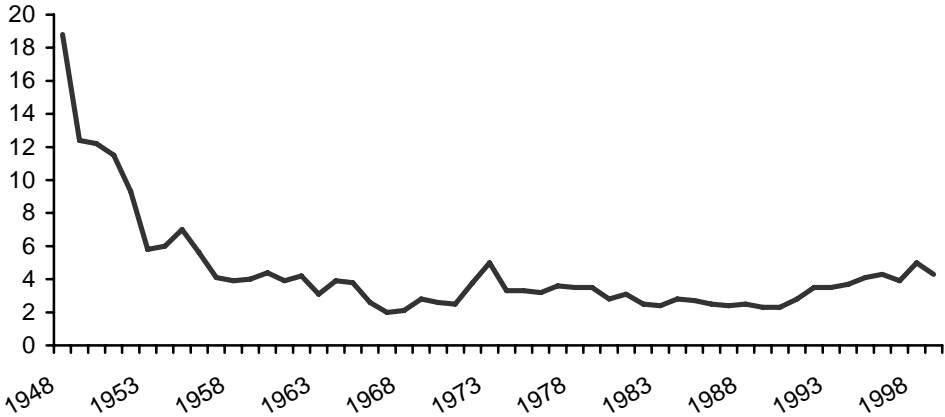


Table 1: Annual Growth Rates of GDP

Country	1981-90	1991-04
Bangladesh	3.7	4.9
India	5.8	5.7
Pakistan	6.3	4.0
Sri Lanka	4.2	4.8
China	9.4	9.7
World	3.1	2.7

Source: Author's calculations using the annual GDP growth rates in the WDI (2005)

Table 2: Exports and Imports of Goods and Services as Proportion of the GDP

Country	Export/GDP		Imports/GDP	
	1990	2000	1990	2000
Bangladesh	6.1	14.0	13.5	19.2
India	7.1	13.9	8.6	14.6
Pakistan	15.5	16.3	23.4	18.0
Sri Lanka	29.2	39.0	38.0	49.6
China	17.5	25.9	14.3	23.2
World	19.0	24.7	19.2	24.9

Source: WDI (2005).

Table 3: Direction of Exports by Major Destinations (Percent)

	USA		EU		Japan		Asean		South Asia	
	1990	2002	1990	2002	1990	2002	1990	2002	1990	2002
India	15	21	21	22	9	4	3	5	3	5
Pakistan	12	25	36	27	8	1	3	2	4	2
Bangladesh	32	35	32	50	4	2	1	0	2	2
Sri Lanka	26	38	26	30	5	3	1	1	4	5

Source: Comtrade via Wits

Table 4: Direction of Imports by Major Origins (Percent)

	US		EU		Japan		ASEAN		South Asia	
	1990	2002	1990	2002	1990	2002	1990	2002	1990	2002
India	11	7	22	20	8	3	3	5	0	1
Pakistan	13	6	24	17	12	6	5	9	2	2
Bangladesh	6	4	16	11	9	7	7	7	9	20
Sri Lanka	8	4	16	15	12	6	9	8	7	15

Source: Comtrade via Wits

Table 5: Population, GDP and Trade in SAARC-5 (2001)

Country	Population (million)	GDP (\$ billion)	Trade (\$ Billion)
Bangladesh	133.30	48.60	15.60
India	1,032.40	477.40	93.10
Nepal	23.60	5.80	2.30
Pakistan	141.50	60.00	20.30
Sri Lanka	18.70	16.40	11.10
SAARC-5	1349.50	608.30	142.30
World	6,130.10	31,400.00	12560.00
As % of World			
Country	Population	GDP	Trade
Bangladesh	2.2	0.2	0.1
India	16.8	1.5	0.7
Nepal	0.4	0	0.0
Pakistan	2.3	0.2	0.2
Sri Lanka	0.3	0.1	0.1
SAARC-5	22.0	1.9	1.1
World	100.0	100.0	100.0

Source: WDI (2003)

Table 6: Simple Average of the Tariff Rates

	India			Pakistan		Bangladesh		Sri Lanka		Nepal	
	1998-99	2002-03	2004-05	1998-99	2002-03	1998-99	2003-04	1998-99	2002-03	1998-99	2002-03
All tariff lines											
Customs duties (CD)	39.6	29.0	22.2	21.3	17.3	20.0	15.7	17.6	9.6	14.0	13.7
Other general protective taxes		6.0	0		0		3.3		2.9		2.5
Other selective protective taxes		0.0	0		0		5.8		0		0
Total		35.0	22.2		17.3		24.8		12.5		16.2
General maximum CD	45.0	30.0	30	35.0	25	40.0	30.0	35.0	25.0	80.0	25
Other general protective taxes		6.0	0		0		4.0		6.0		3
General maximum: CD+ other		36.0	30		25		34.0		31.0		28
Non-agricultural tariffs											
Customs duties		27.4	19.7		16.9		14.3		7.6		13.8
Other general protective taxes		5.9	0		0		3.3		2.5		2.8
Other selective import taxes		0	0		0		3.5		0		0
Total		33.3	19.7		16.9		21.2		10.1		16.6
General maximum: CD+ other		36.0	20		25		34.0		31		28
Agricultural tariffs											
Customs duties		40.6	40.1		19.6		22.0		21.1		13.5
Other general protective taxes		6.5	0		0		3.3		5.2		2.8
Other selective import taxes		0	0		0		3.5		0		0
Total		47.1	40.1		19.6		28.9		26.3		16.3
General maximum CD		100	100		25		30.0		25		25
Other general protective taxes		8.6	0		0		4.0		6		3
General maximum: CD+ other		108.6	100		25		34.0		31		28

Notes: The averages are of non-preferential MFN rates as given in official tariff schedules and do not allow for SAPTA or other preferential rates. The 2004-05 tariffs in India are the rates which came into force on January 9, 2004 in advance of the budget. The 2002-03 tariffs for Pakistan, Sri Lanka and Nepal changed only slightly in 2003-04. Bangladesh figures are updated as of Mar 15, 2004. All the Customs duty and other rates are percent of assessable value (cif in Pakistan, Sri Lanka and Nepal, cif +landing charges in India and Bangladesh). The protective taxes other than Customs duties that have been allowed for are: in India, the Special Additional Duty (Sadd), which was abolished in January 2004; in Bangladesh the IDSC, SD, RD and domestic VAT exemptions; in Nepal the Security tax introduced in FY 2002, and in Sri Lanka the 20 percent Customs surcharge and the 1 percent Port and Airport Development Levy (PAL). They do not allow for duty exemptions for inputs imported by exporters. They also do not allow for exemptions and partial exemptions which are separate from the general tariff schedules and which are often use and/or user-specific. The "general maximum" Customs duty rate is defined as a rate which includes at least 5% of total tariff lines, and above which there are no more than 10% of total tariff lines. [Source: World Bank (2004)]

Table 7: Informal Trade between India and its SAAARC Partners

Trading Partner (year of estimate)	Indian informal exports (\$US million)	Indian informal imports (\$US million)
Pakistan (1996)	100-500	n.a.
Bangladesh (1992-93)	299	14
Sri Lanka (1991)	142	121
Sri Lanka (2000-01)	185	21

Sources: Pakistan: Nabi et. al. (1996). Provides two estimates: the "low" estimate (based on visits to various markets for smuggled goods) suggests Indian informal exports to Pakistan were US\$100 million and the "high" estimate (based on interviews with customs officials) estimates about US\$ 500 million. Taneja (1999) and Rao et al (1996, p.23) cite *The Economist* (1996) as reporting informal exports worth \$2 billion from India to Pakistan in 1996.

Bangladesh: V. L. Chaudhary (1995), based on a detailed survey of Bangladesh-India informal trade.

Sri Lanka: Sarvanathan (1994) gives the estimates for the year 1991 and N.Taneja (2002) gives the one for 2000-2001.

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