

# Weaker Economies in SAFTA

## Issues and Concerns

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### 1. INTRODUCTION

The trade and welfare effects of regional trade arrangements (RTAs) are ambiguous. These effects depend on a number of factors, including inherent member characteristics, intraregional trade patterns before the formation of the trading bloc, member trade with the rest of the world, member trade regimes, and the design and implementation of RTA policies. Therefore, it is not true that preferential trading arrangements will always be trade creating or welfare enhancing on the whole. Furthermore, even when positive gains are achieved, their distribution among the members is unlikely to be equal, and the possibility of some members actually experiencing net adverse consequences cannot be ruled out *a priori*. In North–South RTAs, involving rich and poor countries, the latter tend to do well. However, when preferential trading blocs include low-income countries only, the poorest members tend to lose, resulting in greater divergence between the relatively advanced developing countries and weaker members.

In fact, countries that form an RTA are usually heterogeneous, as reflected in their (*a*) size in terms of geographic area and population as well

as gross national output, (b) economic structure as manifested in the composition of goods and services produced and traded, and (c) policy intervention mechanisms in place by way of fiscal, financial, and trade-related measures, which influence domestic production and trading activities. These varied characteristics of the members greatly influence their gains from an RTA. Under the South Asian Free Trade Agreement (SAFTA), the member countries vividly portray their inherent dissimilarities and also point toward a somewhat uncomfortable scenario of unequal distribution of potential gains from the regional cooperation scheme. Although all the SAFTA members are low-income developing countries, four of them (that is, Bhutan, Bangladesh, Maldives, and Nepal) are among the least developed countries (LDCs) because of a number of overriding problems that constrain their economic growth and development.<sup>2</sup> Consequently, to what extent these relatively weaker economies can benefit from SAFTA constitutes an important question, which is the principal objective of this chapter.

This chapter is organized as follows: after this introduction, Section 2 briefly provides the theoretical perspectives on the situation of weaker members in an RTA involving low-income countries only; Section 3 provides some empirical evidence on the concerns of the poorest countries in SAFTA; Section 4 discusses a number of potential scopes of regional cooperation that can help weaker members gain and benefit; and Section 5 provides some concluding remarks.

## 2. POOREST MEMBERS IN SOUTH–SOUTH RTA: THEORETICAL INSIGHTS

The relative gains to individual member countries have attracted research and analyses, the results of which may be interpreted as providing worrying evidence of unequal distributional and adverse consequences for the weaker economies in an RTA. That is, in a regional integration scheme involving only the low-income countries (that is, South–South cooperation), the poorest member countries will lose.<sup>3</sup> This outcome is ingrained in comparative advantage of member countries relative to each other within the RTA and to the rest of the world as a whole.<sup>4</sup> Based on the theoretical premise, one example from South Asia will help explain this point. Consider the relative comparative advantages of Bangladesh

and India in manufacturing production. Most people would think that India has a comparative advantage relative to Bangladesh, but not relative to the world. Under SAFTA, given this comparative advantage, India will export manufactured goods to Bangladesh, and, as such, tariff preferences exchanged within the trading bloc are likely to result in trade diversion for Bangladesh, because some of the previously manufactured goods imported from the world will be replaced by supplies from India. For India, however, gains are achieved from being able to supply goods and services to the Bangladesh market, protected from competition with the rest of the world.

Bangladesh, as an unskilled labor-abundant country, has a comparative advantage in such labor-intensive items as readymade garments (RMG), as reflected in its exports to the rest of the world. Many Bangladeshi exporters believe that Bangladesh also has comparative advantage in garment making relative to India. Therefore, the situation becomes such that India has a comparative advantage in manufacturing, in general, relative to Bangladesh and not to the rest of the world, whereas Bangladesh enjoys comparative advantage in RMG relative to both India and the rest of the world. Under a free trade area, Bangladesh's garment exports to India will be trade creating as the latter actually imports from the least cost supplier. For Bangladesh, however, trade diversion would be the outcome when Indian suppliers replace imports from the rest of the world.

The analysis of gains from trade under the multilateral liberalization is quite different from that under an RTA. In the case of multilateral trade negotiations, the primary source of gains from trade liberalization is the reduction of home tariffs. When it comes to RTAs, gains for a country primarily arise from a reduction in the partner countries' tariffs.<sup>5</sup> That is, the preferences to be received from partner countries become important under a regional arrangement, which is what mercantilists would want. This preference results from the tariff concessions offered to partner countries, which are like transfers of income (in terms of foregone tariff revenues). It is likely that an advanced developing SAFTA member country, such as India, would increase its exports to weaker economies once the regional preferences have been exchanged. The increase in the imports from partners amounts to trade diversion. In this example, while supplying countries within SAFTA gain by receiving a better price in their weaker partners' countries, the latter lose more than what the supplying countries gain. This loss can be attributed to the fact that the additional transfers from supplying countries (that is, the relatively advanced developing

countries) are received by increasing exports, but the increased exports are more expensive compared with the imports they replace from the rest of the world.<sup>6</sup>

Two important factors determine the extent of trade diversions. Considering an extreme case, if all imports before the formation of the bloc are sourced from members within the RTA, there cannot be any trade diversion. However, when only a portion of imports is sourced from the relatively advanced RTA members, the scope of trade diversion can be quite substantial. This is particularly so if the union members have large supply-side capacities, thereby having the potential of replacing the rest of the world supplies in the aftermath of the formation of the trading bloc. Related to this, a fundamental determinant of making partners' exports more competitive (and thus the RTA trade diverting) is the trade regime maintained by the importing country. When import tariffs are high, partners' imports are better protected against the competition from the more efficient world suppliers, triggering trade diversion.

Another cause for concern arises from the fact that most countries are involved in more than one regional trading initiative, and hence trade and welfare effects are also dependent on the developments taking place in other trade blocs involving members of individual RTAs. When relatively advanced members engage in preferential trading with other countries, weaker members in the original RTA are likely to face increased competition in their partners' home markets. These weaker countries may find that the trade preferences are not provided to them exclusively but rather comparable preferences are available to the suppliers outside of their original bloc. In South–South RTAs, relatively advanced developing countries are generally more inclined to explore new markets, striking more regional arrangement deals, as they might want to maximize gains resulting from their superior supply-side capacities. The third country imports can penetrate into weaker economies taking advantage of the trade preferences granted by one or some of the original RTA members. These trade deflections can be welfare improving.<sup>7</sup> However, if the weaker economies choose to prevent such flows, they can take recourse to rules of origin or other restrictive provisions. In fact, members' involvement in more than one regional bloc can activate more complicated trade regimes and rules of origin procedures, often known as spaghetti bowls, which may have adverse implications for trade and investment flows, particularly for the weaker economies.

### 3. EVIDENCE ON THE POTENTIAL CONSEQUENCES FOR WEAKER ECONOMIES IN SAFTA

#### 3.1 Qualitative Evaluation

Table 16.1 provides some of the basic economic indicators of SAFTA members. These countries differ remarkably in respect to their size and economic characteristics. In fact, they are so heterogeneous that drawing conclusion about their relative strengths based on some aggregate indicators alone might be misleading. For example, LDCs such as Bhutan and Maldives have per capita incomes greater than that of India, which is regarded as a much more advanced country not only in the region but also among other global developing economies.<sup>8</sup> Along with India, Pakistan and Bangladesh are countries with large populations that have debilitating effects on their per capita incomes. However, India's enormous supply-side capacity is reflected in the volume of its absolute exports. Pakistan is considered to be another relatively advanced developing country in the region with a per capita income comparable to that of India's. Conversely, with a population of about 20 million, Sri Lanka is a smaller developing country that has the third highest per capita income after Maldives and Bhutan.

Even within the set of LDCs, one can notice widely diverging characteristics. Bangladesh has by far the largest economy, but its per capita gross national income (GNI) is just one-sixth of Maldives and one-third of Bhutan. Nepal has the lowest per capita income in the region. Merchandise exports from Bangladesh and Nepal are dominated by manufactured items, largely because of textile and clothing products, while Bhutan and Maldives mostly rely on primary goods.<sup>9</sup> Dependence on exports from commercial services (primarily tourism) is unusually high for Maldives with its total trade (exports plus imports of goods and services) registering 182 percent of gross domestic product (GDP)—much higher than any other south Asian countries.<sup>10</sup> Despite these widely varying characteristics, there is consensus to consider the LDCs as the weaker economies among the group of countries, Sri Lanka as a smaller developing economy, and India and Pakistan as the relatively advanced developing countries. This has been reflected in various SAFTA provisions as well, in which LDCs have been given some special and differential treatment by allowing them longer time frames to reduce or eliminate tariffs, greater flexibility in the number of products not to be liberalized, favorable terms for the

**TABLE 16.1 SAFTA Members: Basic Indicators**

<i>Countries</i>	<i>GDP volume (in current US\$ billion)</i>	<i>Population</i>	<i>Land area (square kilometers)</i>	<i>Gross national income per capita (current US\$)</i>	<i>Exports of goods and services (US\$ billion)</i>	<i>Share of manufacturing in GDP (percent)</i>	<i>Trade as percent of GDP</i>
Bangladesh <sup>a</sup>	61.9	156.0	130,170	450	12.9	17.2	44.2
Bhutan <sup>a</sup>	0.94	0.6	47,000	1,430	0.23	7.4	76.7
India	911.8	1,109.8	2,973,190	820	199.0	16.3	48.7
Maldives <sup>a</sup>	0.93	0.3	300	3,010	0.7	n.a.	182.1
Nepal <sup>a</sup>	8.9	27.6	143,000	320	1.2	7.7	45.2
Pakistan	126.8	159.0	770,880	800	20.5	19.5	38.6
Sri Lanka	27.0	19.9	64,630	1,310	8.5	13.9	74.7

**Source** Most figures come from World Bank 2006a.

**Notes** GDP = gross domestic product; n.a. = not applicable.

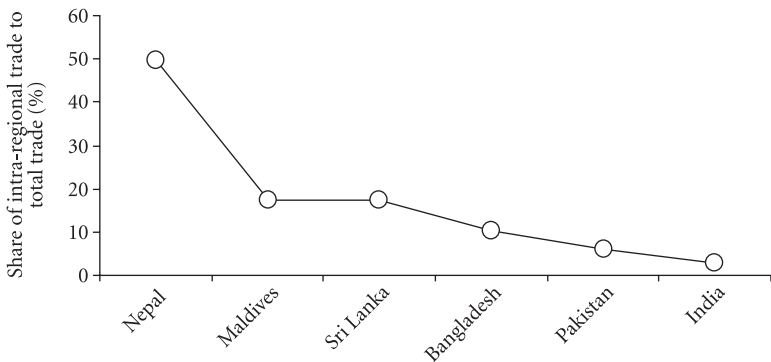
<sup>a</sup>Indicates a least developed country.

elimination of quantitative restrictions, and consideration of special terms when non-LDC members pursue antidumping and countervailing measures (Raihan 2007). Similarly, “less than full reciprocity” was a salient feature of the India–Sri Lanka Free Trade Agreement (ISFTA) under which Sri Lanka received significant concessions on the grounds of asymmetries in the two economies (Weerakoon and Thennakoon 2007).

As discussed above, the depth of intraregional trade and members’ trade regimes are important in understanding the potential effects of RTAs on weaker economies, Figures 16.1 and 16.2 and Tables 16.2 and 16.3 provide some useful information. As the intraregional trade involving the SAFTA members is known to be quite low, Figure 16.1 shows that only in the case of Nepal such trade is significant. On average, the intraregional trade has hovered around 4 percent of SAFTA members’ global trade for the past 50 years or so (Baysan et al. 2006), but for Nepal the corresponding figure is about 50 percent. Being a landlocked country, Nepal’s primary trade is with India, resulting in a high significance of regional trade. Maldives and Sri Lanka also have sizeable proportions of regional trade—their ratio of trade with South Asian countries to the rest of the world is about 17 percent. For the three large countries (that is, Bangladesh, Pakistan, and India), the importance of intraregional trade is less prominent as the corresponding ratios are about 11, 6, and 3 percent, respectively.

The importance of intraregional trade is exhibited in Figure 16.1. The data are based on official statistics, which do not account for informal border trade, which is a remarkable feature of the trade involving the South Asian countries. Some studies and analysis suggest substantial

**FIGURE 16.1** Share of Intra-regional Trade to Total Trade in 2005



**Source** Based on the information provided in Sawhney and Kumar 2007.

magnitudes of informal trade with estimates of the ratio of informal to formal trade being 30 percent in the case of Indo–Sri Lankan bilateral trade, 103 percent between India and Nepal, and 138 percent between Bangladesh and India.<sup>11</sup> Such trade also exists between India and Bhutan, and India and Pakistan. Nevertheless, it is most sensible to conclude that weaker economies in South Asia rely more on the outside region for their international trade. Therefore the scope of trade diversion arises if, by taking the advantage of trade preferences, SAFTA members' exports replace more efficient supplies from outside the region.

In the above context, it is important to consider the growing significance of India as the source of imports for the individual weaker economies. Table 16.2 shows that between 2002 and 2006 imports from India into Maldives more than doubled and rose by a factor of three for Bangladesh; the corresponding Figures for Sri Lanka and Nepal are even higher (about 3.4).

Figure 16.2 shows that the share of India's total imports from Nepal rose rapidly from about 17 percent to more than 40 percent in about 3 years. In the cases of Bhutan, Sri Lanka, and Bangladesh the corresponding share has increased quite significantly as well. This growing significance of India as a source of imports in the region should not be a cause for concern. In fact, when these import flows take place under the Most Favored Nation (MFN) principle, they are potential sources of welfare gains. An important issue to be considered is whether, by taking advantage of regional tariff preferences, these imports are replacing the supplies originating outside the region. Bilateral free trade agreements (FTAs) involving India and Bhutan, India and Nepal, and India and Sri Lanka allow an exchange of tariff preferences to occur, although it is not known whether, and to what extent, these preferential arrangements have been trade diverting.

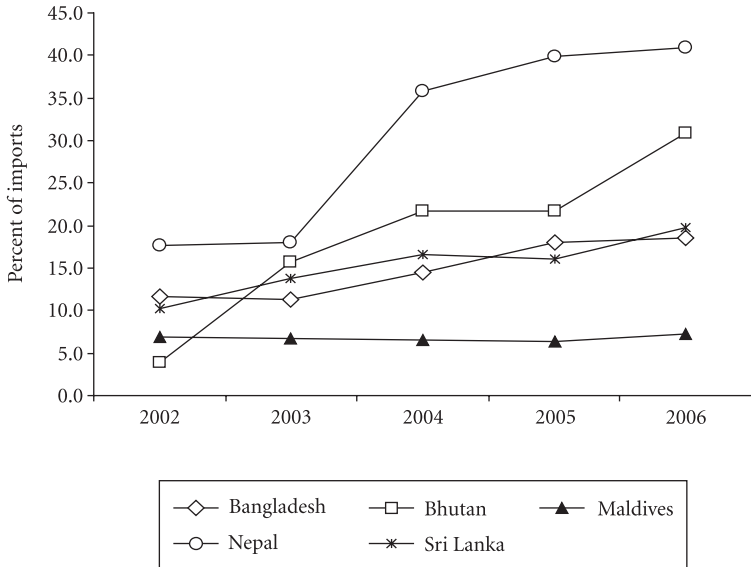
The overall insignificant level of intraregional trade seems to suggest a low probability of having the most efficient suppliers within the region, as observed by Baysan et al. (2006), which sets off the alarm of South Asian FTAs being trade diverting. In addition, by depicting the rapidly rising share of regionally sourced imports for the weaker economies, Figure 16.2 reinforces this concern. Even after implementing serious trade policy reforms, most South Asian countries still maintain considerable protective trade regimes, as evident in the simple average MFN tariff rates for such countries as Bangladesh, Bhutan, and Maldives (Table 16.3). If one goes beyond these simple average tariff rates, information provided in Table 16.3 would reveal that a large proportion of tariff lines attract duties

**TABLE 16.2 Imports from India and the Rest of the World (US\$ million)**

Year	Bangladesh		Bhutan		Maldives		Nepal		Sri Lanka	
	Global imports	Imports from India	Global imports	Imports from India	Global imports	Imports from India	Global imports	Imports from India	Global imports	Imports from India
2002	8,592	1,002	196.5	7.6	391.7	26.8	1,419	250	6,105	630
2003	10,434	1,176	249.0	39	470.8	31.5	1,754	315	6,672	920
2004	12,036	1,740	411.0	89	641.8	42.3	1,870	669	7,973	1,319
2005	13,889	2,500	386.3	84	744.9	47.6	1,860	743	8,834	1,413
2006	16,086	2,990	320.0	99	926.5	67.5	2,100	859	10,258	2,024

**Sources** Author's compilation from World Bank *World Development Indicators* database (World Bank 2008) and Government of India sources.

FIGURE 16.2 Significance of India in Sourcing Imports



Source Author's estimates from the Direction of Trade Statistics of IMF, various years.

TABLE 16.3 Tariff Profiles of South Asian Countries

Countries	Simple average of MFN applied tariffs	Simple average applied tariffs in agriculture	Simple average applied tariffs in nonagricultural products	Share of duty-free tariff lines (% of tariff lines)	Share of tariff lines with duties more than 15 %	Maximum duty rate (MFN tariffs applied) (%)	Coefficient of variation (%)
Bangladesh	15.2	17.3	14.9	7.8	39.9	25	57
Bhutan	22.1	41.3	19.2	3.5	63.4	100	62
India	19.2	37.6	16.4	2.4	21.6	266	91
Maldives	20.2	18.4	20.5	0.1	59.5	200	62
Nepal	13.9	14.9	13.7	0.9	16.6	184	83
Pakistan	14.3	16.3	14.0	0	40.0	119	77
Sri Lanka	11.2	23.8	9.2	12.4	20.9	250	114

Source World Trade Organization 2007.

Note MFN = Most Favored Nation.

greater than 15 percent. Such lines constitute as high as 63.4 percent in Bhutan, 59.5 percent in Maldives, and 40.0 percent in Bangladesh. Therefore, these high MFN tariffs are likely to provide sufficient competitive advantage to partners to inflict trade diversions.

### 3.2 Results from Empirical Exercises

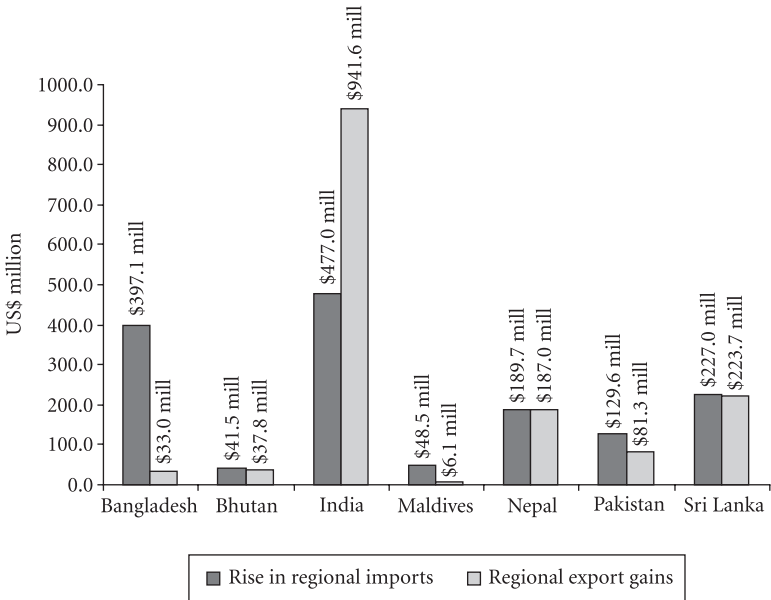
Although qualitative assessments provide important insights, quantitative evidence is perhaps more convincing. It is particularly of interest to know the potential implications of SAFTA arising from the empirical exercises. At the outset, three different techniques (that is, partial equilibrium analysis, econometric estimation of gravity equations, and computable general equilibrium [CGE] exercises) have been used in quantitative assessments. Each of these techniques has inherent limitations. Also, data limitations more often imply limited evidence for weaker economies.

The partial equilibrium models try to unearth the impact of tariff preferences by focusing on a specific sector, utilizing highly disaggregated data. However, they fail to capture the general equilibrium interactions, and thus cannot provide the intersectoral effects on the economy. Among the most important recent partial equilibrium studies that have tried to assess the effects for weaker economies of SAFTA, perhaps the most prominent one is a study by the World Bank (2006b). The study assessed the potential implications of a likely India–Bangladesh FTA for a few industries, including cement, light bulbs, sugar, and apparel. Using limited data from a few firms, the results suggest that in the case of cement, lights bulbs, and sugar, the likely FTA effects seem to provide an expansion of Indian exports to Bangladesh, but result in no exports from Bangladesh to India. This effect is mainly because Indian export prices for these products are substantially lower than ex-factory before-tax prices of the same or similar products in Bangladesh.<sup>12</sup>

The partial equilibrium model that has become most popular in undertaking the effects of regional trading arrangement is the World Integrated Trade Solution model, which has been developed jointly by the World Bank and United Nations Conference on Trade and Development (UNCTAD). This modeling system comes with the necessary database and an analytical tool that allows researchers to undertake simulation exercises to assess, among other things, the effects of tariff preferences exchanged between two countries. Using this framework, when all tariffs are abolished among the SAFTA member countries to postulate a regional free trade scenario in South Asia, the results reported in Figure 16.3 are obtained.

Figure 16.3 shows that SAFTA will lead to an increase in Bangladesh imports from the region of about US\$400 million compared with a rise in regional exports of only US\$33 million. The results show that only India stands to experience regional export gains higher than imports from regional sources. Bhutan, Nepal, and Sri Lanka individually appear to

FIGURE 16.3 Rise in Regional Exports and Imports



**Source** Estimates from the World Integrated Trade Solution (WITS) SMART simulations.

experience increases in exports and imports by similar magnitude; however, for Maldives, the imports are significantly greater than the exports. These intersectoral effects cannot be captured with this partial equilibrium framework, and the assessment of welfare effects from this model is not convincing.

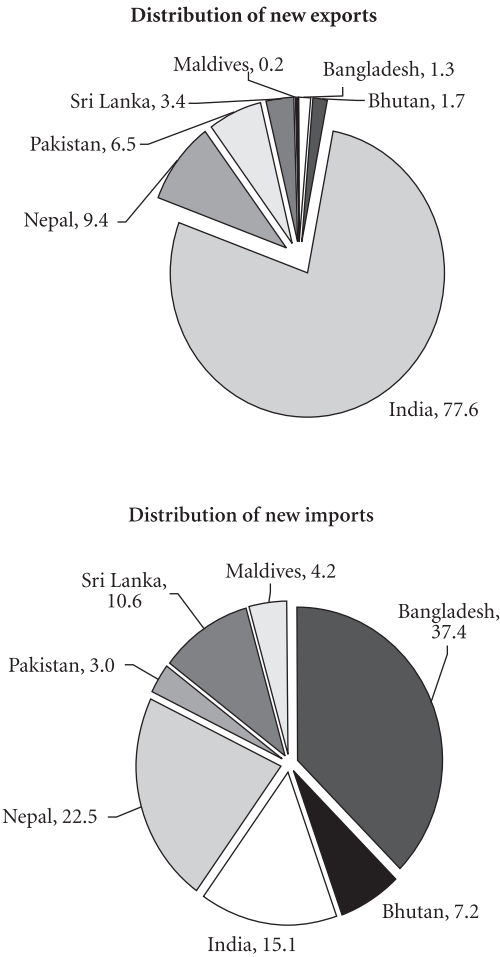
Gravity models, on the other hand, aim to explain bilateral trade flows with a set of explanatory variables that are important in predicting the impact of the arrangement on bilateral trade flows. Gravity exercises are unable to capture the welfare effects, however, because they explain only the trade flows (that is, either exports, imports, or trade). Among the most recent gravity modeling exercises, Tumbarello (2006) and Hirantha (2004) found net trade creation from the South Asian Preferential Trading Arrangement (SAPTA), whereas Rahman (2003a) failed to detect any significant effect of the South Asian trading bloc. The two studies that have attempted to provide disaggregated results for individual South Asian countries include Rahman et al. (2006) and Rodríguez-Delgado (2007). In Rahman et al. (2006), Bangladesh, India, and Pakistan were expected to gain from joining the RTA, whereas Nepal, Maldives, and

Sri Lanka were found to be adversely affected. Rodríguez-Delgado (2007) evaluated the SAFTA within the global structure of overlapping regional trade agreements using a modified gravity equation. The simulation predicted that the SAFTA tariff liberalization program would have a minor effect on regional trade flows. The simulation results suggest that SAFTA would influence regional trade flows mainly by increasing India's exports and Bangladesh and Nepal's imports. Of every US\$100 of new export trade (as Figure 16.4 shows), almost US\$78 would accrue to India, whereas Bangladesh, Maldives, and Bhutan will have little to share. On the import side, Bangladesh and Nepal would be responsible for more 60 percent of new imports, whereas India would attract only 15 percent. For trade flows generated by SAFTA as a share of individual country's GDP, only the smallest countries would obtain significant increases: Bhutan and Maldives would experience increases in trade flows equivalent to 2 percent and 1 percent of GDP, respectively; India, Bangladesh, Pakistan, and Sri Lanka would find trade flows to increase by less than 0.25 percent of GDP. Among other countries, the study found that SAFTA would affect customs revenues in most of the weaker economies: for Bhutan the loss of revenue could amount to 2.5 percent of its GDP, while for Maldives and Nepal the corresponding figures could be 1.5 percent and 1.0 percent, respectively.

These results cannot determine whether or not the increased imports for Bangladesh, Nepal, and other countries are welfare enhancing. The results show only a rather weak export response emanating from the weaker economies and do not draw any inferences about the welfare implications.

Finally, the studies based on the CGE models, by considering intersectoral and intercountry interactions, predict the effects of the trading arrangement on a variety of variables of interest, including production, consumption, trade flows, and, most important, a convincing measure of welfare. One such model that has now become the most widely used analytical framework in assessing the likely effects of multilateral and bilateral or regional liberalization is the Global Trade Analysis Project model (best known as the GTAP model), which has been developed and is based at Purdue University (Hertel 1997). A key advantage of this model is that it combines analytical tool with a detailed database that includes intercountry trade flows, protection measures across countries, and numerical specifications of each of the economies using comparable sectors and factors of production.

FIGURE 16.4 Distribution of Changes in Regional Exports and Imports



**Source** Based on the gravity model simulation results presented in Rodríguez-Delgado 2007.

The CGE or GTAP modeling approach to policy analysis is not free from limitations. Apart from its inherent characteristics and the nature of operation, which are often subjects of criticism, the simulation exercises using the GTAP model require adroit handling of data, database updates,

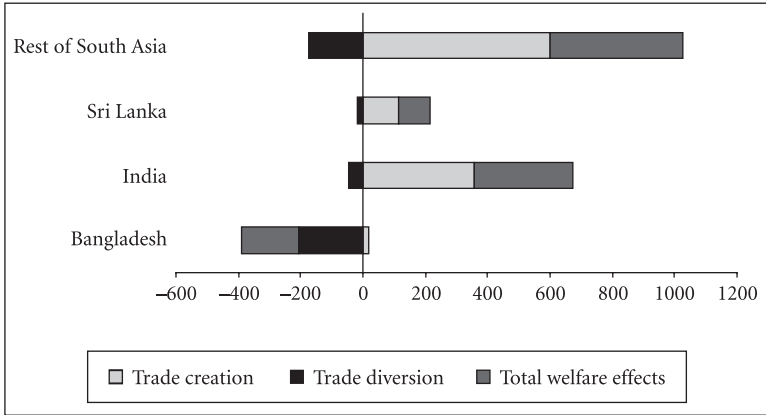
and careful interpretation of results in line with economic theories. Therefore, to derive policy implications, it is important to focus only on judiciously designed and performed simulation results.

Among the recent GTAP studies, Bandara and Yu (2003) find that, in terms of real income, SAFTA would lead to 0.21 percent and 0.03 percent gains for India and Sri Lanka, respectively, while Bangladesh would stand to lose by 0.10 percent. The rest of South Asia, in which Pakistan, Nepal, Bhutan, and Maldives are lumped together, is found to gain by 0.08 percent. The researchers endorse the view that South Asian countries would gain much more from unilateral trade liberalization than from regional liberalization under SAFTA.

In a recent study, Raihan and Razzaque (2007) ran two different simulations using the GTAP model and database. In the first scenario, the authors depict a case in which all member countries eliminate their intraregional tariffs but keep their tariffs with the rest of the world intact. In the second scenario, in addition to SAFTA tariff cuts, the authors let Bangladesh slash its tariffs against the rest of the world by 50 percent. Consequently, the scenario comparisons provided an opportunity to examine the trade diversion effects when determining the overall welfare effects for Bangladesh. The results show that the full tariff liberalization under SAFTA alone leads to a net welfare loss of US\$184 million for Bangladesh (Figure 16.5). India, Sri Lanka, and the rest of South Asia in this scenario register welfare gains, as trade creation effects dominate the trade diversion effects. However, when Bangladesh undertakes MFN tariff cuts by 50 percent along with the full tariff liberalization for SAFTA members, it stands to gain by US\$84.1 million (Figure 16.6). In the latter exercise, the positive welfare gains of other countries were maintained as well.<sup>13</sup>

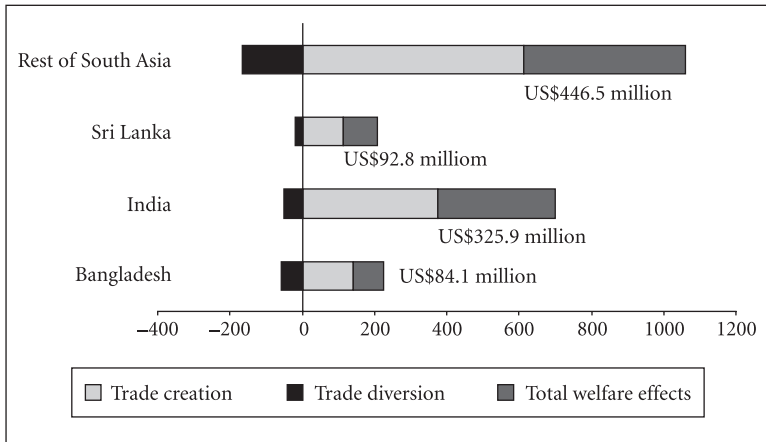
Raihan and Razzaque (2007) also explored the possible reasons for the large trade diversion effects for Bangladesh. From the simulation results, it appeared that under the first scenario, imports from China and other low-cost sources outside the region had declined, while those from India increased significantly. This indicated a replacement of the most efficient supplies with relatively expensive imports. Even when the advanced developing partners are globally efficient, it is possible that high MFN tariffs would prevent weaker economies from maximizing gains from trade creation, because the suppliers may decide not to reduce their prices by the full amount of tariff preferences granted under the regional arrangement.

FIGURE 16.5 Welfare Effects of SAFTA: General Equilibrium Effects



Source Based on the results reported in Raihan and Razzaque 2007.

FIGURE 16.6 Welfare Effects of SAFTA When Bangladesh Reduces MFN Tariffs by 50 Percent



Source Based on the results reported in Raihan and Razzaque 2007.

### 3.3 Loss of Regional Preference Resulting from Other Trading Blocs

Membership in more than one RTA has now become a reality, with an overwhelming majority of developing countries being involved in such a practice. The resultant overlapping membership creates numerous

problems, requiring countries to enact different rules of origin provision. Another serious problem of these overlapping memberships is the loss of preference for some countries. Some of the South Asian members are in the process of forming new trading blocs that include extra SAFTA members (such as Thailand and Myanmar) but that exclude SAFTA members such as Pakistan (as in the case of Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation [BIMSTEC]). As a result, the excluded members in the new initiative likely will experience competition from these new extra-SAFTA members in the markets of some of the original SAFTA members.<sup>14</sup> A recent initiative that is likely to be some serious cause for concern, particularly for weaker economies of SAFTA, is an FTA involving India and the European Union, for which the negotiations are currently under way.

Considering various traded goods across different tariff lines, one can identify four possible implications of the proposed European Union–India FTA on other SAFTA members, including the weaker members. First, there can be no negative or adverse effects. This will be the outcome in the products in which India already provides duty-free access to both SAFTA members and the European Union (that is, the sectors that are without any trade restrictions on an MFN basis). Second, a trade reorientation effect is likely to occur in sectors in which SAFTA members benefit from zero tariff access. The proposed FTA provides similar access to the European Union. If the European Union has the equal condition of providing access to the Indian market, a substitution across suppliers could lead to increases in market share at the expense of other exporters to India. Third, trade diversion effects can occur if the proposed preferential partner (the European Union) faces a tariff in the Indian market equal to that faced by SAFTA members. The preferential access of this tariff could lead to the proposed partner (again the European Union) becoming a less costly supplier solely because of preference. Fourth, a combined trade reorientation and diversion effect could be a possibility—for example, if, before preferences are granted, the proposed preferential partner faces a tariff in India greater than that faced by SAFTA members.

In a recent study, using the above four concepts, Winters et al. (2008) utilized highly disaggregated data to identify the scope of adverse consequences of the European Union–India FTA on different sets of countries, including the SAFTA members (see Tables 16.4 and 16.5). The authors show that a large proportion of tariff lines across SAFTA partners potentially suffer from increased competition from the EU in their access to the Indian market. For Bangladesh, the European Union would match the current access in approximately 5 percent of tariff lines. But, if there

**TABLE 16.4** Tariff Lines and Value of Trade with India Affected by Improved Access by the European Union

	No change			Trade reorientation			Trade diversion			Trade reorientation/diversion			
	Quantity of tariff lines (% of tariff lines)	Value (US\$, 1,000s)	Percent of total exports to India	Quantity of tariff lines (% of tariff lines)	Value (US\$, 1,000s)	Percent of total exports to India	Quantity of tariff lines (% of tariff lines)	Value (US\$, 1,000s)	Percent of total exports to India	Quantity of tariff lines (% of tariff lines)	Value (US\$, 1,000s)	Percent of total exports to India	Share of exports to India (%)
Bangladesh	287 (2.5%)	685.2	0.5	481 (4.1%)	4,824.4	3.8	5,455 (46.7%)	47,051.8	36.9	5,470 (46.8%)	74,929.4	58.8	2.0
Bhutan	287 (2.5%)	72.6	0.1	291 (2.5%)	28,055.8	24.1	5,633 (48.2%)	29,272.8	25.2	5,482 (46.9%)	58,810.5	50.6	99.0
Maldives	287 (2.5%)	0	0	0	0	0	9,622 (82.6%)	1,968.6	99.3	1,744 (14.9%)	13.3	0.7	1.8
Nepal	287 (2.5%)	1,120.6	0.3	291 (2.5%)	30,009.4	7.3	5,633 (48.2%)	187,020.8	45.5	5,482 (46.9%)	193,073.4	47	63.0
Pakistan	287 (2.5%)	17.3	0	0	0	0	9,662 (82.6%)	52,731.5	29.3	1,744 (14.9%)	127,444.0	70.7	1.5
Sri Lanka	287 (2.5%)	3,404.3	0.3	9,121 (78.0%)	553,258	48.8	833 (7.1%)	13,991.0	1.2	1,452 (12.4%)	562,008.0	49.6	23.3

**Source** Compiled from Winters et al. 2008.

**Note** Trade values are for 2004.

TABLE 16.5 Tariff Lines and Value of Trade with the European Union Affected by Improved Access by India

	No Change				Trade Reorientation				Trade Diversion				Trade Reorientation/Diversion			
	Quantity of tariff lines (% of tariff lines)	Value (US\$ 1,000s)	Percent of total exports to EU	Quantity of tariff lines (% of tariff lines)	Value (US\$ 1,000s)	Percent of total exports to EU	Quantity of tariff lines (% of tariff lines)	Value (US\$ 1,000s)	Percent of total exports to EU	Quantity of tariff lines (% of tariff lines)	Value (US\$ 1,000s)	Percent of total exports to EU	Quantity of tariff lines (% of tariff lines)	Value (US\$ 1,000s)	Percent of total exports to EU	Share of exports to EU (%)
Bangladesh	7,865 (55.6%)	101,782	2.5	6,276 (44.4%)	3,893,460	97.5	—	—	—	—	—	—	—	—	—	62.4
Bhutan	7,865 (55.6%)	581	94	6,276 (44.4%)	37	6	—	—	—	—	—	—	—	—	—	0.5
Maldives	7,865 (55.6%)	1,945	8.3	6,276 (44.4%)	21,627	91.7	—	—	—	—	—	—	—	—	—	20.9
Nepal	7,865 (55.6%)	20,643	39.1	6,276 (44.4%)	32,140	60.9	—	—	—	—	—	—	—	—	—	8.1
Pakistan	7,795 (55.1%)	634,075	21.3	—	—	—	6,346 (44.9%)	2,348,697	78.7	—	—	—	—	—	—	25.0
Sri Lanka	7,795 (55.1%)	606,006	41.2	—	—	—	6,346 (44.9%)	865,707	58.8	—	—	—	—	—	—	30.3

Source Compiled from Winters et al. 2008.

Note Trade values are for 2004; — = not available.

was complete liberalization of tariffs between the European Union and India, it would have improved market access in more than 95 percent of tariff lines.

In the case of Maldives and Pakistan, preferences are granted to only 1,744 tariff lines. Thus, the European Union is likely to surpass the South Asian Association for Regional Cooperation (SAARC) partner's market access in India in more than 97 percent of tariff lines. SAFTA LDCs benefit from a few more concessions in the form of 291 tariff lines gaining zero tariff entry to India, and from reduced tariffs in 4,029 products.<sup>15</sup> The European Union will improve its access to India over these countries in 95 percent of tariff lines. In the case of India's FTA with Sri Lanka, the predominant effect is trade reorientation, because the European Union will match its preferential access to the Indian market in nearly 78 percent of the tariff lines. Winters et al. (2008) suggest that the size of the effects on excluded countries of India granting preferences to the European Union will depend largely on the value of their exports to India and on the degree of comparative market access enjoyed by the European Union as a result of these preferences. Because countries like Bhutan and Nepal rely most heavily on the Indian market for their exports, granting EU exports preferential access to India is likely to negatively affect these countries. The amount of "affected trade" could be more than 90 percent of Bhutan's exports to India and 60 percent of Nepal's exports to India.

The European Union–India FTA could affect weaker SAFTA members in the EU market. Although this concerns economies outside the South Asian region, it nevertheless is important. Using the same four concepts as above, it is possible to identify the potential scope of adverse consequences as a result of India's gaining preferential access equal to what is available for SAFTA LDCs under the EU's Everything But Arms (EBA) initiative. These results from the Winters et al. (2008) study are summarized in Table 16.5. Respectively, 98, 92, and 61 percent of exports of Bangladesh, Nepal, and Maldives to the European Union could be subject to a trade reorientation effect as a result of India's better market access provision.

#### 4. MITIGATING THE ADVERSE CONSEQUENCES AND BENEFITING FROM THE REGIONAL COOPERATION

As trade diversion is a dominant concern, there have been suggestions for SAFTA weaker members to reduce their MFN tariffs significantly. As illustrated above, unilateral tariff cuts along with regional trade

liberalization provided welfare gains for Bangladesh, whereas regional liberalization alone resulted in welfare loss. For various reasons, the relatively weaker economies find this option to be difficult. These countries recognize the need to provide protection to some of their domestic industries, and they are dependent on these tariff revenues. It is also true that if tariff concessions are to be given to advanced regional partners, the revenue losses cannot be prevented. Conversely, opening trade to the region only could lead to significant competitive pressure for the domestic industries, particularly when countries like India and Pakistan have well-developed manufacturing bases and mimic the product range supplied by the rest of the world. Therefore, despite the associated difficulties, unilateral and multilateral liberalization is likely to remain a critical factor in mitigating some of the adverse welfare consequences.

The perceived need to support the domestic industries, along with the urgency of protecting tariff revenues, has resulted in developing a list of sensitive products that are not subject to tariff liberalization. While the rationale for such sensitive lists is well understood, it is not clear how judiciously these industries can be selected for protection. An essential feature of any dynamic industry is that eventually it should be able to compete with the rival suppliers without the need for any discriminatory policy support. The political economy factors might imply the selection of sectors for protection, because policymakers tend to select these sectors based on campaigns and pressure from lobbyists rather than from an informed analysis, which is rarely available.

Not only the LDCs have identified a range of products for not making concessions on them; other developing countries, too, have put a large number of items on the negative list. Around 25 percent of the items on the Harmonized Tariff Schedule for Bangladesh and Nepal are on the negative list, while the corresponding figures for India and Pakistan are 14 and 23 percent, respectively.<sup>16</sup> The inclusion of such large proportions of products on the sensitive list somewhat undermines the regional cooperation initiative in South Asia. The critical problem of LDCs is well known—that is, their export baskets lack diversity—in which case even a small number of goods on the negative list will obstruct any meaningful participation in regional trade.<sup>17</sup> Therefore, due consideration by relatively advanced SAFTA members that sectors of important export interest provided by weaker members not be kept on the sensitive list is important in ensuring gains of these countries from the regional trading arrangement.

Apart from the issue pertaining to negative lists, South Asian countries' trade regimes are characterized by nontariff and paratariff barriers. The cost of trading across borders, including the transaction costs for meeting

the procedural requirements for exporting and importing, is excessive. Port facilities are poor and land border crossings suffer from a lack of harmonization of border procedures and a lack of transparency (World Bank 2006c). Improved trade facilitation measures alone can contribute to a significant rise in the intraregional trade in South Asia (Milner 2008).

Despite the current low level of intraregional trade and rather unimpressive quantitative evidence regarding the extent to which trade can be expanded among the SAFTA members, the potential scope of dynamic gains should not be undermined. Quantitative exercises base their predictions on the current levels of trade, and they cannot capture the possibility of dynamic trade gains that can emanate from increased cooperation. Therefore, while the concerns for trade diversion effects are genuine, new sectors triggering trade and welfare gains are not considered. One example in this regard is the trade in new products under the ISFTA, which could not be predicted in advance based on the then pattern of trade flows between these two countries. Between 2000 and 2006, merchandise exports from Sri Lanka to India rose from US\$58 million to about US\$489 million. Exports from India also increased rapidly. While critics point to a handful of items, mainly copper and vegetable oil, in which Sri Lanka's exports have been concentrated, for smaller developing countries and LDCs export growth from a wide range of products should not be expected. The argument that the growth in vegetable oil is due to Indian entrepreneurs setting up a processing plant in Sri Lanka to take advantage of duty-free access in India under the FTA does not constitute a convincing argument against trade gains. Extended cooperation can open up a number of avenues with different natures of trade expansion.<sup>18</sup> The increased trade relations between India and Sri Lanka have resulted in enhanced air travel linkages, with the flights from Colombo to different cities in India expanding enormously and the number of Indian tourists in Sri Lanka increasing significantly.

India's imposition of quantitative restrictions in the face of the rising imports of vegetable oil from Sri Lanka can be regarded as a step toward undermining the increased trade cooperation in the region. As already pointed out, smaller developing countries and other weaker economies are most likely to have a few items for export, and restrictions against them will greatly diminish trade potentials. The relatively advanced developing countries should consider this particular issue carefully before imposing any trade restrictions against these weaker economies.

The current SAFTA arrangement has been built primarily on trade in goods. Services, too, can provide significant opportunities for trade creation.

In services sectors, the neighboring countries (particularly India), are likely to have clear comparative advantage over the rest of the world. As such, opening up such areas as health, education, tourism, information technology, and other areas generally considered to be nontradable services (such as electricity generation and cross-border transmission) could lead to welfare gains for the weaker economies. It is widely recognized that much of the services trade involving education and health takes place through the informal channel.<sup>19</sup> Liberalization in these sectors will certainly enhance consumers' welfare with the current scope of trade diversion being extremely limited. Most of the South Asian countries are endowed with natural circumstances ideal for tourism. Particularly, Bhutan, India, Nepal, and Sri Lanka have been popular tourist destinations and an effective and extended cooperation on a regional basis may result in much larger gains for the region, including for countries like Bangladesh where tourism has not been a significant sector.

Another area of cooperation with high potential for gains is the transit trade. While transit through Bangladesh will help integrate north-eastern Indian provinces into the Indian economy, for landlocked countries like Bhutan and Nepal, access to ports in Bangladesh through Indian territory could promote their international trade. Geographic location is now considered to be an important determinant of international trade, and for landlocked countries, transport costs have been shown to be excessively high, thereby undermining their trading potentials.<sup>20</sup> In this backdrop, regional cooperation can lead to enormous benefits for the weaker economies in landlocked South Asia. When the issue of transit trade is kept out of the regional arrangement initiative, it implies that an important area of natural comparative advantage for these countries, particularly for the weaker economies in the region, is not exploited.

It is often argued that enhanced SAFTA cooperation will lead to a flow of investment from relatively strong countries to weaker economies. Investment flow may not necessarily take place, however, if the relatively advanced developing country suppliers make supplies available to the regional centers by producing goods from their own countries. Also, within the region, there could be a bigger tendency to concentrate investment in places traditionally known to be commercial centers, particularly when wages in different South Asian countries do not differ much. This is true both in the case of investment flows originating within the region and those coming from outside South Asia. Empirical evidence suggests that regional integration, on average, contributes to attracting foreign direct investment (FDI), but the benefits are unlikely to be distributed evenly

(Yeyti et al. 2003). Nonetheless, greater cooperation among these countries may result in FDI inflows from the relatively advanced developing countries to weaker economies. This has already taken place in the case of India–Sri Lanka trade. Bangladesh has witnessed India's investment in the health and information technology sectors along with investment proposals for other sectors.

Finally, regional cooperation in improving the infrastructure can have major beneficial effects for the weaker economies. Trade and cooperation in energy and water are important areas of common interest to most South Asian countries. As South Asia is a fast-growing region, developing uninterrupted sources of energy supplies will be crucial for future growth and economic activities. According to World Bank (2006c), regional cooperation in cross-border management of water resources, among other types of cooperation, may contribute to hydro and irrigation benefits to Nepal, flood control benefits in Bihar, India, and flood control and dry season water augmentation in Bangladesh. Developing better transport infrastructure is another area in which countries can cooperate and through which regional trade can be promoted. Cooperation is needed to create harmonization of standards and policies. Lack of harmonization of policies is currently a major nontariff barrier obstructing trade flows.

## 5. CONCLUSION

The existing literature and empirical evidence suggest that weaker economies within a South–South RTA are likely to lose, irrespective of whether or not the regional arrangement on a whole is welfare enhancing. Trade diversion is the principal cause of this adverse implication for the poorer countries. When the stronger economies tend to replace most imports from the rest of the world for a weaker economy, foregone revenues coupled with trade diversion become the worst consequences for these weak economies. While the protection of some domestic industries and the need for tariff revenues have resulted in a list of sensitive products for member countries, the depth of the product range not for liberalization along with the existing behind-the-border measures greatly restrict the scope of intraregional trade flows. Therefore, SAFTA, as it stands today, remains a paradoxical means for attaining development for the LDCs. Analysis of trade flows and tariff profile of the individual South Asian countries in this chapter suggests that the issue of unilateral liberalization

is going to be important for weaker members to ensure overall trade creation effects of SAFTA. Weaker members of SAFTA may be challenged by other developments associated with the formation of trading blocs involving South Asian members and countries outside the region. This may create a loss of trade preferences not only in the regional market but also in other major global markets.

Despite all these grim assessments, the scope of dynamic gains arising from SAFTA can be substantial. Opening up the region can generate new exports, exerting trade effects much larger than what analytical exercises can predict based on the existing information on bilateral trade and protection structure. However, supportive policies in the relatively advanced developing countries will be required so that these new sectors do not become subject to restrictive trade measures. This is particularly important for LDCs, because they produce only a few items for export.

To exploit the maximum benefits of SAFTA, greater cooperation involving services, transit trade, investment, and regional infrastructure development should be seriously considered. Trade expansion can take place in these areas in the absence of adverse implications arising from trade diversion. These sectors cover the mutual interests of South Asian countries from the perspectives of their long-term growth and development, thereby creating a win-win situation for all members involved.

A political will is required on the part of the advanced developing members to ensure that the weaker economies benefit from the regional integration process. This political will requires providing generous treatment to all LDC goods immediately, including those included on the list of sensitive products. Advanced developing countries in collaboration with their weaker counterparts may devise fiscal and financial incentive packages so that regional and international investors find it attractive to invest in the weaker countries.

The LDC members of SAFTA should continue with their concerted efforts, in terms of reforms and addressing supply-side bottlenecks, so that they can benefit from a bigger regional market. In fact, South Asian countries will have to be involved in far more extended cooperation if the poorest countries can make use of SAFTA for their trade, economic growth, and development. It may be useful for LDC members to realize that regional cooperation may not depend on trade preferences alone. Mutual and extended cooperation are likely to augment trade irrespective of preferences exchanged.

## NOTES

1. The author is currently Economic Adviser, Economic Affairs Division, Commonwealth Secretariat, London, UK. Views expressed here are those of the author, and do not necessarily reflect those of the Commonwealth Secretariat or its Members.
2. Maldives is in the process of graduating out of the group of LDCs, but it will perhaps remain as a weaker economy. In fact, it is very difficult to define weaker economies precisely in the group of low-income countries. Based on manufacturing base, supply-side capacity, and overall economic dynamism, Sri Lanka also may be regarded as a weaker economy in the group that includes such countries as India and Pakistan.
3. The empirical literature seems to suggest that RTAs involving relatively high-income countries promote convergence of per capita income levels. Ben-David (1993, 1996), for example, showed that lower-income countries within the European Union (such as Ireland, Portugal, and Spain) registered more rapid growth than the larger and richer countries. On the other hand, Venables (2003), referring to the East African Common Market, among others, as an example of South–South integration, pointed out how the greater divergence within the member countries eventually led to the collapse of the cooperation scheme. In general, North–South trading blocs involving the rich industrial and poor countries are regarded as beneficial to the poorer countries.
4. A nice illustration of this can be found in Venables (2003), based on which the South Asian example in this chapter is drawn.
5. This is well-demonstrated in Panagariya (1998).
6. A numerical illustration of this point can be found in Hoekman et al. (2002).
7. But, it is not necessarily so. Most efficient exporters may remain outside the original and secondary RTAs.
8. It is the large population of India that makes its per capita income smaller.
9. However, Nepal's exports of textile and clothing items have declined substantially in the aftermath of the abolition of the Multi-fibre Arrangement (MFA) quotas in 2005.
10. Note that small countries, in terms of population, are likely to have greater trade-to-GDP ratios. Because of their small home markets, firms in small countries generally target the world market for production and export. In contrast, firms in a large domestic market may be more inclined to produce and sell to home consumers, even within a neutral trade regime, thereby exerting a negative influence on the degree of trade orientation (see Gylfason 1999).
11. Sawhney and Kumar (2007) provide a summary of the evidence on informal border trade in South Asia.
12. One interesting finding of the study is India's comparative advantage over Bangladesh in the production of apparel. Nevertheless, India has been reluctant to open its market to Bangladeshi apparel. Recently, under a tariff rate quota arrangement, India has allowed duty-free imports of 8 million pieces of apparel. Such a volume of exports appears to be small considering Bangladesh's total garment exports to the world market.
13. It should be noted that the original GTAP framework does not provide the decomposition of welfare effects into trade creation and trade diversion. To disentangle these two effects, the authors incorporated some necessary adjustments into the model. The GTAP model provides a net welfare estimate of the SAFTA simulation, which includes trade

creation and trade diversion effects. With a view toward isolating the trade creation effect from the total welfare effect, a separate simulation was run in which the relevant model closure was modified so that the imports to all South Asian countries from all regions (except from the South Asian countries) could be held fixed. The welfare effects from this scenario produced trade creation effects for individual SAFTA members. These trade creation effects were then deducted from the total welfare effects in the original simulation to get the estimates of trade diversion effects.

14. This is in addition to the problem of trade deflection that the excluded SAFTA members from the new initiative will have to face.
15. Tariff is above zero but below MFN level.
16. Countries in SAFTA make a distinction between sensitive items for LDC and non-LDC members. For example, India's sensitive items for non-LDC members account for about 17 percent of its Harmonised Trading System (HTS) lines as against 14 percent for LDCs. Among others, Bhutan and Maldives (LDCs) currently consider, respectively, 3 and 13 percent of their product range to be sensitive. The other developing country, Sri Lanka, has included about 20 percent of its tariff lines in the negative list (Raihan and Razzaque 2007).
17. This has particularly become evident since the conclusion of the WTO Hong Kong Ministerial, as many analysts are of the view that the duty-free access to 97 percent of tariff lines does not mean any meaningful market access given their exports' high concentration on a few items. In light of this, the depth in SAFTA member countries' list of sensitive goods is most likely to severely restrict LDCs' trading capacity.
18. However, note that tariffs in Sri Lanka are among the lowest in South Asia, which helps it protect from excessive trade diversion costs. For other South Asian countries with high MFN tariff barriers the scope of such adverse implications can be quite substantial, as discussed earlier.
19. Rahman (2003b) finds that annual payments made by Bangladeshi nationals to access education and health services in India could be about US\$100 million, an overwhelming proportion of which goes unrecorded in the official balance of payments.
20. According to Redding and Venables (2004), *ad valorem* transport costs of 20 percent on both final output and intermediate goods can reduce the domestic value added by 60 percent when intermediate goods account for 50 percent of costs. The implication is that only because of unfavorable geography, some countries will experience much lower gains from trade, and foreign firms might be reluctant to move or relocate their production to those countries that are far from their main export markets, even when wages in those countries are low.

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