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SAFTA

Current Status and Prospects

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1. INTRODUCTION AND BACKGROUND

South Asian countries, which had open economies in the immediate post-independence period in the 1940s, had become some of the most highly protectionist economies in the world by the 1970s. Tariff and, even more important, nontariff barriers were extremely high, state interventions in economic activity had become pervasive, attitudes to foreign investments were negative, often hostile, and stringent exchange controls were in place. This started to change in the late 1970s, however. In 1977, Sri Lanka initiated a process of policy liberalization, and other countries followed in the 1980s. The liberalization process, however, was often rather hesitant and was uneven across countries. It was from the early 1990s, with the start of a major reform process in India, that the region as a whole really started to liberalize. By the end of the decade, although important policy barriers to trade and foreign investment remained, enormous progress had been made throughout the region in this direction (World Bank 2004).

The changes to the trade policy regime in South Asia have been driven primarily by across-the-board, unilateral liberalization by individual countries. However, a process of preferential trade liberalization also has been ongoing since the establishment in 1985 of the South Asian Association for Regional Cooperation (SAARC). South Asia was fairly late in embracing the concept of regional economic cooperation—it took a decade after the initial establishment of SAARC for the region to turn its attention to the promotion of trade through a regional agreement. Nevertheless, having accepted the concept of regional economic cooperation, SAARC was quick to set itself an ambitious agenda. The proposal to set up a South Asian Preferential Trade Agreement (SAPTA) was accepted and came into formal operation in December 1995. In 1996, SAARC member countries agreed in principle to go a step further and attempt to enact a South Asian Free Trade Agreement (SAFTA) by 2000, but not later than 2005. With the apparent progress of three rounds of negotiations under SAPTA completed by 1998, it was proposed that the date for establishing SAFTA be brought forward to 2001.

The momentum of economic cooperation in South Asia suffered a setback from late 1998, however, with the deterioration in bilateral relations between India and Pakistan that saw the consequent postponement of SAARC Heads of State Summits for the next three years.[1] With the resumption of official contact in January 2002, negotiations on a Framework Treaty on SAFTA were initiated and the framework was adopted in January 2004. Outstanding issues in key areas of the tariff liberalization program, rules of origin, sensitive lists, and so on, were completed on schedule by January 2006 to allow the implementation of SAFTA to begin in July 2006. Under the proposed tariff liberalization program (TLP), SAFTA will become fully effective for non–least developed country (LDC) member countries of SAARC by 2013 (and by 2016 for LDC member states).

To date, the SAFTA process has generated only limited enthusiasm. It suffers from significant shortcomings, primarily on account of a cautious approach adopted to achieve the ultimate objective of free trade within the South Asian region. Concerns about the very usefulness of SAFTA have been mounting in light of more liberal bilateral free trade agreements (FTAs)—as well as preferential access that could conceivably be granted through alternative trading arrangements—among SAARC countries. The dynamics of regional integration in South Asia have also changed with the growing emergence of India not only as an Asian economic power, but also as a rapidly emerging world economic power. With India looking increasingly to strengthen economic relations with the wider Asian region through initiatives such as Association of Southeast Asian

Nations (ASEAN)+3+India, the strategic interests of the smaller South Asian economies are likely to become inextricably linked to successful integration with the Indian economy. The evidence to date suggests that economic integration of the South Asian region is gathering pace, but that SAFTA remains fairly marginal in that process.

2. FROM SAPTA TO SAFTA: WILL "FREE" TRADE IN SOUTH ASIA YIELD BENEFITS?

Despite a number of empirical studies that have looked at the prospects for regional integration in South Asia, the results remain inconclusive. The quantitative assessments have used a variety of methodologies, including gravity models, computable general equilibrium (CGE) models, and partial equilibrium studies. Early studies predicted pessimistic outcomes for the most part. They concluded that most of the preconditions required for a successful trading arrangement were not present in South Asia (De Melo et al. 1993; De Rosa and Govindan 1994; Srinivasan and Canonero 1993; Srinivasan 1994), and that the region would be better off liberalizing trade unilaterally (Bandara and Yu 2003). Others argued strongly that regional trade integration initiatives in South Asia will yield a net welfare loss and slow unilateral liberalization (Baysan et al. 2006; Panagariya 2003). Indeed, it has long been recognized that the fact that South Asian countries share some basic similarities (low income, relatively abundant labor, comparative advantage in similar commodities, such as tea and garments) reduces the potential for comparative advantage–driven trade.

Nevertheless, it has been argued that increased economic integration would carry with it the ability not only to secure new and larger markets for traditional products, but also to enable the diversification of domestic economic structures. More recent studies have highlighted benefits to be had from pursuing economic integration in South Asia, not only in trade in goods but also in services and investment (ADB/UNCTAD 2008).

Notwithstanding the inconclusive nature of empirical assessments, the notion that deeper regional trade integration can create spillover effects that would strengthen economic and political ties between South Asian countries has persisted (SAARC Secretariat 1999). SAPTA was intended as the initial step in the process to support regional economic integration. However, the SAPTA process was rather ineffective. Three rounds of negotiations were completed under SAPTA where the consolidated list of concessions covered 3,857 tariff lines, including special concessions (2,762 tariff lines) offered to LDCs.[2] The most limiting factor of SAPTA was the actual trade coverage of preferential access granted. In fact, it has been estimated that on average only 8.4 percent of tariff lines in the case of imports from non-LDCs (and 6.2 percent in the case of imports from the LDCs) were covered (World Bank 2004). In reality, products imported under SAPTA concessions translated to only 15 percent of total imports between SAARC member countries (Mukherji 2000). Thus, SAPTA had little or no impact in changing the existing trade patterns in South Asia. Intra-SAARC trade continued to stagnate in the region of 5 percent of total trade with the rest of the world—one of the lowest volumes of intraregional trade of any major geographic region.

SAFTA was intended o provide a fresh boost to the integration process. Unlike SAPTA, SAFTA adopted a negative list approach with the intention that South Asian countries would phase out import tariffs to other member countries on all goods apart from those items reserved under a "sensitive" list. The key features of the Agreement related to the modalities of the TLP, the treatment of sensitive goods, and the rules of origin.

2.1 SAFTA: Key Features and Current Status

As far as the TLP is concerned, the approach adopted makes a commitment toward a top–down reduction of tariffs in which non-LDC member states are required to reduce existing tariffs to 20 percent within 2 years of implementation of the agreement, and thereafter to further reduce tariffs to a range of 0–5 percent in the next 5 years.[3] LDC member countries are required to reduce existing tariffs to 30 percent in 2 years and further ensure a reduction to a range of 0–5 percent in the next 8 years (Table 3.1).

One criticism that may be made of this formula is that it may allow back-loading in the tariff-reduction process. That is, those countries whose tariffs are well below 20 percent may not have to commit to substantial reductions until the last minute. The agreement only requires a 10 percent margin of preference reduction in each of the two years and recommends a 15 percent reduction each year in the second phase. However, the formula adopted—unlike the alternative of a progressive linear reduction formula—is not without its benefits. It is likely to be more efficient if convergence is achieved initially by all countries lowering their tariffs to a maximum rate and then proceeding further. An alternative of an annualized percentage reduction, on the other hand, would have meant that countries with high tariffs still continue to benefit in relation to the other regional partners. International experience of regional blocs

TABLE 3.1 Comparative TLP across FTAs in South Asia

	SAFTA	*ISFTA*	*PSFTA*
Immediate 0%	Not applicable	India: 1,351 items Sri Lanka: 319 items	Pakistan: 206 items Sri Lanka: 102 items
TLP for others	Non-LDCs: reduce tariffs to 20 percent over 2 years (LDCs 3 years)	India: duty on balance items to be phased out over 3 years	Pakistan: duty on balance items to be phased out over 3 years
	Non-LDCs: reduce to 0–5 percent over next 5 years(LDCs 7 years)	Sri Lanka: duty on balance items to be phased out over 8 years	Sri Lanka: duty on balance items to be phased out over 5 years
Date of full implementation	2016	2008	2010

Source Respective agreements.

Note FTP = Free Trade Agreement; ISFTA = India–Sri Lanka Free Trade Agreement; PSFTA = Pakistan–Sri Lanka Free Trade Agreement; SAFTA = South Asian Free Trade Agreement; TLP = Tariff Liberalization Program.

generally finds clauses that favor convergence—as in SAFTA—to be more successful in ensuring that benefits of tariff reduction are extended to all member countries.

Another key area is rules of origin (ROO), which is an important provision in any FTA. Within trade arrangements, ROO have a number of functions. The most important are to limit the benefit of preferences to countries within the agreement, and related to that, to encourage industrial development within the member countries. ROO can have positive as well as negative effects. Positive effects of properly constituted ROO requirements generally include prevention of trade deflection, facilitating value addition, and augmenting the volume of intraregional trade. On the negative side, it is often argued that ROO might inhibit intraregional trade and favor high cost and inefficient production. Ideally ROO should, therefore, be open, transparent, predictable, and consistent in application, as simple as possible and leave little room for administrative discretion.

Three criteria are generally used to determine whether 'substantial transformation' of goods—that is, the final product should be distinct from its constituents—has taken place. Each rule could be applied in isolation, in the alternative, or in tandem. The rules are:

- a percentage test according to which a minimum percentage of domestic value addition (DVA) should be achieved on the basis of domestic inputs;

- a change in tariff heading (CTH) test whereby the tariff heading of the final product is different from the tariff headings of its components; and
- specified process tests that require a product to undergo certain stipulated processes.

The SAFTA agreement requires domestic value addition (DVA) of 40 percent for India and Pakistan (as non-LDC member countries), 35 percent for Sri Lanka (as a small economy), and 30 percent for LDCs, in combination with a change of tariff heading (CTH) at classified at the four-digit Harmonized Commodity Description and Coding System (HS) code (Table 3.2). However, derogation from the General Rule has been permitted under SAFTA because some products may undergo substantial transformation and allow the DVA criteria to be met without CTH at the four-digit code and vice versa. Besides the single-country ROO, there is also provision for cumulative ROO with a minimum aggregate content of 50 percent with the proviso that the minimum input from the exporting country should be 20 percent. The SAFTA ROO is more or less the same as those under the bilateral FTAs in the region.

One of the most critical provisions in SAFTA is the one that deals with sensitive sectors. It seems reasonable that each country has some

TABLE 3.2 Comparative Rules of Origin across FTAs in South Asia

	SAFTA	*ISFTA*	*PSFTA*
Single-country ROO			
DVA (% of FOB)			
India and Pakistan	40%	35%	35%
Sri Lanka	35%	35%	35%
LDCs	30%		
CTH	4-digit	4-digit	6-digit
Cumulative ROO			
Minimum Aggregate Content	50%	35%	35%
Input from Exporting Country	20%	25%	25%
Derogation from General Rule	DVA: 25, 30, 40, or 60% CTH: at 4- or 6-digit Process: PSR		Not applicable

Source Respective agreements.

Note CTH = Change of Tariff Heading; DVA = Domestic Value Addition; FTP = Free Trade Agreement; ISFTA = India–Sri Lanka Free Trade Agreement; LDC = Least Developed Country; PSFTA = Pakistan–Sri Lanka Free Trade Agreement; ROO = Rules of Origin; SAFTA = South Asian Free Trade Agreement.

sensitive industries that should not face increased competition, even from relatively less competitive neighbors. An improvement in the SAFTA treaty compared with the bilateral FTAs in the region was that it provided room for negotiations to ensure a maximum ceiling on items that can be placed under the negative list by each member country. It appeared in the initial stages of negotiations that a fairly liberal approach would be adopted, perhaps limiting the negative list to 10 percent of tariff lines (of a total of 5,224 tariff lines at the HS six-digit level), but the final decision was to retain a negative list of 20 percent of tariff lines for non-LDC member states and a close approximation of that for the LDC member countries (Table 3.3).

TABLE 3.3 Comparative Negative Lists across FTAs in South Asia

	SAFTA	*ISFTA*	*PSFTA*
Bangladesh	1,254[a]		
Bhutan	137		
India	865[b]	419	
Maldives	671		
Nepal	1,335		
Pakistan	1,183		540
Sri Lanka	1,065	1,180	697

Source Respective agreements.
Notes FTA = Free Trade Agreement; ISFTA = India–Sri Lanka Free Trade Agreement; PSFTA = Pakistan–Sri Lanka Free Trade Agreement; SAFTA = South Asian Free Trade Agreement.
[a] For LDCs 1,249.
[b] For LDCs 744.

This means, in principle, that the actual trade coverage of the negative lists of each country could be quite high. Perhaps of more concern is that there is no formal and binding provision in the framework agreement requiring that negative lists are pruned down over time. In contrast, the ASEAN Free Trade Agreement (AFTA) requires explicitly that its negative list products—the corresponding Temporary Exclusion List—be phased out in five equal installments. The only provision that the SAFTA treaty has made is for a "review" of the negative list at least every four years "with a view to reducing the number of items" (Agreement of South Asian Free Trade Area, Article 7(3b), p. 5). The underlying intention may be to prune it, but the provision is vague and has no authority to require any movement from the current position of member countries. Given that SAFTA has left the issue of negative lists fairly open ended—even four years is a fairly long time horizon to wait for any improvement in the agreement—there is always the danger that the agreement will fall short of free trade even in the long term. By comparison to SAFTA, the negative lists of existing bilateral FTAs in the region are more limited.

Indeed, mapping the sensitive list of each country to their imports from the rest of South Asia reveals that nearly 53 percent of total import trade among South Asian countries by value (at the time negotiations were initiated in 2004) is excluded from the liberalization of tariffs proposed under the SAFTA treaty (Table 3.4). The LDC member countries such as Bangladesh, Maldives, and Nepal have sought to "protect" 65–75 percent of their imports from South Asia by excluding them from being subject to tariff liberalization. Sri Lanka (51.7 percent) and India (38.4 percent) also have restricted a fairly high share of imports from being subject to tariff cuts. At first glance, it appears that Pakistan has been fairly generous in restricting only around 17 percent of its current imports to the sensitive list, despite the fact that it has the largest number of items in the sensitive list of non-LDC members. However, Pakistan maintains a positive list of items in regard to its trade with India that, in theory, can limit the potential trade volumes to a great extent.

TABLE 3.4 Trade Restriction under SAFTA

	Value of imports from SAARC subject to SL (%)	*Value of exports to SAARC subject to SL (%)*
Bangladesh	65.0	22.0
India	38.4	56.5
Maldives	74.5	57.6
Nepal	64.0	46.4
Pakistan	17.2	34.0
Sri Lanka	51.7	47.0
Total	52.9	

Source Weerakoon and Thennakoon 2008.

Note SAARC = South Asian Association for Regional Cooperation; SL = Sensitive List.

Another area of concern in the SAFTA treaty is the lack of an explicit commitment to deal with the issue of nontariff barriers (NTBs). In identifying NTBs, a distinction can be made between those that have to be eliminated and those that have to be harmonized, such as measures relating to technical standards, plant and animal health, and environmental protection and safety. If any quantitative restrictions exist, these can more easily be converted to tariffs and subsequently reduced. Generally, the experience of FTAs has been that customs surcharges, technical measures and product characteristic requirements, and monopolistic measures (particularly in relation to exclusive import rights of state-controlled enterprises) are the most difficult to identify and eliminate. While South Asia has made significant progress in eliminating quantitative restrictions (QRs), nontariff measures do exist that can act as a barrier to the free flow of goods between SAARC countries (World Bank 2004).

The SAFTA framework agreement has provisions to deal with paratariffs and NTBs, but no explicit commitment is required of countries. In particular, there is no commitment in the SAFTA framework agreement to eliminate NTBs on items for which tariff reductions are to be made. By contrast, an important feature in AFTA, for example, is that member countries are required to eliminate QRs on products on which they receive concessions, and eliminate other NTBs within 5 years of receiving such concessions. What is contained in the SAFTA treaty appears to be merely an understanding that NTB-related issues will be subject to continuous negotiations.

The SAFTA treaty has been confined to trade in goods, which is viewed as a limiting factor. Globally, the trends governing bilateral and regional trade initiatives are toward implementing broader economic partnership agreements that include trade in services and investment, and areas of economic cooperation. SAARC has taken some initial steps to incorporate services and investment into the SAFTA framework agreement by commissioning a joint study to examine the issues that need to be addressed.

Thus, it is clear that SAFTA as it stands contains certain limitations. Nonetheless, implementation is progressing per the terms of the agreement, subject to the early dispute that arose with regard to the application of Pakistan's Positive List to trade with India regarding the implementation of SAFTA.[4] However, the required initial tariff liberalization (for example, to achieve a threshold of 20 percent) is quite minimal given that most South Asian economies have been unilaterally lowering Most Favored Nation (MFN) tariffs quite substantially over time. For instance, if the liberalization formula is applied to the Sri Lankan context, leaving aside those items in Sri Lanka's SAFTA sensitive list, it is clear that the only commitment required is to reduce tariffs from 28 percent to 20 percent on approximately 300 tariff lines (at HS six-digit) in three installments over a 2-year period.[5]

The other main area of progress is perhaps that of pruning sensitive lists. But here again, it is confined largely to a voluntary exercise, with India taking the initiative with an offer to unilaterally prune its sensitive list ahead of schedule by removing an additional 264 items applicable to LDCs. India has long been viewed as the key to enabling a successful regional economic integration effort in South Asia, given the significantly asymmetric nature of economic power it wields. In light of India's growing economic stature—alongside a rapidly changing pattern of trade and investment linkages across the wider Asian region—the prospects for integration in South Asia have to be viewed from a broader perspective. Such a perspective would include an assessment not only of India's own economic interests and how they relate to the South Asian region, but also how other South Asian economies respond to new challenges.

3. TRENDS IN ECONOMIC INTEGRATION IN SOUTH ASIA: THE ROLE OF INDIA

The current low levels of intraregional trade in South Asia and the limitations of the SAFTA process to provide dynamism to kick-start the process might be taken as an indication that regional economic integration in South Asia is likely to remain a distant dream. However, a key issue that needs to be looked at is whether such integration must necessarily be achieved through the SAFTA process or whether alternative arrangements are, in fact, already paving the way for an eventual approximation to free trade in the South Asian region. In this context, the role and relevance of India is overwhelming.

India remains the dominant trading partner for all South Asian economies (Table 3.5). Indeed, more than 90 percent of regional trade for such countries as Bangladesh, Nepal, and Sri Lanka is confined to a bilateral relationship with India. Even Pakistan finds nearly two-thirds of its total trade with South Asian economies relate to its bilateral trade with India. In effect, economic integration in South Asia can be argued to consist, in principle, of bilateral links to India, bypassing any notable degree of trade with third countries in the SAARC grouping.

Thus, the notion of creating a free trade area within the South Asian region, in practice, involves market access between India and other South Asian economies. In this context, it is also clear that India has played a more proactive role in the bilateral process than in the regional arena with regard to its engagements in South Asia (Box 3.1). India was much more generous in allowing significant asymmetric treatment to Sri Lanka under the bilateral FTA regarding the size of its negative list, additional years for implementation of the tariff liberalization, and so on, than the

TABLE 3.5 South Asia's Bilateral Trade with India

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
India's share in total intra-SAARC trade (%)							
Bangladesh	86.6	90.3	91.5	90.2	90.2	89.8	89.5
Maldives	34.7	38.4	35.9	37.0	43.6	57.9	57.9
Nepal	98.4	98.4	98.3	98.9	98.5	99.3	99.5
Pakistan	44.2	54.9	46.4	47.3	58.7	63.3	64.5
Sri Lanka	73.4	77.4	84.3	86.6	88.0	91.2	91.2
India's share in total world trade (%)							
Bangladesh	7.6	9.5	9.5	10.5	9.4	10.3	9.9
Maldives	7.7	9.0	8.7	8.2	8.7	10.0	9.9
Nepal	37.1	43.6	47.2	51.8	56.5	65.8	71.5
Pakistan	1.2	1.6	1.0	1.2	2.0	2.2	2.4
Sri Lanka	5.6	6.2	9.3	11.2	13.3	15.8	17.3

Source IMF 2007.

Note SAARC = South Asian Association for Regional Cooperation.

BOX 3.1 Asymmetric Treatment from India: SAFTA versus Bilateral FTAs

SAFTA	*ISFTA*
Non-LDCs maintain 20 percent of tariff lines; LDCs approximately 25 percent.	Sri Lanka maintains 25 percent of tariff lines; India maintains 8 percent.
No such immediate zero-duty concessions.	India offered immediate zero-duty concessions on 25 percent of tariff lines; Sri Lanka offered only about 6 percent.
LDCs get additional three years to implement.	Sri Lanka gets additional five years to implement.

Source Compiled from relevant agreements.

Note FTA = Free Trade Agreement; ISFTA = India–Sri Lanka Free Trade Agreement; LDCs = Least Developed Countries; SAFTA = South Asian Free Trade Agreement.

concessions it offered to LDCs at the regional-level SAFTA negotiations. The differences in the level of engagement are clear from a cursory look at the applicability of negative lists at the time of implementation of the two agreements. For example, only 13 percent of Sri Lanka's exports to India were subject to the Indian negative list under the India–Sri Lanka Free Trade Agreement (ISFTA), while nearly 42 percent of Sri Lanka's exports to India were found to be excluded under the Indian negative list under SAFTA (Weerakoon and Thennakoon 2008).

Indeed, the ISFTA is viewed as the most successful bilateral or regional trade initiative in South Asia. Sri Lanka's exports to India have been rising faster than India's exports to Sri Lanka since the implementation of the ISFTA in March 2000. Perhaps even more critical, India has emerged as a significant investor in Sri Lanka, partly in response to the cementing of economic relations governed by the ISFTA (for an evaluation of post-implementation performance, see Kelegama and Mukherji 2007). The perceived advantages of the ISFTA in generating trade in goods between the two countries, in fact, prompted the initiation of negotiations to deepen and broaden the agreement by including trade in services and investment under a Comprehensive Economic Partnership Agreement (CEPA).

Thus, India's stance and approach toward initiatives to promote economic integration in South Asia can be viewed as a crucial component. A possible Indian role has to be looked at not only in terms of the South Asian region but also in terms of India's wider strategic economic relations in the Asian region. These have inevitably evolved since the start of negotiations on the SAFTA framework in 2004, which governed the subsequent terms on which it has since been implemented. India as a rising economic power is increasingly more confident of its demonstrated capacity to sustain a strong growth momentum in the coming decades.

Does India's economic interest lie in South Asia? The recent pattern of import and export trade suggests otherwise. India's exports to South Asia have stagnated in the region at 5–5.5 percent of its total exports, while its imports from the region have consistently hovered around 1 percent of its total imports. By contrast, India trade with the East Asian region (ASEAN+3)[6] has been growing quite sharply: exports have grown from 13.5 percent to nearly 22 percent, while imports have grown from 17.1 percent to 27 percent between 2000 and 2006 (Table 3.6).

The growing trade links with the East Asian region clearly demonstrate why India has enunciated a "Look East" policy (Grarer and Mattoo 2001). The Indian economy is increasingly developing complementarities with East Asian economies in knowledge-based segments such as microchips, information technology, and other areas. Strengthening trade and investment linkages with the region, therefore, makes sound economic sense—a policy reflected in India's recent bilateral and regional trade initiatives in the region (Box 3.2).

It is not only India that appears to strengthening its trade links with East Asia, as opposed to stronger trade flows with the rest of South Asia. Most of the other South Asian economies, too, are witnessing a progressive increase in trade with the East Asian region, while their share of intra–South Asian trade is stagnating (Table 3.7). In addition to India,

TABLE 3.6 Relative Share of India's Trade with SAARC and ASEAN+3

(in percent)

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
SAARC							
Exports	4.2	5.7	5.1	6.4	5.6	5.2	5.5
Imports	0.9	1.3	0.9	0.9	0.8	0.9	1.0
ASEAN+3							
Exports	13.5	18.1	16.7	18.2	18.9	20.6	21.9
Imports	17.1	24.9	19.3	21.4	20.6	19.9	27.0

Source IMF 2007.

Note ASEAN+3 = Association of Southeast Asian Nations, plus China, Japan, and the Republic of Korea; SAARC = South Asian Association for Regional Cooperation.

BOX 3.2 India's Bilateral and Regional Engagements in East Asia

Country	*Type of Agreement*	*Date*
Singapore	CECA	Signed 2005
Korea, Rep. of	JSG JTF to develop CEPA	Completed 2006 Ongoing
Thailand	Framework Agreement Aim for FTA	Signed 2003 Ongoing
ASEAN	Framework Agreement Aim for CECA	Signed 2003 Ongoing
China	JSG JTF to develop trade agreement	Completed 2005 Ongoing
Malaysia	JSG Aim for CECA	Completed 2007 Ongoing
Indonesia	JSG Aim for CECA	Commenced 2007
Japan	JSG JTF aim for CEPA/EPA	Ongoing

Source Department of Commerce, India. Web site: www.commerce.nic.in.

Note CECA = Comprehensive Economic Cooperation Aagreement; CEPA = Comprehensive Economic Partnership Agreement; EPA = Economic Partnership Agreement; FTA = Free Trade Agreement; JSG = Joint Study Group; JTF = Joint Task Force.

Bangladesh, Maldives, and Pakistan have seen their share of trade with ASEAN+3 countries improving significantly, whereas their share of trade with SAARC countries has been stagnating or even declining over time. The exceptions are Nepal and Sri Lanka—interestingly, the two countries that have the most comprehensive bilateral FTAs with India in the SAARC region. Both have seen their share of trade with SAARC increase—indeed, wholly with India (Table 3.5)—while their trade share with East Asia has declined (Nepal) or stagnated (Sri Lanka).

TABLE 3.7 Direction of Trade for South Asian Economies

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
India							
SAARC	2.4	3.3	2.9	3.4	2.9	2.7	2.8
ASEAN+3	15.5	21.7	18.1	20.0	19.8	20.2	24.9
Pakistan							
SAARC	2.7	2.9	2.2	2.6	3.3	3.5	3.8
ASEAN+3	18.7	18.3	19.1	19.4	18.9	19.9	26.7
Bangladesh							
SAARC	8.7	10.6	10.4	11.6	10.5	11.5	11.0
ASEAN+3	25.4	25.9	27.4	26.2	23.0	24.6	30.3
Nepal							
SAARC	37.7	44.3	48.0	52.4	57.4	66.3	71.9
ASEAN+3	17.3	21.2	18.7	16.4	16.1	17.2	12.5
Maldives							
SAARC	22.3	23.5	24.3	22.3	19.9	17.3	17.1
ASEAN+3	42.9	40.2	39.9	43.1	42.2	42.1	46.9
Sri Lanka							
SAARC	7.7	8.1	11.0	12.9	15.2	17.4	19.0
ASEAN+3	23.9	22.6	22.2	23.1	21.7	20.7	22.1

Source IMF 2007.

Note ASEAN+3 = Association of Southeast Asian Nations, plus China, Japan, and the Republic of Korea; SAARC = South Asian Association for Regional Cooperation.

4. CHALLENGES AND PROSPECTS FOR SAFTA: SOME CONCLUSIONS

What is clear from a cursory examination of current trading patterns of South Asian economies is the progressive strengthening of trade links in a wider Asian context. For India, the priority will be to strengthen strategic links with East Asia. It could well carry other South Asian economies along, in which case India would be the hub that connects South Asian countries and also would be the bridge that connects South Asia to East Asia. Two key issues that arise in this context are whether SAFTA has a meaningful role in this process, or whether it has already lost the opportunity to be the main dynamic force from within South Asia.

Evidence suggests that SAFTA has already lost a great deal of momentum in the evolving dynamics of regionalism in Asia. As previously argued, SAFTA has made only a cautious attempt to enact free trade in the SAARC region. It already has been overtaken by the bilateral process in many instances, and would appear to be in danger of being further upstaged by bilateral and other regional initiatives. As previously argued, India is the key to South Asian economic integration. Bilateral market access is fast providing an environment that could reasonably approximate free trade in South Asia. Bhutan, Nepal, and Sri Lanka have virtual free trade access to the Indian market for their exports despite having a significant share of their exports to India restricted under SAFTA (Table 3.8). India has restricted only a limited share of imports from Maldives (3.6 percent) and Bangladesh (11.2 percent) under SAFTA.

TABLE 3.8 Bilateral Trade Restriction under SAFTA

	Bangladesh	*India*	*Maldives*	*Nepal*	*Pakistan*	*Sri Lanka*
% of imports under SL						
Bangladesh		11.2	0.0	29.7	31.3	45.2
Bhutan	69.4	36.8	0.0	15.0	50.4	0.0
India	66.0		65.2	64.2	14.5	53.5
Maldives	72.9	3.6		0.0	0.0	59.2
Nepal	87.8	46.2	0.0		25.4	17.6
Pakistan	54.5	16.4	15.5	30.0		28.4
Sri Lanka	66.6	41.5	85.4	37.6	29.7	

Source Weerakoon and Thennakoon 2008.

Note SAFTA = South Asian Free Trade Agreement; SL = sensitive list.

Alternative regional initiatives in the pipeline will grant Bangladesh opportunities to further its access to the Indian market. These include the proposed transition of the Bangkok Agreement to an FTA under the Asia Pacific Trade Agreement (APTA) and the implementation of an FTA under the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). In addition, Bangladesh has indicated interest in negotiating a bilateral FTA with India. Bangladesh and Maldives will both stand to benefit from enhanced access to India with the proposed unilateral reduction of India's sensitive list by a further 264 items applicable to LDCs. This may still restrict some amount of trade, but it is being offered on a nonreciprocal basis and ahead of the scheduled four-year revision of sensitive lists.

Thus, bilateral market access to India for the smaller South Asian economies is evolving at a much more rapid pace than under the SAFTA framework (Box 3.3). The net result of these alternative bilateral and regional agreements in South Asia—with India playing a pivotal role—may eventually become something approximating free trade within the region. However, Pakistan is conspicuously absent in the evolving network of such alternative agreements. In contrast to the other South Asian countries, Pakistan is seeking its own trade arrangements with the East Asian region. To date, it has signed FTAs with China (2006) and Malaysia (2007).[7]

BOX 3.3 Bilateral and Regional Agreements Involving India (except SAFTA)

Country	*Bilateral*	*Other*
Afghanistan	PTA (2003)	
Bhutan	FTA (1995)[a]	BIMSTEC
Bangladesh	Trade Agreement (2006)	APTA, BIMSTEC
Maldives	Trade Agreement (1981)	
Nepal	FTA (1991)[b]	BIMSTEC
Pakistan		
Sri Lanka	FTA (1998)	APTA, BIMSTEC

Source Department of Commerce, India, available at www.commerce.nic.in.

Notes APTA = Asia Pacific Trade Agreement; BIMSTEC = Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation; FTA = Free Trade Agreement; PTA = Preferential Trade Agreement; SAFTA = South Asian Free Trade Agreement.

[a] Renegotiated in 2006.

[b] Renegotiated in 2002.

Thus, there are obvious divergences of interests and strategic interests amongst SAARC countries. These developments pose internal challenges to the SAARC process and the future pace of regional economic cooperation under SAFTA. A multiplicity of alternative bilateral and regional arrangements among SAFTA members would not pose a major constraint, if the SAFTA process was keeping pace with such developments. Unfortunately, the current experience is that SAFTA is, in fact, lagging.

India's attention on issues of regional trade initiatives is spreading rapidly beyond South Asia. India's more accommodative approach to SAFTA—such as the unilateral decision to enhance market access to LDC—as well as its bilateral agreements with South Asian countries can be read as a signal of its growing economic confidence, and a sign of its willingness to carry along the South Asian region as it links up with East

Asia. The onus will be on the other South Asian economies to weigh the advantages and disadvantages of strategically linking with a fast-expanding Indian economy and to take advantage of potential intraregional trade and investment linkages.

For SAFTA to be the catalyst for this process of integration, the two economies that remain the least integrated in the SAARC region (that is, India and Pakistan) will need to enforce an expanded trade liberalization program.[8] This will require not only a relaxation of sensitive lists, but also a means of addressing bilateral trade issues between the two countries. In addition, other South Asian economies will need to consider opening up their economies. At present, most South Asian economies are restricting 55–65 percent of their imports from India under SAFTA sensitive lists (Table 3.8). Although Pakistan appears to have offered more favorable treatment (limiting only around 16.5 percent of Indian imports), this figure has to be viewed in the context of the existing trade restrictions between the two countries. Alongside efforts to broaden the scope of the TLP, moves to incorporate trade in services and investment into SAFTA also need to be advanced to stimulate spillover effects.

In the absence of progress on these fronts—particularly in expanding the scope of the TLP—there is a very real threat that the SAFTA process can stagnate, or worse, that it can fragment, as countries pursue bilateral market access and other alternative regional arrangements. An approximation of free trade in South Asia may be achievable through such means, but it would compromise many of the political and economic goals that were intended to be achieved through regional economic integration that includes all the member states of SAARC.

NOTES

1. In the interim, bilateral free trade agreements (FTAs) among SAARC member countries were negotiated; the India–Sri Lanka FTA (ISFTA) was concluded in December 1998 and negotiations on a Framework Agreement on a Pakistan–Sri Lanka FTA (PSFTA) were concluded in June 2002.
2. A fourth round was initiated but was never ratified by member countries.
3. Sri Lanka is given an additional one year in recognition of its small vulnerable economy status.
4. The notifications issued by Pakistan includes a rider that Indian imports into Pakistan would continue to be as included on the positive list of importable items from India, which at present consists of 1,075 tariff lines.

5. On the basis of information from Department of Customs, *Sri Lanka Customs Imports Tariff Guide 2007,* Colombo.
6. Includes ASEAN plus China, Japan, and the Republic of Korea.
7. Pakistan also entered into an FTA with Sri Lanka in 2002.
8. Sri Lanka, as the other non-LDC member, has a limited role in view of its more liberal bilateral FTAs with both countires.

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