# 7 Trading Choices of South Asia

Arvind Panagariya

## Introduction

Trade economists have identified three main avenues to trade liberalisation: unilateral, multilateral, and bilateral. Unilateral trade liberalisation refers to a country going on its own; that is, removing trade barriers without waiting for its trading partners to do the same. Unilateral trade liberalisation, unlike unilateral disarmament, is in a country's own interest since it promotes specialisation in products of its comparative advantage and allows imports to come from the most efficient source abroad. Much of India's liberalisation that began in the late 1970s, with the reintroduction of the open general licensing, and which was considerably accelerated in the early 1990s falls into this category.

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

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

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

While trade economists generally favour unilateral and multilateral trade liberalisation, they are less sanguine about preferential trade liberalisation because of its discriminatory nature, the fragmentation of the trading system such discrimination entails, and the ambiguous welfare effects it engenders. Indeed, in recent years, trade economists have increasingly turned against such liberalisation. Leading Pascal Lamy, the then European Union Trade Commissioner and now WTO Director General, remarks that half of the world's economists now oppose bilateral free trade arrangements.

Preferential trade areas have, nevertheless, proliferated because potential exporters like them because of the protected access they provide to the partner country market. For example, when Singapore forms an FTA with India, its steel exporters get to sell steel duty free in an Indian market that is otherwise protected by high duties. PTAs have also acquired a life of their own because other countries have them and they offer the country leaders opportunities to hold summits, stay virtually continuously in the limelight, and make political statements to the effect that they too are fellow travellers in pursuit of free trade.

Therefore, in thinking about trading choices of South Asia, the issue whether the countries in the region should liberalise unilaterally or multilaterally is not a difficult one, at least for a trade economist. The experience of the countries themselves since the early 1990s testifies to the benefits such liberalisation confers. The critical and controversial question, instead, is whether the region should promote preferential trade liberalisation among its members and with other countries.

Here we will argue against expending scarce political capital on turning the South Asia region into an FTA. This should not surprise those familiar with our published works on PTAs in general and SAFTA in particular. The new element here is to bring the evidence from SIFTA to bear on the argument. We will then argue that if the countries in the region want to seriously pursue the option to form a trade bloc, they must look toward an Asia-wide bloc. Though we have generally opposed PTAs because they fragment the world trading system and throw barriers in the path of non-discriminatory liberalisation at the national as well as multilateral level, proliferation of PTAs already in place has taken the teeth out of this argument. The world trading system is now hugely fragmented with a 'spaghetti bowl' of tariffs characterising the global trade regime. The only effective solution to it will be the eventual worldwide free trade under the WTO auspices. In the meantime, having been subject to huge discrimination in North American and European markets by the numerous PTAs in those regions, Asia perhaps needs to strategically respond with a bloc of its own and force those blocs to open up. The starting point for an Asia-wide bloc is an India-China FTA, however, not SAFTA.

## Triumph of Trade Liberalisation

After more than three decades of near stagnation in per-capita incomes during 1950–80, South Asia showed signs of growth beginning in the 1980s that accelerated in the 1990s and beyond. Table 7.1 summarises the growth rates in gross domestic product (GDP) in Bangladesh, India, Pakistan, China, and Sri Lanka during 1981–2004.

**Table 7.1: Annual Growth Rates of GDP**

| *Country* | *1981–90* | *1991–2004* |
|---|---|---|
| Bangladesh | 3.7 | 4.9 |
| India | 5.8 | 5.7 |
| Pakistan | 6.3 | 4.0 |
| Sri Lanka | 4.2 | 4.8 |
| China | 9.4 | 9.7 |
| World | 3.1 | 2.7 |

*Source*: Author's calculations using the annual GDP growth rates in the *World Development Indicators* (World Bank, 2005).

Throughout the period, the region has grown at rates nearly twice those of the world economy. Because India accounts for more than three quarters of the region's GDP, its growth has decisive impact on the overall regional growth. India grew 3.2 per cent during 1965–81, shifted up to 5.1 per cent during 1981–7, and then to 6.0 per cent rate during 1987–2004.[1] It is this steady rise of the Indian economy, especially since the late 1980s, which has attracted the world's attention to the region.

This acceleration in growth has taken place in an environment of declining trade barriers in the entire region. The recent comprehensive regional study by the World Bank (2004) offers an excellent documentation of this liberalisation.[2] Rather than repeat it here, exports and imports of goods and services as proportions of the GDP are presented in Table 7.2. According to this table, both ratios rose in all four South Asian Association for Regional Cooperation (SAARC) countries shown between

**Table 7.2: Exports and Imports of Goods and Services as Proportion of the GDP**

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

*Source*: World Bank, 2005.

1990 and 2000 except the imports/GDP ratio in Pakistan. In India, exports/GDP ratio rose from 7.1 per cent to 13.9 per cent and imports/GDP ratio from 8.6 to 14.6 per cent. Likewise, in Bangladesh, exports rose from 6.1 per cent of the GDP in 1990 to 14 per cent in 2000 while imports rose from 13.5 per cent to 19.2 per cent over the same period. Thus, the shift in the growth rate has clearly happened in a more open trading environment.

There are at least two reasons why the GDP growth actually understates the actual gains from liberalisation. First, in so far as opening to trade better aligns the domestic prices with the world prices, the measurement of the GDP at domestic prices understates the true value of output that must be measured at the world prices. This is readily seen from Figure 7.1. Thus, suppose AB in Figure 7.1 gives the economy's initial production possibilities frontier and Good X is the import competing good. Though the slope of pp represents the world price, protection to Good X establishes the price shown by qq in the domestic market. Production takes place at M, and the GDP is given by line qq. Suppose next that the economy frees up trade fully and simultaneously the production possibilities frontier shifts to A′B′. Because producers now face the world price shown by p′p′, production moves to M′. But if we continue to measure the GDP at the old protection-ridden domestic price, qq, GDP would be given by line q′q′. When growth is computed as the proportionate change between qq and q′q′, it will turn out to be less than when measured as the proportionate change between pp and p′p′. From the welfare standpoint, the latter rather than the former measures growth accurately.

The second reason why GDP even if measured at post-liberalisation prices would understate growth is the appearance of many new and higher-quality products not previously available. To a consumer in India, these benefits of liberalisation are obvious today. Many of the top quality computers, electronic equipment, cell phones, automobiles, clothing, and even fruits available today would not have existed under a protected regime. Even when the finally assembly of these products is done at home, it is safe to say that the components used to produce them would not be available in

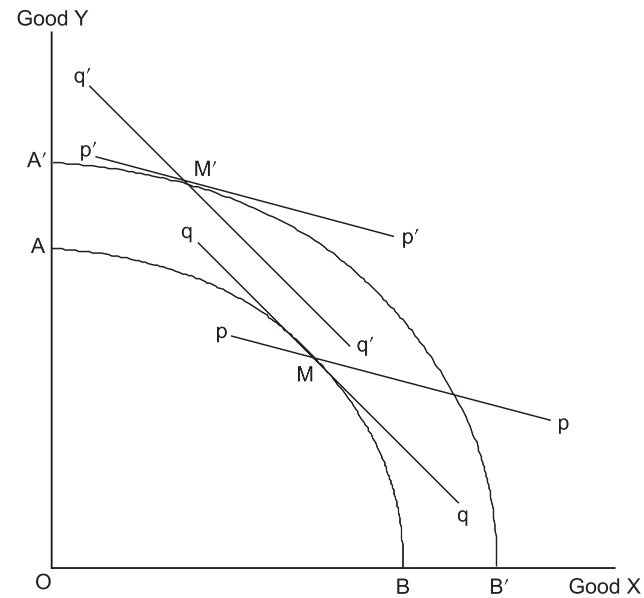


**Figure 7.1: Measuring GDP at Pre-liberalisation Domestic Prices Understates Growth**

the absence of relatively free trade. While economists have increasingly recognised the gains from trade liberalisation along the new variety and quality dimension, traditional GDP figures still fail to capture them.

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

## Preferential Trading in South Asia: A Brief Historical Background

During the first three years of their independence, intraregional trade among India, Pakistan, and Sri Lanka as a percentage of their total trade was in the double digits (World Bank, 2004). In part, this large proportion reflected the relatively protectionist trade regime in developed countries that had come to exist in the 1930s and 1940s. But it also reflected low barriers to trade within the subcontinent. In the subsequent years, while the developed countries opened their markets, and thus opening the door to trade between them and other countries including those in South Asia wider, those other countries themselves turned inward. Import-substituting industrialisation, with massive public-sector participation in the production activity and tight control of the private sector, became the cornerstone of the development strategy pursued in the region.

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

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

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

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

But the worldwide proliferation of preferential trade arrangements in the 1990s has now led to a change in thinking in the region, especially India, which has begun to negotiate a series of preferential trade agreements of its own. Within the region this has recently led to the signing of SAFTA with the ultimate objective of turning South Asia into a full-fledged FTA with the internal liberalisation beginning in 2006. This agreement has come in the wake of a bilateral FTA agreement between India and Sri Lanka in 1998 that became operational on 1 March 2000. In addition, India has also had prior trade agreements involving an FTA with Bhutan and substantial one-way preference to Nepal.

## SAFTA: A Critical Examination

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

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

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

Nevertheless, since intraregional trade remains a key target of PTAs, we will briefly describe its evolution without any suggestion that its existing level has a bearing on the likelihood of either trade creation or trade diversion dominating upon the formation of the union. Figure 7.2 taken from World Bank (2004), shows the evolution of the total intra-regional trade in South Asia since the end of the British rule in the region. Until 1951, this trade as a percentage of the region's total trade was in the double digits.

As noted previously, this pattern reflected two facts: The world markets were relatively closed and South Asia was relatively open. In the years that followed, the two trade regimes exchanged places: The world markets opened up while South Asian borders became progressively closed. Moreover, in the case of India and Pakistan, political tensions virtually closed official international trade between them. By 1967, intra-regional trade had already fallen to just 2 per cent of the region's total trade. It recovered briefly in the early 1970s, but declined steadily thereafter until 1990 when it fell back to the 1967 level of 2 per cent of total trade. The share began to recover again only when the region, especially India, began to open its trade regime in the 1990s, reaching 4.2 per cent in 1999.

Tables 7.3 and 7.4 show country-level data on the direction of exports and imports, respectively. The pattern at the country level essentially mirrors that at the aggregate level. On the exports side, the countries trade mainly with developed countries and relatively little with South Asian partners. For India and Pakistan, this fact also holds true on the imports side. But Bangladesh and Sri Lanka import as much as 20 and 15

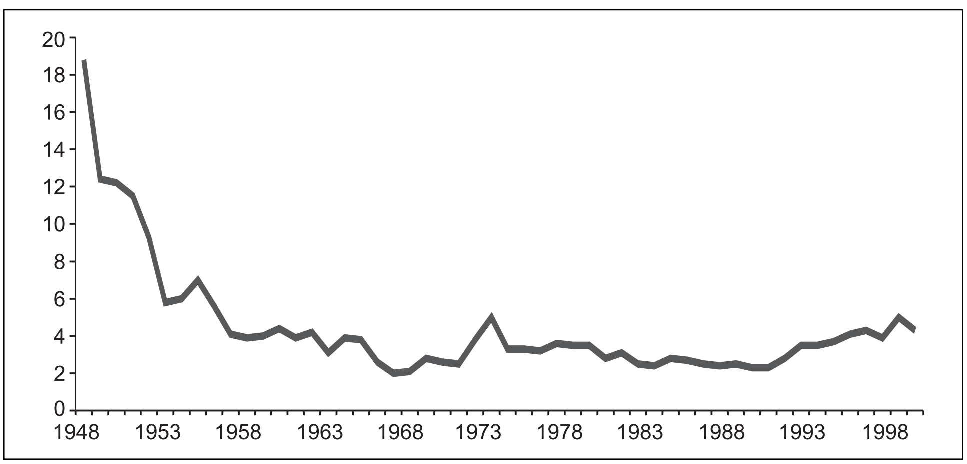


**Figure 7.2: South Asia's Intra-regional Trade as a Share of Total Trade, 1948–99**

*Source*: World Bank, 2004.

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

**Table 7.3: Direction of Exports by Major Destinations (Per Cent)**

| *Country* | *United States* | | *European Union* | | *Japan* | | *ASEAN* | | *South Asia* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *1990* | *2002* | *1990* | *2002* | *1990* | *2002* | *1990* | *2002* | *1990* | *2002* |
| India | 15 | 21 | 21 | 22 | 9 | 4 | 3 | 5 | 3 | 5 |
| Pakistan | 12 | 25 | 36 | 27 | 8 | 1 | 3 | 2 | 4 | 2 |
| Bangladesh | 32 | 35 | 32 | 50 | 4 | 2 | 1 | 0 | 2 | 2 |
| Sri Lanka | 26 | 38 | 26 | 30 | 5 | 3 | 1 | 1 | 4 | 5 |

*Source*: COMTRADE via Wits.
*Note*: ASEAN, Association of Southeast Asian Nations.

**Table 7.4: Direction of Imports by Major Origins (Per Cent)**

| *Country* | *United States* | | *European Union* | | *Japan* | | *ASEAN* | | *South Asia* | |
|---|---|---|---|---|---|---|---|---|---|---|
| | *1990* | *2002* | *1990* | *2002* | *1990* | *2002* | *1990* | *2002* | *1990* | *2002* |
| India | 11 | 7 | 22 | 20 | 8 | 3 | 3 | 5 | 0 | 1 |
| Pakistan | 13 | 6 | 24 | 17 | 12 | 6 | 5 | 9 | 2 | 2 |
| Bangladesh | 6 | 4 | 16 | 11 | 9 | 7 | 7 | 7 | 9 | 20 |
| Sri Lanka | 8 | 4 | 16 | 15 | 12 | 6 | 9 | 8 | 7 | 15 |

*Source*: COMTRADE via Wits.
*Note*: ASEAN, Association of South-East Asian Nations.

Against this background, we see three important features of the South Asian economies that make an FTA among them economically unattractive.[3] The economies are relatively small in relation to the world both in terms of the GDP and trade flows. Table 7.5 shows the population, GDP, and the volume of trade in the SAARC-5 (Bangladesh, India, Nepal, Pakistan, and Sri Lanka) in the year 2001. In terms of population, the region is substantial: one-fifth of the world. This clearly indicates the future potential of the market if per capita incomes reach the levels prevailing currently in the Association of South-East Asian Nations (ASEAN) economies. But the current per capita incomes are tiny in relation to the latter so that the economic size of the region remains small: less than one-twentieth of the world in terms of the GDP. And if we take India out of the picture, this proportion drops to 0.4 per cent. The probability that the most efficient suppliers of the member countries are within the region is slim. Correspondingly, the probability that the FTA is likely to be largely trade diverting is quite high.

Trade-related indicators reinforce this conclusion. Thus, the last column of Table 7.5 shows the share of SAARC countries in the world trade (exports plus imports). Together, the countries in the region account for only 1.1 per cent of the world trade. Again, if India is excluded, the proportion drops to 0.4 per cent. The scope for trade diversion due to tariff preferences is indeed very large.

**Table 7.5: Population, GDP, and Trade in SAARC-5 (2001)**

| *Country* | *Population (Million)* | *GDP (US$ Billion)* | *Trade (US$ Billion)* |
|---|---|---|---|
| Bangladesh | 133.30 | 48.60 | 15.60 |
| India | 1,032.40 | 477.40 | 93.10 |
| Nepal | 23.60 | 5.80 | 2.30 |
| Pakistan | 141.50 | 60.00 | 20.30 |
| Sri Lanka | 18.70 | 16.40 | 11.10 |
| SAARC-5 | 1349.50 | 608.30 | 142.30 |
| World | 6,130.10 | 31,400.00 | 12,560.00 |
| *As Per Cent of the World* | | | |
| Bangladesh | 2.2 | 0.2 | 0.1 |
| India | 16.8 | 1.5 | 0.7 |
| Nepal | 0.4 | 0 | 0.0 |
| Pakistan | 2.3 | 0.2 | 0.2 |
| Sri Lanka | 0.3 | 0.1 | 0.1 |
| SAARC-5 | 22.0 | 1.9 | 1.1 |
| World | 100.0 | 100.0 | 100.0 |

*Source*: World Bank, 2003.

The second reason for why prima facie the economic case for SAFTA is weak relates to the relatively high level of protection among the SAARC economies. If the country participating in a regional arrangement were itself open, it would not suffer from trade diversion even if it were tiny. For example, Singapore does not have to fear trade diversion in its own market since its union partners must compete with the outside union countries on equal footing: Everyone faces near zero tariffs in Singapore. In an India-Singapore FTA, it is India that must suffer all the negative consequences of trade diversion. Against this background it is useful to consider the existing trade barriers in the SAARC countries. This is done in Table 7.6. It is evident that the level of protection within the SAARC region remains high in all countries except, arguably, Sri Lanka. The simple average of the applied duties in non-agricultural goods ranges from 10 per cent in Sri Lanka to 21 per cent in Bangladesh. In India, this tariff is approximately 20 per cent. In agriculture, the level of protection is even higher and ranges from 25 per cent in Pakistan to 100 per cent in India.

The third and final reason that makes the economic case for SAFTA weak concerns the political economy of the selection of excluded sectors and rules of origin. When countries are allowed to choose sectors that can be excluded from tariff preference

**Table 7.6: Informal Trade between India and its SAARC Partners**

| *Trading Partner (Year of Estimate)* | *Indian Informal Exports ($US Million)* | *Indian Informal Imports ($US Million)* |
|---|---|---|
| Pakistan (1996) | 100–500 | n.a. |
| Bangladesh (1992–3) | 299 | 14 |
| Sri Lanka (1991) | 142 | 121 |
| Sri Lanka (2000–1) | 185 | 21 |

*Sources*: Pakistan: Nabi et al. (1996) provides two estimates: the 'low' estimate (based on visits to various markets for smuggled goods) suggests Indian informal exports to Pakistan were US$100 million and the 'high' estimate (based on interviews with customs officials) estimates about US$500 million. Bangladesh: Chaudhary (1995), based on a detailed survey of Bangladesh-India informal trade. Sri Lanka: Sarvanathan (1994) gives the estimates for the year 1991, and Taneja (2002) gives the one for 2000-1.

of free trade, domestic lobbies make sure that the sectors in which they may not withstand competition from the union partner are the ones that get excluded.

On the other hand, lobbies go along with free trade in the sectors in which they are competitive and the preference will threaten the imports from outside countries. In the same vein, lobbies tend to go for tight rules of origin or outright quantitative restrictions in precisely those sectors in which they fear the competition from the partner most. On the other hand, when the threat is mainly to the imports from outside countries, they are willing to accept greater liberalisation.

The rules of origin can also be subject to abuse by the bureaucrat administering them. In cases where imports from the partner may be threatening an inefficient domestic competitor, bureaucratic discretion may be employed to block entry of the imports.

A common argument advanced in favour of SAFTA is that there is a substantial informal trade among the countries of the region (Table 7.6) and that this trade involves large real costs. For example, the bulk of India-Pakistan trade is routed through Dubai, which is costly. An FTA may help eliminate these costs. There are three issues relating to this argument that must be examined critically. First, insofar as the illegal trade between India and Pakistan is concerned, it is important to find out what part of it is due to the restrictions that preclude trade at the MFN terms and what part tries to evade even the MFN tariff.

Second, is it possible that informal trade is largely driven by considerations other than the evasion of tariffs? Taneja et al. (2003) studies the transacting environments in the formal and informal trading between India and Sri Lanka. They find that the transaction cost in formal trading in India as well as in Sri Lanka is significantly higher than in informal trading.[4] Thus, the presence of informal trade may simply reflect excessive transactions cost of passing the goods across the border through formal channels. An FTA will likely add to this cost, especially for small and medium firms, by adding the costs of complying with the rules of origin. Therefore, paradoxically, the FTA might divert trade from the low- to high-transactions cost channel. Finally, even if the real costs associated with informal trade are higher (contrary to what the Taneja et al. study shows), benefits from such cost savings through the FTA must be weighed against the costs of trade diversion.

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

In the context of SAFTA, this last argument has its limitations. For example, one may argue whether SAFTA is itself feasible in the absence of political harmony between India and Pakistan. The case of France and Germany involved a victorious power and a vanquished one and the military presence of an outside superpower that made compliance feasible. The circumstances facing India and Pakistan are altogether different. With an ongoing conflict and closed borders, they effectively deny MFN status to each other.

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

## Sri Lanka-India FTA: Sectoral Exceptions and Rules of Origin

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

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

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

Similar observations apply to preferences given by Sri Lanka to India. As Weerakoon (2001) points out in her excellent paper, at the time the lists of concessions were finalised, of the 319 items on which Sri Lanka offered zero duty to India, the latter exported only three to the former. Looked another way, of the 2,907 products exported by India to Sri Lanka, only 21 per cent received any tariff preference at all. Conversely, of the 1,351 items in the zero-tariff list of India, Sri Lanka exported only 68 items to the former. Of the 380 items exported by Sri Lanka to India, 50 were on the Indian negative list, 44 received a 25 per cent tariff preference, 218 received a 90 per cent preference (expanded to 100 per cent as of 1 March 2003), and 68 received a 100 per cent preference.

## The Way Forward: An Asian Bloc via India-China FTA

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

But insofar as the promotion of PTAs is concerned, as the largest country in the region, India needs to think big and focus its efforts on forging an India-China FTA with the eventual goal of creating an Asia-wide FTA. In 1994, we wrote arguing against an East Asian discriminatory trade bloc (Panagariya, 1994). But the circumstances have changed considerably since then requiring re-evaluation.

In particular, since the conclusion of the North American Free Trade Association, PTAs have proliferated in North America, Latin America, and Asia. Whereas as of 1990, only 32 such agreements notified to the General Agreement on Tariffs and Trade (GATT) were still in force, they had gone up to 170 by 1 January 2005.[6] There is no member of the WTO that does not belong to at least one PTA today and some belong to as many as 20![7] More than 70 agreements are being negotiated or signed that have not yet been notified to the WTO.

This proliferation of trade blocs has created very substantial discrimination against Asian exports in North America, Europe, and Latin America. Of course, it will be best if the Doha Round would bring about free trade in industrial products and substantial liberalisation in agriculture and services. In that case, discrimination faced by Asian goods in these markets will end at the source since preferences against zero tariffs are also zero. But the ground reality is that the Doha Round will not eliminate trade barriers entirely even in industrial products let alone agriculture and services. Therefore, the current discrimination is likely to persist.

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

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

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

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

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

The second reason why this fear is misplaced is that India's own experience during the 1990s and the 2000s demonstrates that Indian entrepreneurs are perfectly capable of competing with the best in the world. From a regime with strict import licensing and more than 100 per cent average tariff rate in 1991, India has moved to a regime with free imports with the highest tariff of 15 per cent (with some exceptions) on industrial products. This transition has not slowed down industrial growth in India. On the contrary, Indian industry today is perhaps much more efficient than 20 years ago. Though more progress is required, its specialisation is also closer to its comparative advantage than 20 years ago.

These arguments are reinforced by the fact that India-China trade has been one of the most rapidly growing bilateral trade relationships since the early 1990s. And while the bilateral balance remains in favour of China, rapid growth has taken place in both directions with concomitant benefits to both countries. According to the Indian Commerce Ministry data, India's exports to China rose from a paltry US$18 million in 1990-1 to approximately US$4.6 billion in 2004-5. India's imports from China expanded equally rapidly, from US$35 million to US$6.7 billion over the same period. While China is now the largest source of India's imports, it is also the second largest destination of its exports (not counting the United Arab Emirates, which is only a way station for Indian exports).

## Conclusions

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

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

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

Insofar as preferential trading is concerned, its goal should be an Asia-wide trade bloc for which the best starting point is an India-China FTA. These are growing economies and together reasonably large. Because of the highly competitive nature of China's firms in many products on the worldwide scale, risks of trade diversion for India are much lower than in SAFTA. An India-China FTA also offers the best prospects for forging the Asia-wide FTA eventually.

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

## Notes

1. During 1988–90, India grew 7.4 per cent, which is the reason why the average growth rate during 1981–90 appears as high as during 1991–2004. Once we separate 1988–90 from the remaining years in the 1980s, the two periods are no longer comparable. Growth during 1988–2004 was distinctly higher than during 1981–7.
2. Earlier accounts of trade policies for the major countries of the region can be found in Panagariya (1999) and for India in Panagariya (2004).
3. Some of these concerns are discussed in greater detail with the associated analytics in Panagariya (2003).
4. This is analogous to the international financial transactions. Despite the adoption of the current-account convertibility by India, many traders continue to prefer moving funds through Hawala because of the lower transactions costs and its substantially more rapid transmission mechanism.
5. This argument, while quite fashionable, is not without flaws. For one thing, it was the military presence of the United States in both Germany and Japan that ensured peace in the respective regions. If the PTA was such a potent force, why is it that the US military presence continued in Germany? Indeed, no FTA or customs union was formed in the Far East and yet a lasting peace could be established there because the US military was present in Japan. Moreover, even without any regional arrangement, the Far Eastern economies have come to be as integrated economically as those in Europe.
6. The total number of agreements notified to the GATT and WTO as of 1 January 2005, was 312. But only 170 of them were still in force with the rest having either lapsed or been superseded by new agreements. Of the 124 agreements notified to the GATT during 1948–94 before it was replaced by the WTO on 1 January 1995, only 32 are in force currently. See Crawford and Fiorentino (2005) for further details.
7. See http://www.wto.org/english/tratop_e/region_e/regfac_e.htm.

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