



DEEPENING REGIONAL ECONOMIC INTEGRATION IN SOUTH ASIA : POTENTIAL AND PROSPECTS

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The ratification and phased implementation of the SAFTA by the SAARC countries since 2006 is an important landmark in evolution of SAARC as a regional economic grouping. SAFTA is the initial but important step in the journey of SAARC towards formation of the South Asian Economic Union (SAEU) that was set as the goal of the grouping by its leaders at the Kathmandu Summit in January 2002. SAFTA has the potential of expediting the growth of the member countries in a balanced and equitable manner. However, SAFTA faces considerable challenges for exploiting its full potential. Realization of the cherished objective of forming a SAEU will also require a number of steps beyond effective implementation of SAFTA.

REGIONAL ECONOMIC INTEGRATION IN SOUTH ASIA

Although the regional economic integration in South Asia is at an early stage, there are indications for a substantial potential for it to serve as an engine of growth and balanced regional development. Generally the proportion of intra-regional trade is used to find out the extent of synergies or complementarities between the countries of the region. The low level of intra-regional trade in South Asia is often construed as indicating a limited potential for regional economic integration or of lack of complementarities. The proportion of intra-SAARC trade in global trade of SAARC countries was very low at about 5 per cent in 2006 even though it has gone up from 3.12 per cent in 1986 and 4.5 per cent in 1996. This low proportion, however, is not a true indicator of the potential of mutual trade or the complementarities. Firstly, formal or recorded trade is only a part of the total intra-regional trade with rampant informal trade taking place in the region or trade through third countries such as Dubai or Singapore to obviate trade restrictions. Studies suggest that the informal trade could be upto twice as large as the formal trade in South Asia. If informal trade is taken into account, the proportion of intra-regional trade would appear more respectable. Secondly, the importance of SAARC as a market is very high for smaller countries such as Afghanistan (44 per cent), Bhutan, and Nepal (60 per cent) but is also significant for Pakistan (13 per cent) and Sri Lanka (11 per cent), registering considerable rise in 2006. Thirdly, intra-SAARC trade has started to grow fast with the growing dynamism of the region's economies. Between 2003 and 2006, the intra-SAARC trade nearly doubled from US\$ 5.4 billion to \$ 10.3 billion growing at an average rate of nearly 23 per cent per annum.

Another limitation of the intra-SAARC trade is the persisting trade surpluses that the largest economy of the region, that is, India has with the trade partners in the region. While trade liberalization and trade facilitation are important for enhancing mutual trade, the problem seems to be compounded by the lack of supply capacities in smaller and lesser developed economies in the region in the products of import interest of India. An analysis conducted at RIS identifying the potential of trade creation (due to price competitiveness) and trade diversion (through trade preferences offered by India or SAFTA liberalization), A substantial potential of exports to India in view of India's growing import requirements from global sources. However, only a small fraction

of that is realizable in view of supply constraints in the South Asian countries. For instance, with the duty-free access to India's market, Bangladesh can be a potentially competitive supplier for nearly US\$ 6 billion worth of India's imports. However, the existing supply capabilities will permit only \$ 30 million worth of additional exports by Bangladesh to India, even with a completely duty free access to Indian market. A similar pattern holds good for all other SAARC countries, that is, sizeable potential in view of India's large import requirements, but limited scope of realization due to lack of supply capability.

The basic thrust of the findings of UNCTAD-ADB study are corroborated by other evidence at the bilateral level that has become available. For instance, another general equilibrium analysis based recent study has shown that trade liberalization between India-Bangladesh 'could provide ample opportunities for Bangladesh to expand its trade with India and to slow down the growing trade imbalance' and 'that a great deal of benefits to Bangladesh will come from improved performance in highly labour-intensive manufacturing sectors' and 'it can assist poverty alleviation'. The recent evidence has therefore corroborated that least developed countries like Bangladesh have a significant potential to benefit from regional trade liberalization.

A recent study conducted by the State Bank of Pakistan that estimates bilateral trade volume crossing US\$ 5.2 billion with the liberalization of bilateral trade. The study finds that 32 per cent of Pakistan's export products are currently bought by India from other countries and constitute one-third of India's total imports. The report notes that about 1,181 items worth \$ 3.9 billion, covering 45 per cent of the total items exported by Pakistan, were at par with India's imports during 2004. It indicates that about 70.3 per cent of the common items exported from Pakistan have unit values less than or equal to Indian imports' unit values, and there is a large scope for the export of those items simply by producing the quality required by India. The study also finds that India currently earns \$ 15 billion in export revenue from 2,646 items being imported by Pakistan from other countries and notes that in 2004 the unit value for Pakistan's imports was higher than the unit value of Indian exports for 48.7 per cent of these items. Forty five per cent of those common imports were not included in the Pakistan's positive list and hence their import from India was not allowed. Pakistan was losing \$ 400 million to \$ 900 million by importing those items from alternative sources. This corroborates a number of previous studies that had found the opportunity cost of overlooking intra-regional sources for South Asian requirements.

The findings of the quantitative studies are corroborated by the emerging patterns of trade and investments resulting from experiences of bilateral trade liberalization such as the India-Sri Lanka FTA that can be taken as an early experiment towards regional economic integration. It is now documented that between the year 2000, when the FTA became effective and 2005-6, India's exports to Sri Lanka have recorded an average annual growth of 34.5 per cent while those of Sri Lanka to India grew an average rate of 132 per cent. Sri Lanka's imports to exports ratio fell from 10.3:1 to 3.3:1. The number of Sri Lankan export items increased from 505 to 1,062 with a visible shift from low-value-added agricultural products to high-value-added manufacturing goods including value-added tea, sausages, biscuits, chocolates, ceramics, furniture, metal products, footwear, wooden toys, herbal products, machinery and mechanical appliances, memory chips, etc. India has emerged as the 3rd largest export destination since 2003 compared to 16th largest in 2000. As many as 74 per cent of Sri Lanka's exports have been undertaken within the framework of FTA preferences.⁸ Therefore, the FTA has helped in a more equitable and balanced growth of bilateral trade. Although there are anomalies, this has happened largely due to the fact that the India-Sri Lanka FTA has facilitated Indian

investments in Sri Lanka and has also strengthened the country's supply capabilities. As a result, India has emerged as the fourth largest source of investments in Sri Lanka during 2004-5, next to the US, UK, and Singapore. Encouraged by the performance of the FTA, the two countries are now seeking to expand the scope of the FTA to cover trade in services and investments under a comprehensive economic partnership agreement (CEPA).

Similar effects, that is, market access offers assisting equitable expansion of trade through spurring investments resulting from bilateral trade liberalization have been observed in the case of Nepal. The India-Nepal Trade and Transit Treaty giving to Nepal non-reciprocal duty-free access to Indian market has helped expand the bilateral trade and has enabled Nepal to diversify its trade in terms of commodities and markets. It has spurred Indian investments in Nepal and some of the major non-conventional items exported by Nepal to India include packaged fruit juices, toothpaste and other toiletries, among other products that have been produced by Indian joint ventures in Nepal. With the restoration of peace in Nepal more such trade creating investments could take place in the country. Similarly, the prospect of trade liberalization under SAFTA seems to have encouraged Indian companies to explore the potential of Bangladesh for investment. Among the recently proposed investments has been a US\$ 3 billion investment proposal by the Tata group of India in integrated power, fertilizer, and steel manufacturing plants, that is awaiting approval. Projects like this could assist in addressing the trade imbalances by creating export supply capabilities in Bangladesh.

Regional economic cooperation and integration's potential for expediting the growth process in a balanced manner is complemented by its potential for strengthening the region's competitiveness in specific sectors. In particular, the South Asian countries face an enormous challenge of sustaining their competitive advantage in textiles and clothing industry, the major source of export earnings and job creation in most of the region in the post-MFA scenario especially after the phase out of safeguards on Chinese exports expiring by the end of 2008. As argued in greater cooperation and specialization between South Asian countries could assist in strengthening their competitive position in the global industry.

South Asian Free Trade Agreement (SAFTA): Enhancing its Effectiveness

South Asian countries had initially signed the SAPTA in 1993 to liberalize intra-regional trade. However, the process of trade liberalization under SAPTA was slow being based on positive lists negotiated in the rounds and margin of preferences shallow. Hence, the arrangement had a rather limited, even though positive effect.¹¹ Eventually SAARC countries agreed to sign the SAFTA at the Islamabad Summit in 2004. With the ratification by all the signatories, the Agreement came into force on 1 January 2006.

SAFTA Treaty provides for a tariff liberalization programme spread over 2006-16, with different time frames for least developed countries (LDCs) and other members subject to sensitive lists (or negative lists), rules of origin, dispute settlement mechanism, and institutional arrangements. As a part of special and differential treatment provisions in favour of LDCs, it provides for, besides a more generous time frame for implementation of commitments, technical assistance and a mechanism for compensation of revenue loss. As per the implementation schedule provided, the tariffs imposed by India and Pakistan for goods originating in the region (other than those in the sensitive list) should come down to 0-5 per cent by 2013, by 2014 in the case of Sri Lanka, and by 2016 in the case of Bangladesh, Bhutan, Maldives, and Nepal.

SAFTA is a step forward in the right direction for fostering regional economic integration.

However, a look at the text on SAFTA clearly suggests that it is a case of 'too little, too late'. This calls for urgent effort in considerably enhancing the pace of regional trade liberalization as well as expanding its scope. Against that background, following suggestions are made for making SAFTA really effective.

Expediting The Tariff Liberalisation Programme (TLP)

Although the TLP phased over 10 years is a time frame compatible with WTO rules, in the current context it appears too long and may render it irrelevant in view of ongoing liberalization in the context of competing FTAs as an autonomous liberalization. It needs to be expedited. In this context, it is worth-mentioning that ASEAN had expedited the schedule of implementation of AFTA from 2008 to 2012. A shorter time frame of 3-5 years to attain a free trade area is clearly feasible. One option for expediting the trade liberalization schedule is the offer of duty-free access by non-LDCs in favour of LDCs. This possibility is provided under Article 7(2) of the Agreement. In that context, India has already extended the duty free market access in favour of LDCs on a non-reciprocal basis. Other non-LDCs namely Pakistan and Sri Lanka may consider making a similar offer.

Expanding The Coverage Of Trade Liberalization

A major limitation of SAFTA is its narrow coverage. Different countries have kept a significant part of their imports out of the purview of the TLP by putting them on the sensitive or negative list. Apparently 22 per cent of Bangladesh's exports to SAARC countries are subject to sensitive lists. The proportions for other countries are, India: 58.5 per cent, Maldives: 57.6 per cent, Nepal: 46.4 per cent, Pakistan: 34 per cent, Sri Lanka: 47 per cent.¹² Furthermore, Pakistan's imports from India are still governed by a positive list as Pakistan has not provided Most Favoured Nation (MFN) to India. Therefore, there is urgent need for extending the coverage of the Agreement to substantially all trade in the region, as per the WTO requirement. SAFTA has a provision for review of the sensitive lists every four years and reduction of the number of products covered by them. Member countries should reduce their sensitive lists to allow the regional trade liberalization to take hold and enable SAFTA to achieve its potential.

Addressing The Non-tariff Barriers

The removal of non-tariff barriers merits urgent attention since these could become instruments for protection with the phasing out of tariff barriers thus nullifying the benefits of TLP. The Agreement only states that contracting parties have to notify the incidence of all non-tariff and para-tariff measures to the SAARC Secretariat. It further states that all Quantitative Restrictions need to be eliminated. However, no time frame for their removal has been set. In this context, a time frame of say, three years for their removal appears to be quite reasonable. The official Committee of Experts (CoE) set up under SAFTA has created a SAFTA Sub-Group on Non-Tariff Measures. In this context, unilateral actions by member-countries should be encouraged. India has already set up a task force for identifying and eliminating non-tariff barriers and para-tariff measures on intra-SAARC trade.

Effective Provisions for Dispute Settlement Mechanism (DSM)

The current DSM within the SAFTA agreement follows many international practices in terms of being time bound, beginning with joint consultations, offering appeal and recommending appropriate trade sanctions. However, there are certain clauses that vary from international best practices. For instance, the entire process of DSM under SAFTA can take up to 330 days, in comparison ASEAN DSM

can take up to 290 days, NAFTA 310, and MERCOSUR 265 days. Furthermore, the length of time allowed for compliance is 90 days in SAFTA, whereas in ASEAN, NAFTA, and MERCOSUR the time allowed is 30 days. Thus, there is a need for tightening the provisions.

Ensuring Trade Facilitation, Transit, And Transport Connectivity

Trade facilitation measures need to complement the removal of tariff and nontariff barriers to be effective. The SAFTA text cursorily refers to this aspect under heading Additional Measures. Simplification and harmonization of customs operation is an area that SAFTA needs to address on an urgent basis. An innovative way of trade facilitation could be to consider creating a SAARC Single Window, which would allow SAARC goods to pass through customs more rapidly. The other concerns transit facilitation as countries like Afghanistan, Pakistan, Bangladesh, India,

Nepal, and Bhutan all face transit requirements from one another. The third aspect of trade facilitation concerning standards harmonization could be an important step towards achieving a common market. The free movement of goods and services will not be possible if different countries have different standards on health, environment and safety rules among others. Along with common standards it is important to harmonize testing, import inspections, product certification, and systems certification. Finally, implementation of trade facilitation measures, often requires advanced infrastructure such as ICT.

Addressing Supply Capacities In Smaller And Lesser Developed South Asian countries

Trade liberalization and facilitation by themselves cannot enhance the intra-regional trade and bridge the trade imbalances that exist because of poor supply capacities in the SAARC LDCs, as observed earlier. The duty free access to India's market, offered by India to LDCs, is by itself likely to encourage industrial restructuring and prompt Indian enterprises to make investments in these countries and help in expanding supply capabilities for exporting back to India. As observed above, liberalization of bilateral trade under India-Sri Lanka FTA has already led to Indian investments in Sri Lanka in enhancing supply capabilities. In addition, a number of measures can be taken to promote intra-regional investments to strengthen supply capabilities in SAARC LDCs and other economies including the capital market integration and SAARC, investment facilitation, as proposed later.

Therefore, a much more serious constraint on the intra-regional trade is the lack of supply capability in the neighbouring countries for the goods that have markets in India, than the lack of market access.

The existing levels of intra-regional trade in South Asia are relatively low due to prevalence of substantial informal trade, lack of supply capacities among other problems. Given the low levels of intra-regional trade, a number of early studies had projected limited potential of regional economic integration in the region. However, some recent studies have found substantial potential of South Asian economic integration in generating welfare gains for all the countries in the region especially the smaller and lesser developed ones.

Using an augmented Gravity Model based framework, an RIS analysis found that nearly 74 per cent of the potential of intra-regional trade remained to be realized in 2006. The potential of intra-SAARC trade in 2006 was estimated to be nearly US\$ 40 billion compared to the existing formal trade of \$ 10.5 billion. Such a high extent of underutilization of the intra-regional trade potential can be explained in terms of a substantial proportion of informal trade, lack of supply capabilities as discussed earlier, and indeed the trade barriers and poor transport links and trade facilitation. Implementation of SAFTA can

hopefully assist in realizing this potential as well as that of further trade creation that regional trade liberalization is expected to create.

A further look at points to the fact that proportion of intra-SAARC trade potential remaining to be exploited varies across countries. In particular, over 90 per cent of India-Pakistan trade potential remains to be realized, although a part of that is conducted through informal and third-country channels. It also shows that full exploitation of intra-regional trade could also bring down trade imbalances. For instance, while nearly 84 per cent of potential of Bangladesh's exports to India remains to be realized, the figure for potential for India's exports to Bangladesh is lower at 70 per cent. In a few bilateral country pairs, the existing trade seems to have surpassed the potential as determined by the gravity factors, due to preferential trade regime or other exceptional circumstances, such as Pakistan's exports to Afghanistan. Hence, the realizable potential is negative.

The above findings have been corroborated by other recent studies undertaken in regional as well as bilateral frameworks. For instance, a recent UNCTAD-ADB study has found improving range of complementarity and intra-industry specialization among SAARC countries and the potential of intra-regional trade grossly underexploited. Using a general equilibrium analysis, it found the SAFTA to be having considerable potential for trade creation and expediting growth with much higher welfare effects for the LDCs. It also finds the potential of SAFTA in enhancing FDI inflows to the region including those that will enable vertical integration between them.

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