

Regional Trade Agreements in South Asia

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1. MAIN TRENDS AND CHARACTERISTICS OF REGIONAL TRADE AGREEMENTS

Regional Trade Agreements (RTAs) are a major and perhaps irreversible feature of today's multilateral trading system. The number of preferential arrangements as well as the world share of preferential trade has been steadily increasing over the last decade. The total number of the notified preferential arrangements in force upto 1 February 2005 was 170. About 20 RTAs are due to enter into force upon completion of their respective ratification procedures. A further 70 RTAs are under negotiation/proposal stage. Between January 2004 and February 2005 alone, 43 RTAs have been notified to the World Trade Organisation (WTO) making this the most prolific RTA period in recorded history of GATT/WTO. RTA activities have intensified across all world regions, particularly in the Western Hemisphere and Asia-Pacific.¹

This implies that if all the RTAs come to effect, there will be nearly twice as many RTAs as there are WTO members. The growing number of RTAs has resulted in a 'spaghetti bowl' of criss-crossing RTAs with overlapping membership and a complex myriad of trade rules.

Before the WTO come into operation in 1995, the world witnessed two waves of regionalism. Modern regionalism began with the signing of the Treaty of Rome in 1957 which established a common market of six

European countries: the Federal Republic of Germany, France, the Netherlands, Belgium, Italy and Luxembourg. This triggered an upsurge of regionalism all over the world, particularly in Africa and Latin America.

By the early 1970s, most of these regional groupings failed or survived on paper only except the EU, EFTA and ASEAN. The main reasons for their failure to meet external shocks were their excessively inward looking policies, inability to implement deeper integration measures, low level of infrastructure links and similar production structures. In many cases political and security objectives dominated the formation of most of the groupings.

A second wave of regionalism started sweeping the economies of the world from the end of the 1980s and the beginning of the 1990s. This saw the unprecedented deepening of the European integration in the form of a single market, the establishment of such mega groupings such as the North American Free Trade Area (NAFTA) and the Asia and Pacific Economic Cooperation (APEC) and the revival and deepening of the existing regional integration schemes in new forms, with a new agenda and sometimes under new names such like the MERCOSUR (South American Common Market), ASEAN free trade area (AFTA), East Asian Economic Caucus (EAEC), African Economic Community (AEC), etc.

The second wave of integration differed markedly from the first wave in several respects. During the second wave we notice the

¹ Crawford and Roberto V. Florentino, in 'The Changing Landscape of Regional Trade Agreements', WTO: Discussion Paper No.8,2005: 1

Countries participating in RTAs seek to secure access to large markets. Access to large markets permits opportunities to even smaller countries to attract more domestic and foreign investment. A regional agreement can also help with region-specific issues such as environment, border controls, transit, migration or movement of labour or development of trans-boundary infrastructure.

participation of the United States, a country that was earlier the staunchest advocate of multilateralism. Secondly, this phase coincided with globalisation that supported multilateral trade liberalisation as well. Thirdly, these groupings brought together both developed and developing countries as well as economies in transition transcending geographical continuity (eg. Asia Pacific Economic Community). Fourthly, these groupings are multi-dimensional providing not only for trade preferences, but also co-operation in security, as well as in the social and cultural fields. Finally, almost all of them involve a process of deeper integration incorporating liberalisation in services, movement of capital, evolving or harmonising common standards and competition policies and protection of intellectual property rights.² Some of these policies are WTO-plus, implying that they even go beyond the baseline requirements set under WTO.

The recent upsurge of Bilateral Free Trade Agreements (BFTAs) manifests the third wave of RTAs.³ For example, Singapore has signed Free Trade Agreements (FTAs) with New Zealand, Japan, Australia, the US, EFTA and Jordan. Thailand has signed or is contemplating FTAs with the US, New Zealand, Australia, China and Japan.

Trade between RTA partners today makes up nearly 40 percent of the total global trade. The value of preferences has however, steadily fallen as most countries have been reducing tariffs across the border to all partners on a MFN basis at the same time as they have been eliminating barriers preferentially through RTAs.⁴

The increasing numbers of RTAs that include large industrial countries as well take the shape of a 'hub-and-spoke' structure in world trade. In a hub-and-spoke system, the

largest countries sign bilateral agreements with many small countries. Such a system could marginalise the spokes where market access conditions are much less advantageous than in the hub, which offers improved access to all of the spokes.⁵

Thus, RTAs are being embraced by most WTO members as trade policy instruments where economic considerations are only one facet of the complex RTA strategies being pursued by WTO Members which often include broader foreign policy aims such as political and security considerations.⁶ Besides, the sluggish progress in multilateral trade negotiations under the Doha Development Round, appears to have accelerated further the urge to forge RTAs. The emergence of NAFTA is an illustration of this. The US in particular, felt that should the Uruguay Round fail, an alternative would be in place to go ahead with regional trade liberalisation. Further, the steps initiated under NAFTA could be used as a bargaining instrument to urge similar advances in liberalisation at the multilateral level. Under RTA with limited Members, decisions can be taken faster in contrast to the multilateral process under WTO in which decision-making has to be arrived at by consensus among a large group of heterogeneous members.⁷

Countries participating in RTAs seek to secure access to large markets. Access to large markets permits opportunities to even smaller countries to attract more domestic and foreign investment. A regional agreement can also help with region-specific issues such as environment, border controls, transit, migration or movement of labour or development of trans-boundary infrastructure. Some RTAs have also included dispute resolution mechanisms.

² Muchkund Dubey, *New Regionalism and Countries of the South*, (Mimeo, 2001: 9-10).

³ Saman Kelegama: 'WTO and Regional Trade Arrangements' in Bibek Debroy and Mohammed Saqib (Eds), *WTO at Ten* (Delhi: Konarak Publishers 2005), 148.

⁴ World Bank, *Global Economic Prospects-Trade, Regionalism and Development*, Washington, 2005, 41.

⁵ *Ibid.* 40.

⁶ Jo Am Crawford, *Above*, n 1:1

⁷ This advantage however is offset to some extent by the capacity to administer a complex web of non-uniform rules of origin.

A regional agreement can reinforce internal regulatory or structural reforms through external treaty obligations and visible political commitments. Locking such reforms clearly motivated agreements between the EU and countries in Central and Eastern Europe.⁸

2. LEGAL BASIS

At the heart of GATT was the principle of non-discrimination, characterised by the Most Favoured Nations (MFN) clause embodied in Article 1. The MFN clause was regarded as the central organising rule of the GATT. It required that the best tariff and non-tariff conditions extended to any contracting party of the GATT had to be automatically extended to every other contracting party. As the Sutherland Report points out, nearly five decades after the founding of GATT, MFN is no longer the rule, it is almost the exception. However for both practical and theoretical reasons, GATT provided for a number of departures from the MFN clause.

The practical reason for permitting free trade areas or customs unions was that many countries would not have joined GATT if it totally prohibited RTAs with neighbours or between countries having a special relationship historically. At the theoretical level, genuine FTAs or customs unions were viewed as compatible with the principle of non-discrimination when the move was in the direction of freeing trade among members rather than raising fresh barriers with non-members. Special provisions were therefore made in Article XXIV to induce the trade creating effects of integration schemes and to minimise their trade diverting effect.⁹

Deviations from Article 1 of GATT and Article II of GATS from MFN principle are permitted under three sets of rules. Para 4-10

of Article XXIV of GATT (as clarified in the understanding on the interpretation of Article XXIV of the GATT 1994), provides for the formation of customs unions and free trade agreements.

Para 4 recognises that 'the purpose of a customs union or of a free trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories'. Article 5(a) specifies that with respect to customs union, or an interim agreement leading to the formation of customs unions, the duties and other regulations of commerce in respect of trade with non members such an union 'shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union or the adoption of such interim agreement.' Article 5(b) makes similar conditions with respect to free-trade areas or an interim agreement leading to a free-trade area. Article 5(c) further provides that any interim agreement 'shall include a plan and schedule for the formation of such a customs union or of such a free-trade within a reasonable length of time.'

An Understanding on the Interpretation of Article XXIV of GATT, 1994 further clarified the interpretation of Article 5(a) by specifying:

'the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union shall in respect of duties and charges be based on overall agreement of weighted average tariff rates and of customs duties collected based on the import statistics of a previous representative period to be supplied by the customs union, on a tariff line basis and in values and quantities broken down by WTO country of origin'.

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⁸ Augustin Carstens, 'Making Regional Economic Integration Work', The Quaid-i-Azam Memorial Lecture, presented at the 20th Annual General Meeting and Conference, Pakistan Society of Development Economists, 10-12 January 2005: 6.

⁹ Muchkund Dubey, Above n1, 3.

Departures from the MFN principle is also permitted in the so-called Enabling Clause as embodied in 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries. This decision by signatories to GATT allows derogations to the MFN (non-discrimination) treatment in favour of developing countries.

The Understanding further clarified the 'reasonable length of time' referred to in para 5(c) of Article XXIV 'should exceed 10 years only in exceptional cases' for which justification needed to be provided to the Council of Trade.

All notifications made under para 7(a) of Article XXIV shall be examined by a working party in the light of the relevant provisions of GATT 1994 and para 1 to this Understanding. The working party shall submit a report to the Council for Trade in Goods on its findings in this regard. The Council of Trade in Goods may make recommendations to Members, as it deems appropriate.

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Para 4 states that any differential or more favourable treatment provided under this clause would not be designed to raise barriers of any other contracting party or hinder the reduction tariffs on an MFN basis. It shall enable developed contracting States to respond positively to the developed financial and trade needs of developing countries.¹⁰

Under the General Agreement on Trade in Services (GATS), Article II provides for MFN treatment. Article V of GATS governs the conclusion of RTAs in the area of trade in services, for both developed and developing countries.

This Agreement shall not prevent any of its Members from being a party to or entering into an agreement on trade in services between or among the parties to such an agreement provided such agreement has substantial sectoral coverage and eliminates substantially all discrimination in the sectors liberalised. Besides, developing countries have been given flexibility in the extent to which they can liberalise in accordance with their levels of development. Further, such agreement is intended to facilitate trade among Members and not to raise barriers to Members outside the agreement.¹¹

3. RTAs IN SOUTH ASIA

BILATERAL ARRANGEMENTS

Agreement on Trade and Commerce between India and Bhutan

The Treaty of Friendship and Co-operation of 1949 governs the basic framework of bilateral relations between India and Bhutan. The India-Bhutan Trade Treaty was first signed in 1972; being renewed every ten years up to March 2005. The validity of the Treaty in its existing form has been extended till such time as the new agreement enters into force through exchange of letters dated 27-26 February

¹⁰ www.wto.org/regenb_e-rules/enabling/clus.htm (visited 5 May 2005).

¹¹ www.wto.org/regats_e-art/V.htm, See para 1(a), (b), (c), paras 3 & 4, (visited 5 May 2005).

2005 between the Ambassador of India and Minister of Foreign Affairs of Bhutan.

Article 1 of the Agreement provides for free trade and commerce between the two countries. However, Bhutan is permitted to impose non-tariff restrictions on Indian goods as may be required to protect Bhutanese industries (Article III). Further, each country may impose restrictions on imports to protect public morals, human, animal and plant life, etc. (Article VI).¹²

India-Nepal Bilateral Trade and Transit Treaties

Bilateral trade and trade-related activities between India and Nepal are generally governed by the treaties of trade transit and other agreements for co-operation to control unauthorised trade. Being land locked with India, such treaties are of enormous significance to Nepal's development.

Over time various amendments to these treaties were made, offering Nepal easier access to the Indian market. The most significant development in Indo-Nepalese trade relations was the incorporation of a new Part V in the Treaty of Transit and Trade with Nepal (1991) under Protocol to the Treaty of Trade on the basis of letters of exchange between HMG of Nepal and Government of India on 3 December 1996. Under this amendment, the Government of India was to provide access to the Indian market, free of customs duties and QRs for all articles manufactured in Nepal on the basis of Certificate of Origin to be issued by the agency designated by HMG of Nepal. It is important to note that no quantitative level of minimum raw material/labour content or value addition norm had been prescribed.

The total elimination of Rules of Origin requirement however, created problems for the Indian government with the dumping

of large quantities of third country imports including *vanaspatti ghee* (hydrogenated vegetable oil) and acrylic fibre in India by the Nepalese traders. Its severe impact on small and medium entrepreneurs in some states, particularly in north and eastern India, soon took a political turn.

The Treaty of Trade of 1996, scheduled to expire on 5 December, 2002, was renewed on 5 March 2002 for a period of five years. A Protocol to the Treaty of Trade (as modified on 2 March 2002) made some changes to Article V of the previous treaty by re-introducing Rules of Origin.

A qualifying criterion for availing duty free access was introduced on products not manufactured wholly from Nepalese and/or Indian materials. Such products would henceforth involve a manufacturing process that brings about a change in classification at the four-digit level of the harmonised coding system, different from those in which all third-country origin materials are classified. Those manufacturing activities that do not qualify as processing have been listed. Further, from 6 March 2003 onwards, the total value of materials, parts or produce originating from third countries were not to exceed 70 percent of the ex-factory price of the articles produced and the final process of manufacturing is to be performed within the territory of Nepal. The third important change is that four sensitive products—vegetable oils, acrylic yarn, copper products and zinc oxide have been subjected to zero duty tariff quotas, beyond which they will be subject to normal duties.¹³

It must be noted that Nepal offers India only preferential access to the Indian market. For products with import duty below 40 percent, India gets a 20 percent preference while for products above the 40 percent import duty, India gets a 10 percent preference.

¹² Agreement on Trade and Commerce Between the Government of the Republic of India and the Government of the Kingdom of Bhutan, February 2005.

¹³ Treaty of Trade Between the Government of India and His Majesty's Government of Nepal, 6 March 2002 and Protocol to the Treaty of Trade (as notified on 2 March 2002).

India–Sri Lanka Bilateral Free Trade Area and the Proposal for Comprehensive Economic Partnership Agreement

A Bilateral Free Trade Agreement was signed between the Prime Ministers of India and Sri Lanka in New Delhi on 28 December 1998 and has been in operation since March 2000.

The Agreement seeks to establish a Free Trade Area (FTA) through the elimination of tariffs in a phased manner as under:

(a) **India's Commitments:** India would reduce tariffs to zero on 1350 tariff lines immediately on implementation of the Agreement. For the rest, except 429 items included in the Negative List, across the board duty free access would be given over a period of three years from the date of implementation of the Agreement.

There is a tariff rate quota on tea for 15 million kgs. and on garments for eight million pieces. From 18 March 2003, India's commitment of duty reduction has been completed. The items in the Negative List of 429 tariff lines at the six digit level of Harmonised Code are from various sectors like rubber and rubber products, paper and paper boards, plastics and products thereof, coconuts, alcoholic beverages and textile items, etc.

(b) **Sri Lanka's Commitments:** Sri Lanka would give 100 percent duty concessions on 319 tariff lines on the date of operationalisation of the Agreement. In addition, it has given 50 percent tariff concessions on 839 tariff lines on the date of operationalisation of the Agreement, which has been deepened to 100 percent by 2003. For the remaining items, Sri Lanka would reduce tariffs to zero percent over a period of 8 years in three phases, i.e. by 35 percent, and 70 percent and 100 percent before the expiry of third, sixth and eighth year, respectively. Sri Lanka's Negative List comprises of 1180 tariff lines.

The preferential trade under the FTA is governed by the Rules of Origin which

specify three criteria namely: (i) the domestic value addition should be 35 percent (ii) inputs to undergo substantial transformation at the four digit level of customs harmonised code, and (iii) a list of operations like simple packing, cutting and assembly, etc. have been defined which would not qualify for duty free market access. If the other contracting party sources the raw material/inputs from one country, the value addition is reduced to 25 percent of the Free On Board (FOB) value of the product under export subject to the condition that the aggregate value addition in the territories of the contracting parties is not less than 35 percent of the FOB value of the product under export.

The lists for exchange of tariff concessions and procedures were finalised through Letters of Exchange between the Commerce Secretary, Government of India and the Treasury Secretary, Government of Sri Lanka on 2 February 2000. Subsequently, the Agreement was implemented after issuance of the Customs Notification by Sri Lanka on 15 February 2000 and by India on 1 March, 2000 and the related notifications issued in May 2000. The Tariff Rate Quota Mechanisms for the import of Tea and Garments were finalised in April 2000 in New Delhi.¹⁴

c) **From FTA to Comprehensive Economic Partnership Agreement (CEPA):**

When the Prime Ministers of India and Sri Lanka met in New Delhi in June 2002, they took cognisance of the significant expansion of trade made possible by the ISLFTA. However, they also noted that there was much scope for expanding the areas of coverage of economic co-operation. Accordingly, a Joint Study Group (JSG) was set up to explore ways and means of deepening and widening economic cooperation through a Comprehensive Economic Partnership Agreement (CEPA). The JSG completed its study and had submitted its report to the two Prime Ministers in October 2003 at New Delhi.

¹⁴ <http://commerce.nic.in.rta.main.htm> # b5 (visited 15 May 2005).

BOX 1

Summary of Recommendations of the JSG

- Enter into a Comprehensive Economic Partnership Agreement.
- Build upon the ILFTA by deepening and widening the coverage of trade in goods.
- Enter into broad negotiations covering all service sectors and modes of supply under the GATS framework.
- Facilitate greater investment flows by addressing identified regulatory and operational constraints.
- Implement measures to enhance economic co-operation to complement trade and investment liberalisation.
- Complete negotiations on the CEPA within 4-6 months.
- Establish institutional mechanisms to monitor the progress of the CEPA so that the objectives are realised.
- Facilitate interaction between, and participation of, the private sectors of the two countries in the negotiations of the CEPA and its implementation.

The first meeting on CEPA at the Commerce Secretary level was held on 18 August 2004 in Colombo. In this meeting, both sides highlighted the importance of deepening and broadening the scope of ISLFTA to CEPA. It was primarily an exploratory discussion broadly covering the scope of CEPA as well as use of the JSG Report as a reference document for possible approaches and negotiations.¹⁵

MULTILATERAL/INTER-REGIONAL AGREEMENTS

Bangkok Agreement

The Bangkok Agreement is an initiative under the Economic and Social Commission for Asia and the Pacific (ESCAP) for trade expansion through exchange of tariff concessions among developing country members of the ESCAP

region. This agreement was signed on 31 July 1975. Seven countries namely, Bangladesh, India, Lao PDR, Republic of Korea, Sri Lanka, the Philippines and Thailand met at Bangkok and agreed to a list of products for mutual tariff reduction. However, this agreement was not ratified by Thailand and the Philippines due to their ASEAN commitments, which was also coming into force at that time. Lao PDR is not an effective participating member since it has not issued Customs Notification on the tariff concessions granted to other participating States. Papua New Guinea acceded to the Agreement in December 1993, but has not yet ratified it.

The developing countries and associate members of ESCAP are eligible to accede to the Agreement. The applicant country may accede to the Agreement if at least two-thirds of participating States recommend its accession. China's accession to the Agreement was approved by consensus by the Member countries at the Sixteenth Session of the Standing Committee of the Bangkok Agreement in April 2000 and subsequently, China deposited the Instrument of Accession to the Bangkok Agreement with the ESCAP Secretariat. With China's accession, the Agreement has acquired an altogether new importance, and provides an ideal platform for South Asian Member Countries (SAMCs) and China to engage with each other for a meaningful exchange of tariff concessions.¹⁶ Thus, this Agreement has remained operational among five countries, namely, Bangladesh, India, Republic of Korea, Sri Lanka and China.

To date, the Participating States have exchanged concessions on 4,279 products (apart from 609 that have been offered exclusively to LDCs) in the Second and Third Round of negotiations. The concessions offered for all countries nearly trebled from 1,721 products in the Second Round to 3,596 products in the Third, while those offered to least developed countries (LDCs) increased

¹⁵ <http://commerce.nic.in.rta.main.htm#b5>.

¹⁶ <http://commerce.nic.in.rta.main.htm#b14> (visited 22 May 2005).

five times from 112 to 519, respectively as may be seen in Table 1 below. Taking the two rounds together, China has offered the largest number of concessions (39.1 percent), followed by the Republic of Korea (30.3 percent), India (13.5 percent), Sri Lanka (12.2 percent), and Bangladesh (5 percent) on products for all countries. Thus, both India and Sri Lanka have offered concessions on almost the same number of products, which appear to be disproportionate in terms of their size. Comparing the growth in the number of products offered concessions in the two Rounds, it is clear that the Republic of Korea offered the largest increase (5.6 times).

The average Margin of Preference (MOP) after the Third Round was 26.8 percent for all countries and 58.8 percent for LDCs. The highest MOP was offered by the Republic of Korea for all countries (35.4 percent) while the highest MOP for LDCs was offered by China (77.9 percent).

The number of products offered concession in the two rounds has been on a product-by-product basis (Positive List Approach). Even though the number of products offered concessions have increased considerably, they constitute only a small portion of the total number of tariff lines of these countries. It will involve several rounds of negotiations to cover

‘substantially all trade’. Besides experiences with trade liberalisation has clearly demonstrated that it is not product coverage, but product value coverage that really demonstrates the extent of trade liberalisation. In the absence of this information, it would be difficult to ascertain the magnitude of trade liberalisation underlying the products conceded concessions. Furthermore, the existing MOPs need to be deepened substantially to make regional trade liberalisation meaningful.

Since the Bangkok Agreement was signed in 1975, it was felt that the text of the Agreement needed amendments, taking into account the economic developments that have taken place since then. The text was revisited and was slightly modified. It now has a Ministerial Council as the apex body which would decide policy issues relating to the Agreement. The text is required to be signed by the Ministers in their first meeting which is scheduled to be held in 2005. However, prior to this meeting, the Rules of Origin are required to be finalised for which purpose a meeting of the Standing Committee of the Agreement will be convened by the ESCAP Secretariat. At this meeting, the dates for notifying concessions agreed upon during the Third Round of Negotiations would also be finalised.¹⁷

TABLE 1
Number of Products Offered Tariff Concession by Participating States under Second and Third Rounds of Bangkok Agreement with Margin of Preference (Preliminary)

Concession Offering States	Second Round		Third Round		After Third Round	
	No. of Products	MOP (percent)	No. of Products	MOP (percent)	No. of Products ^a	MOP (percent)
Bangladesh	129	13.96	86	13.5	210	14.1
China ^a	902 (18)	15.4 (55.1)	769 (138)	40 (80.9)	1,671 (156)	26.7 (77.9)
India	188 (33)	52.6 (32.2)	396 (24)	10 (50)	577 (57)	23.9 (39.7)
Republic of Korea	214 (29)	30.3 (38.2)	1,204 (291)	36.4 (66.3)	1,298 (316)	35.4 (64.6)
Sri Lanka	288 (32)	17.8 (14.0)	239 (48)	9.2 (10.7)	523 (80)	14.0 (12.0)
Total	1,721 (112)	21.6 (32.2)	3,596 (519)	30.2 (62)	4,279 (609)	26.8 (58.8)

Source: ESCAP Secretariat.

Note: () relates to special concessions to LDCs. China already incorporated the Second Round concessions.

MOP: Margin of Preference estimated as simple average of all items.

The Rules of Origin under the Bangkok Agreement are based on a one-dimensional concept of value addition in which Non-LDCs are required to input at least 50 percent local material content while LDCs are required to input at least 40 percent material content.

¹⁷ <http://commerce.nic.in.rta.main.htm#b14> (visited 22 May 2005).

South Asian Preferential Trading Agreement (SAPTA) and South Asian Free Trade Agreement (SAFTA)

(a) South Asian Preferential Trading Agreement (SAPTA)

South Asian Association for Regional Co-operation (SAARC) consists of seven countries, namely, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. A regional trade block among these members was formed when SAARC Preferential Trading Arrangement (SAPTA) was signed in April, 1993 for giving preferential market access to the exports of the member countries in a limited way. Four rounds of negotiations have been completed and no further round is now contemplated following the signing of the Agreement on SAFTA.

Three rounds of SAPTA negotiations were held (see Table 2).

The operationalisation of SAPTA in December 1995 and the subsequent three rounds of negotiations entailing tariff liberalisation have been major developments in the regional trade liberalisation. A modest beginning was made in the First Round when 226 products were conceded at the HS 6-digit level. The number of products offered

TABLE 2
Customs Notifications Issued by SAARC Member States

Rounds	Issuing countries	Date of issue
First	All SAARC CS	7-12-1995
	Bangladesh	26- 02- 1997
	Bhutan	04- 02-1997
Second	India	01-03-1997
	Maldives	01-03-1997
	Nepal	31-03-97
	Pakistan	13-06-1997
	Sri Lanka	17-06-1997
Third	India	10-08-1999
	Other Contracting States	By 31-10-1999

Source: SAARC, Secretariat

concessions accelerated to 1868 and 3456 items during the Second and Third Rounds, making a total of 5550 items of which 3449 items were exclusively for LDCs, viz. Bangladesh, Bhutan, Maldives and Nepal. The largest number of concessions was offered by India, being 2927 products of which as many as 2450 products were in favour of LDCs. Bilaterally, the largest number of non-reciprocal concessions were offered in

TABLE 3
Number of Products on which Tariff Concessions has been extended by SAARC Member States in the Three Rounds of Trade Negotiations Under SAPTA

Countries	First Round			Second Round			Third Round			Grand Total
	For LDCs	For All	Total	For LDCs	For All	Total	For LDCs	For All	Total	
Bangladesh	1	11	12	11	215	226	143	338	481	719
Bhutan	7	4	11	10	37	47	101	23	124	182
India	62	44	106	514	390	904	1874	43	1917	2927
Maldives	0	17	17	3	2	5	0	368	368	390
Nepal	4	10	14	67	166	233	137	52	189	436
Pakistan	15	20	35	131	227	358	271	24	295	688
Sri Lanka	11	20	31	23	72	95	54	28	82	208
Total	100	126	226	759	1109	1868	2580	876	3456	5550

Source: SAARC Secretariat

favour of Bangladesh (later multilateralised in favour of all LDCs). The details of the tariff concessions offered by all Contracting States (CS) till the end of the Third Round has been presented in Table 3.

The tariff concessions offered has varied in depth from 5-100 percent. The tariff cuts offered by India have been the deepest, varying from 25-100 percent for LDCs and 10-90 percent for all countries. The other countries offered much milder tariff cuts ranging from 7.5-10-15-20 percent for all countries (except Sri Lanka, which offered cuts up to 75 percent). The details of tariff cuts offered by CS have been presented in Table 4.

The Rules of Origin, as in the case of the Bangkok Agreement, is one-dimensional under which Non-LDCs are required to input at least 40 percent local material content while Non-LDCs are required to input at least 30 percent.¹⁸

(b) Agreement on South Asian Free Trade Area (SAFTA)

At the 9th SAARC Summit held in Male in May 1997, the Heads of State or Government

recognised the importance of achieving a free trade area by the year 2001 and reiterated that steps towards trade liberalisation must take into account the special needs of the smaller and the LDCs and that benefits must accrue equitably.

The mandate of the Tenth SAARC Summit held at Colombo in July 1998, reiterated the importance of achieving SAFTA as mandated by the Ninth SAARC Summit. To this end, they decided that a Committee of Experts (CoE), in consultation with Member States, be constituted with specific Terms of Reference (TOR) to work on drafting a comprehensive treaty regime for creating a free trade area.

Recognising the need to move quickly towards a South Asian Free Trade Area, the Heads of State or Government directed the Council of Ministers to finalise the text of the Draft Treaty Framework by the end of 2002 at the 11th SAARC Summit held at Kathmandu, Nepal in January 2002. They also directed that in moving towards the goal of SAFTA, the Member States expedite action to remove tariff and non-tariff barriers and structural impediments to free trade.

TABLE 4
Depth of Tariff Concessions Agreed by the SAARC Member States in the Three Rounds of Negotiations under SAPTA (percent)

	First Round		Second Round		Third Round	
	For LDCs	For All	For LDCs	For All	For LDCs	For All
Bangladesh	10	10	10	10	10,15	10
Bhutan	10, 13, 15	15	15	10	10, 18, 20	10
India	50, 100	10,25,30,50,90	25, 30	10, 15, 25, 40	50-100	10, 20
Maldives	7.5	7.5	15	10	5, 10	5, 10
Nepal	10	10	15	10	10,15	10
Pakistan	15	10	15	10	30	20
Sri Lanka	10,15	10,20	10,50,60	10	10,30,50	10

Source: SAARC Secretariat

¹⁸ Indra Nath Mukherji, 'Towards a Free Trade Area in South Asia: Charting a Feasible Course for Trade Liberalisation with Reference to India's Role', RIS Discussion Paper 86, 2004, Research and Information System for Non-Aligned and Other Developing Countries, New Delhi, 4-6.

BOX 2

Agreement on South Asian Free Trading Area (SAFTA)

Non-LDC countries would reduce their existing tariffs to 20 percent within a time frame of two years from the date of coming into force of the Agreement (2008). If the actual tariff rates are below 20 percent then there shall be an annual reduction of 10 percent on Margin of Preference basis for each of the two years. The subsequent tariff reductions from 20 percent or below to 0–5 percent by all Non-LDCs (except Sri Lanka) shall be done within a period of five years (2013). For Sri Lanka it is six years, beginning from the third year from the date of coming into force of the Agreement (2014).

The LDC Member countries would reduce their existing tariff to 30% within a time frame of two years from the date of coming into force of the Agreement. (2008). If the actual tariff rates are below 30 percent there will be an annual reduction of five percent on Margin of Preference basis for each of the two years. The subsequent tariff reductions from 30 percent or below to 0–5 percent shall be done within a period of eight years, beginning from the third year from the date of coming into force of the Agreement (2016).

Notwithstanding the above provisions, the Non-LDC member States shall reduce their tariffs to 0-5 percent for the products of the LDC member States within a period of three years beginning from the date of coming into force of the Agreement (2009).

The CoE held several meetings during 2002 and 2003 in Kathmandu to finalise the text of the Agreement. Some of the contentious issues were finally resolved in the Council of Ministers (Foreign Ministers) Meeting on 2-3 January 2004 and the Agreement was signed during the 12th SAARC Summit held in Islamabad on 4-6 January, 2004.

The Agreement provides for free trade in goods among SAARC member countries and lays down a Trade Liberalisation Programme.

Each country will maintain a Sensitive List to protect the interests of the domestic stakeholders. This will be subject to a maximum ceiling and shall be finalised after negotiations among the Contracting States (CS) with flexibility to the Least Developed Contracting States to seek derogation in respect of the products of their export interest. This in effect means that the Non-LDC Member States would maintain a smaller sensitive list for the LDC Member States. The sensitive lists are subject to review after every four years or earlier with a view to reducing the number of items, which are to be traded freely among the SAARC countries.

The Agreement also provides for an

institutional mechanism of the SAFTA Ministerial Council (SMC); Safeguard Measures in case of surge in imports of product(s) covered under SAFTA concessions; and a detailed Dispute Settlement Mechanism.

Apart from provisions for longer phase out schedules and longer Sensitive Lists to be maintained by the LDCs, it provides for technical assistance in trade-related areas and some relaxations for imposing safeguard measures against LDCs. The Agreement also provides, as mandated in the 10th SAARC Summit, for compensation of revenue to LDCs who suffer from loss of customs revenue due to the implementation of the Trade Liberalisation Programme, the operational modalities of which are to be worked out through further negotiations.

The SAFTA agreement will enter into force on 1 January 2006 upon completion of negotiations on Sensitive Lists, Rules of Origin, Revenue Loss Compensation Mechanism for LDCs. These negotiations would be carried out by the existing Committee of Experts and are expected to be completed by the end of June 2005.

This Agreement shall supersede the

Agreement on SAARC Preferential Trading Arrangement (SAPTA).¹⁹

BIMST-EC

The initiative to establish Bangladesh-India-Myanmar-Sri Lanka-Thailand Economic Co-operation (BIST-EC) was taken by Thailand in 1994 to explore economic co-operation on a sub-regional basis involving contiguous countries of South East & South Asia grouped around the Bay of Bengal. Myanmar was admitted in December 1997 and the initiative was renamed as BIMST-EC. It may be mentioned that the initiative involves three members of SAARC (India, Bangladesh & Sri Lanka) and two members of ASEAN (Thailand, Myanmar). BIMST-EC is visualised as a “bridging link” between two major regional groupings, i.e. ASEAN and SAARC. BIMST-EC is an important element in India’s ‘Look East’ strategy and adds a new dimension to the economic cooperation with South East Asian countries.

The Framework Agreement on the BIMST-EC FTA was signed on 8 February 2004 in Phuket, Thailand by Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand during the Fifth BIMST-EC Economic Ministers’ Meeting. Bhutan and Nepal had joined BIMST-EC as new members formally, only the day prior to the signing of the Framework Agreement. Bangladesh had participated in the GoE all along for drafting the Framework Agreement, but did not sign it. In February 2004, however, it later expressed its interest in signing the Agreement and has acceded by signing a Protocol to this effect in June 2004.

The Framework Agreement includes provisions for negotiations on FTA in goods, services and investments. The major highlights of the Framework Agreement are as follows:

The negotiations for tariff reduction/elimination for FTA in goods shall commence

in July 2004 and be concluded by December 2005. The negotiations will be held to finalise the negative list items, on which no-tariff concessions will be exchanged to begin with. The tariff liberalisation on rest of the items would be done by following the two tracks mentioned below:

Under Fast Track, products listed in the Fast Track by a Party on its own accord shall have their respective applied MFN tariff rates gradually reduced/eliminated in accordance with specified rates to be mutually agreed by the Parties, within the following timeframe:

Products listed in the Normal Track by a Party on its own accord shall have their respective applied MFN tariff rates gradually reduced/eliminated in accordance with specified rates to be mutually agreed upon by the Parties, within the following timeframe:

For trade in services and trade in investments, the negotiations on the respective Agreements shall commence in 2005 and be concluded by 2007.

The identification, liberalisation, etc. of the sectors of services/investments shall be finalised for implementation subsequently in accordance with the timeframes to be mutually agreed; (a) taking into account the sensitive sectors of the Parties; and (b) with special and differential treatment and flexibility for the LDC Parties.

Member countries have constituted the Trade Negotiating Committee to carry forward the programme, as stipulated in the Framework Agreement. Thailand is the chair country for the TNC. The First TNC meeting was held in Bangkok on 7-8 September 2004 where the TNC finalised its Terms of Reference as well as work programme for the year 2004.²⁰

Looking at the legal basis of RTAs in South Asia, it has to be noted that India’s free trade agreements with Bhutan and Nepal have not been as yet notified to WTO. This is because Bhutan is yet to accede to WTO

¹⁹ htm # b6 (visited 12 May 2005). However, all products negotiated under four rounds of negotiations would continue to be operative.

²⁰ <http://commerce.nic.in> # b2 (visited 2 June 2005).

while Nepal has done so only recently. The Bangkok Agreement came into force on 17 June 1976 and was notified by GATT on 2 November 1976 under the Enabling Clause. Similarly SAPTA, which entered into force on 7 December 1995, was notified by WTO on 25 April 1997 under the Enabling Clause. ILFTA, which entered into force in March 2000, was also notified under the Enabling Clause. BIMST-EC has yet to be notified. Thus, it will be seen that while some bilateral RTAs in South Asia have not been notified at all, others have been so notified under the less rigorous Enabling Clause.²¹ A move towards conformity with Article XXIV of GATT is taking shape under ILFTA and SAFTA.

4. RTAs AND DEVELOPMENT

Theoretically, a free trade regime extending globally is the first best choice for achieving maximum global welfare from trade. However, if for various reasons examined earlier, trade liberalisation is initiated or accelerated at the regional level, this is often considered to be the second best option. Regional trade liberalisation would result in increased competition, efficiency and acquisition of new technology through widening of the market and increased specialisation. The net welfare implications would however, depend on the initial conditions and the nature of regional trade liberalisation.

The classical trade theory framework was provided by Jacob Viner (1950). Viner introduced the concept of 'trade creation' and 'trade diversion' According to him 'trade creation' takes place when there is movement of factors of production from high domestic cost to a low cost domestic source of one or more partner countries. 'Trade diversion' takes place when there is a movement of factors of production from low cost extra-regional producers to high cost regional producers.

Kemal (2005) has pointed out that change in welfare due to preferences granted

to members would depend upon whether the most efficient producer in the world is part of the group or is outside the group. If it is part of the group, the economic integration would be welfare promoting. However, even if the most efficient producer is outside the group, then forming of regional blocks could result in trade diversion or trade creation depending on the initial conditions. Prior to the formation of a regional block, let us say that the tariff was prohibitive and the country met the entire demand of the product from domestic supplies. However, when the tariff rates are reduced preferentially, some participating regional member State may become competitive enough to enter the regional market, thereby replacing the erstwhile high cost domestic producers. This will be trade creating and welfare enhancing. Thus, in any preferential trading arrangement, trade creating (welfare augmenting) and trade diverting (welfare diminishing) influences will be at work simultaneously and the net outcome on welfare will depend on the strength of the two influences.

Viner made restrictive assumptions of inelastic supply and demand. Subsequently, Meade (1955) relaxed the assumption of zero price elasticity of demand. Lipsey (1957) relaxed the assumption of zero supply elasticity as well. Consumers get the goods cheaper than before PTA was introduced so that they realise pecuniary gains. The domestic firms also realise producer's surplus. However, the importing country loses tariff revenue by shifting to an intra-PTA source. In the case of trade diversion the member country's import price increases, even though domestic consumer prices are lower on account of the tariff reductions. It is not clear a priori whether the direct gain for consumers and producers is larger or smaller than the revenue and terms of trade loss sustained by the importing country. The empirical studies give conflicting results to the desirability or otherwise of PTAs.

²¹ WTO, (2005) above n1, Annex VII and World Bank (2005), above n 4.

The theoretical literature on regional trade integration covers every side of the argument. Models based on traditional trade theory tend to find PTAs being potentially welfare reducing. However, models based on new trade theories find PTAs to provide avenues for welfare improvements that arise from the dynamic context.

The analysis presented by Viner, Meade and Lipsey has been static and it has been argued that the dynamic advantages may be even stronger. Traditional trade theory is typically based on perfect competition, constant returns to scale and abstracts from innovations and economies of scale. PTAs increase the market size for producers and allow them to move down the average cost curve by exploiting the economies of scale. A large market also leads to increase R&D and their innovation. However, the estimates of dynamic gains have been subject to controversies as well (see for example, Bhagwati 1993; Bhagwati and Panagariya 1996; Levy 1997; Krugman 1993; Srinivasan 1991). The authors conclude that regional blocks are stumbling blocks rather than building blocks to free trade.

Wonnacott and Lutz (1989), Summers (1991) and Krugman (1993) have espoused the hypothesis of 'natural trading partners' and conclude that the more the two countries trade with each other relative to the rest of the world, the less likely will be the possibility of trade diversion among them in case they form one union.

Several authors have used CGE simultaneous equations to provide the counterfactual. However, CGE models are very sensitive to the assumptions, parameters structure of the model and data used to estimate them, and have to be interpreted with caution. Gravity equations have also been estimated to assess the impact of preferential arrangements on trade flows but these models also suffer from various problems. The dummy variables may not be capturing the effects of preferential trade liberalisation only and may reflect the impact of certain other variables. Second, they fail to distinguish the extent of trade creation relative to trade diversion. Third, trade flows are examined at a highly

aggregate level and hence fail to distinguish trade liberalisation across goods, sectors.²²

Carstens (2005)²³ brings out the theoretical case for and against PTAs. He states that the impact of regional integration and PTAs in particular, on member countries (as well as non-members) can differ substantially depending on specific circumstances. PTAs, can lead to increased trade among members, but also to reduced trade with another member. In addition to pure trade effects, PTAs can strengthen investment and the growth of member countries and may create pressures for further integration, particularly in the financial area.

The theoretical literature on regional trade integration covers every side of the argument. Models based on traditional trade theory tend to find PTAs being potentially welfare reducing. However, models based on new trade theories find PTAs to provide avenues for welfare improvements that arise from the dynamic context.

A PTA can trigger increase in both domestic and foreign direct investment because of increased market size. In such a context even small countries offering a congenial investment climate can attract large inflows of foreign direct investment in order to cater to the enlarged regional market. Besides gains from specialisation can, be realised by breaking up the value added chain, including for commodities that will eventually be exported from the PTA.²⁴

The proposition that trade liberalisation and openness are closely linked to economic growth is widely supported by empirical studies. The link between PTAs and growth however, is less researched or less unambiguous.

Perhaps reflecting the theoretical uncertainties discussed above, empirical studies arrive at different results regarding

²² A.R. Kemal, Presidential Address, 'Exploring Pakistan's Regional Cooperation Potential', The 20th AGM, and Conference, 10-12 January, 2005. See also references to literature survey.

²³ Augustin Carstens, Above, n 8, 6.

²⁴ Ibid., p.11.

the impact of PTAs. Very few studies find outright harmful effects from trade diversion. Since PTAs particularly in the nineties, emerged in parallel with multilateral opening/globalisation, it is difficult to separate PTA-specified effects from a multitude of other effects.

There have been several studies attempting to highlight the implications of a free trade area for South Asia, based primarily on *ex ante* estimations or projections. One of the early studies estimates the static trade effects of a customs union comprising five South Asian countries. Although the effects are found to vary between countries, for the region as a whole the trade creation effects appear to be higher than trade diversion effects. Despite their smallness (increase in intra-regional imports being about 43 percent of pre-union intra-regional imports), the study points to the favourable effects of a customs union for the region.²⁵

More recent simulation exercises by Srinivasan (1994) using a gravity model, show that following the establishment of an FTA in South Asia, trade between Bangladesh and other South Asian countries would go up 8.9 times and for Pakistan by 9.5 times. The corresponding figures for India, Sri Lanka and Nepal are 12.8, 10.3, and 17.2 times, respectively. Given the initial trade pattern, Nepal and Bangladesh stand to gain most significantly from such an arrangement. Their simulation shows that the effect of removing all tariffs would be to increase total trade between three percent of GDP for India and 59 percent of GDP for Nepal and in between for the other countries.²⁶

In another exercise done by the World Bank, the welfare implications of regional trade liberalisation in South Asia using the

Global Trade Policy Analysis Project (GTAP) model have been analysed. The results of the simulation indicate significant benefits for both India and the rest of South Asia. The welfare gains amount to 0.5 percent of GDP for India and 1 percent for the rest of South Asia. In case of unilateral trade liberalisation (when tariffs by all South Asian countries are removed for the world), the welfare gains are however much greater, particularly for India.²⁷

A paper by Govindan (1994) used econometric estimates of price elasticities of demand for food imports by several SAARC countries to gauge the trade effects of SAPTA within the framework of a partial equilibrium model. His results indicate that SAPTA will improve economic welfare through a substantial expansion of intra-block trade in food commodities.

Dean A. DeRosa *et.al.* (1995) use for exploratory purposes, a simple import demand framework. Specifically, in conjunction with a *priori* values of demand elasticities of substitution, recent disaggregated data on SAARC foreign trade, and protection statistics of the four major South Asian countries, it employs the Armington system of bilateral trade demands to illustrate the trade and economic welfare effects of alternative approaches to trade liberalisation by the South Asian countries, within a partial equilibrium framework. The results of the study reveal an increase of one and a half times the level of intra-regional trade in South Asia in 1988.²⁸

According to a study by Bhattacharya and Mukhopadhyay (1966), if India gives total duty free access to all SAARC countries, aggregate revenue loss on account of customs duty is estimated to be Rs.1434 million, equivalent to only 0.41 percent of India's total

There have been several studies attempting to highlight the implications of a free trade area for South Asia, based primarily on ex ante estimations or projections. One of the early studies estimates the static trade effects of a customs union comprising five South Asian countries.

²⁵ M.A. Rahman, et al., 'The Trade Effects of a South Asian Customs Union: an Expository Study', The Pakistan Development Review, Spring 1991.

²⁶ T.N. Srinivasan, 'Regional Trading Arrangements and Beyond: Exploring Some Options for South Asia-Theory, Empirics and Policy', The World Bank, South Asian Region, (Washington: Office of the Chief Economist, 1994).

²⁷ Maria Pigato et al., South Asia's Integration into the World Economy, (Washington: The World Bank, 1997).

²⁸ Dean A. DeRosa and K. Govindan, Agriculture, Trade, and Regionalism in South Asia., Washington: International Food Policy Research Institute, 1995).

Products exchanged by India and Pakistan have been relatively well targeted, such that their shares in India's bilateral trade has been increasing.

revenue from customs. The authors estimate a substantial increase in India's imports from the SAARC countries due to trade diversion, for commodities, which have the highest potential of trade diversion. The total increase in India's imports from the SAARC countries is Rs. 464 million based on 1995–96 data.²⁹

Again, using a static partial equilibrium framework, a study by Mukherji (1998), analyses the effects of unilateral trade liberalisation by India in favour of other South Asian countries, assuming two scenarios, viz. total elimination of tariffs and para tariffs, and a fifty percent reduction of the same. Based on data for 1994-95, the study tries to simulate trade creation/trade diversion, revenue loss following India's unilateral trade liberalisation, based on assumed import demand elasticities. The results point to a very marginal increase in India's imports from South Asian countries and overall trade creation, which again, is quite modest, being no more than 26 percent from the region.³⁰

Based on estimates of tariff elasticities provided by Srinivasan and Cononero (1993), Bhattacharya (2001) estimates the percentage increase in India's imports from SAARC countries (excluding Nepal and Bhutan)³¹ under the SAPTA Rounds. According to the estimates made by him, under the SAPTA Rounds I, II and III, the percentage increase in imports on the basis of the 1993-94 value of exports would be 172, 106, and 159 percent, respectively. Under SAFTA, the projected increase is estimated to be 172 percent. Given

the very low base of India's imports from South Asian countries, the increase in imports would be quite marginal in relation to the country's total imports.³²

There are very few *ex post* studies on actual impact of tariff liberalisation under SAPTA. However, one attempted by Mukherji (2004), looks at the impact of trade liberalisation on India's trade with other Contracting States of SAPTA (excluding Nepal and Bhutan). He examines whether India's import and export shares in relation to its bilateral imports and exports to the partner countries have increased under different Rounds following tariff cuts. On the whole, he finds that the impact has not been encouraging. There are, however some bright spots in the generally grey landscape. For instance, he observes that products exchanged by India and Pakistan have been relatively well targeted, such that their shares in India's bilateral trade has been increasing. Further, he observes that in case of India's offer of duty-free imports from Bangladesh, the latter has been able to make entry to the Indian market in a number of non-traditional products such as pharmaceutical and chemicals. He also points to some modest trade diversification in its preferential imports from Bangladesh, Pakistan and the Maldives.³³

Drawing from both theoretical and empirical studies, the welfare creating impact of PTAs depends on the following key factors:

- (a) the larger the pre-PTA tariff and NTBs, the more likely that the trade creating effect will dominate;

²⁹ B. Bhattacharya and S. Mukhopadhyay, , Duty Free Access to India Within SAPTA Framework, (New Delhi: Indian Institute of Foreign Trade, 1966).

³⁰ Indra Nath Mukherji, 'The South Asian Preferential Trading Arrangement: Identifying Products in India's Regional Trade' XL (15) (1998), Asia-Pacific Development Journal, 1, (1998), Bangkok: ESCAP.

³¹ India already has bilateral free trade agreement with Bhutan and free imports from Nepal while its exports to the latter receives 10-20 percent preference.

³² Swapan K. Bhattacharya, Regional Trading Arrangements among SAARC Countries and India's Imports, 2(2) South Asia Economic Journal, July – December, 2001, p. 301.

³³ For a detailed study of India's preferential trade with Contracting States of SAPTA, including its coverage, impact, changing composition and potential, see Indra Nath Mukherji, Towards a Free Trade Area in South Asia: Charting a Feasible Course for Trade Liberalisation with Reference to India's Role, RIS-DP, 86/2004, Research and Information System for Non-Aligned and Other Developing Countries, New Delhi. See Section 6 of this paper on 'Impact Assessment' for further discussion.

- (b) the greater the demand for each country's goods by the partner country, the greater the scope for specialisation and trade creation;
- (c) the greater the elasticity of demand for regional products and greater their supply elasticity, the greater the possibility of trade creation;
- (d) the greater the level of intra-regional trade among partners and greater the share of such trade liberalised, the greater the possibility of trade creation;
- (e) the lower the external tariff after the formation of the grouping, the lesser the trade diversion; and
- (f) the more restrictive the rules of origin, the greater the possibility of trade diversion.

at four percent of global exports during most of the years under study as may be seen in Figure 1.

There are however, considerable differences in the export shares of individual SAMCs. For example, the export shares of Nepal and Maldives are higher than other SAMCs. On the other hand, the export shares of Bangladesh have been the lowest, followed by Pakistan. These countries also show declining shares, particularly since 1998. India's export share almost doubled between 1990-1996 and thereafter continued to remain above four percent. The shares of Sri Lanka too increased from 1998 with a marked increase between 2001–2002. In value terms the dominance of India's exports to Bangladesh and Sri Lanka is well established. Although India is also the principal market for Bangladesh and Sri Lanka in the region, the export values are quite modest in relation to India's exports to these two countries.

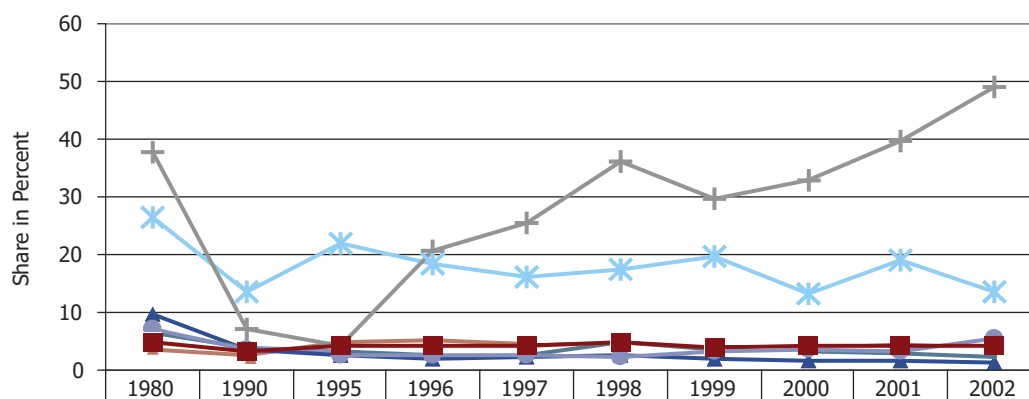
5. INTRA SOUTH ASIAN TRADE

INTRA-REGIONAL EXPORTS

Intra-regional exports of South Asian Member Countries (SAMCs) as a group were modest

FIGURE 1

Share of Intra-regional Export of South Asian Countries in World Export



	1980	1990	1995	1996	1997	1998	1999	2000	2001	2002
▲ Bangladesh	9.67	3.59	2.65	1.84	2.26	2.69	1.91	1.58	1.58	1.33
■ India	3.64	2.73	4.98	5.07	4.67	4.90	4.06	4.20	4.50	4.25
* Maldives	26.58	13.46	22.00	18.53	16.08	17.36	19.55	13.17	18.96	13.52
+ Nepal	37.82	6.94	4.32	20.58	25.37	36.25	29.63	32.97	39.73	48.94
● Pakistan	6.30	3.99	3.14	2.57	2.61	4.92	3.57	3.12	2.87	2.32
◆ Sri Lanka	7.09	3.64	2.65	2.67	2.59	2.36	3.09	3.47	3.34	5.48
■ South Asia	4.97	3.16	4.32	4.32	4.15	4.79	4.01	4.09	4.30	4.20

Year

Source: Estimated from IMF, Direction of Trade Statistics Yearbook (various issues).

INTRA-REGIONAL IMPORTS

In Figure 2 the intra-regional imports of SAMCs has been presented.

The intra-regional imports of SAMCs as a group is seen to be less than four percent of the world imports. This share increased between 1990 to 1996, but thereafter no significant trend is visible.

The import shares of individual SAMCs however, stands in marked contrast to the export shares. The import shares of both India and Pakistan are quite low in comparison to other SAMCs. The import shares of Bangladesh, Nepal and Sri Lanka have been growing particularly since 2000. A look at the figures in value terms will clearly reveal that the major import source of Bangladesh, Sri Lanka and Nepal is India. These dominate the overall intra-regional imports of SAMCs.

INTRA-REGIONAL TRADE

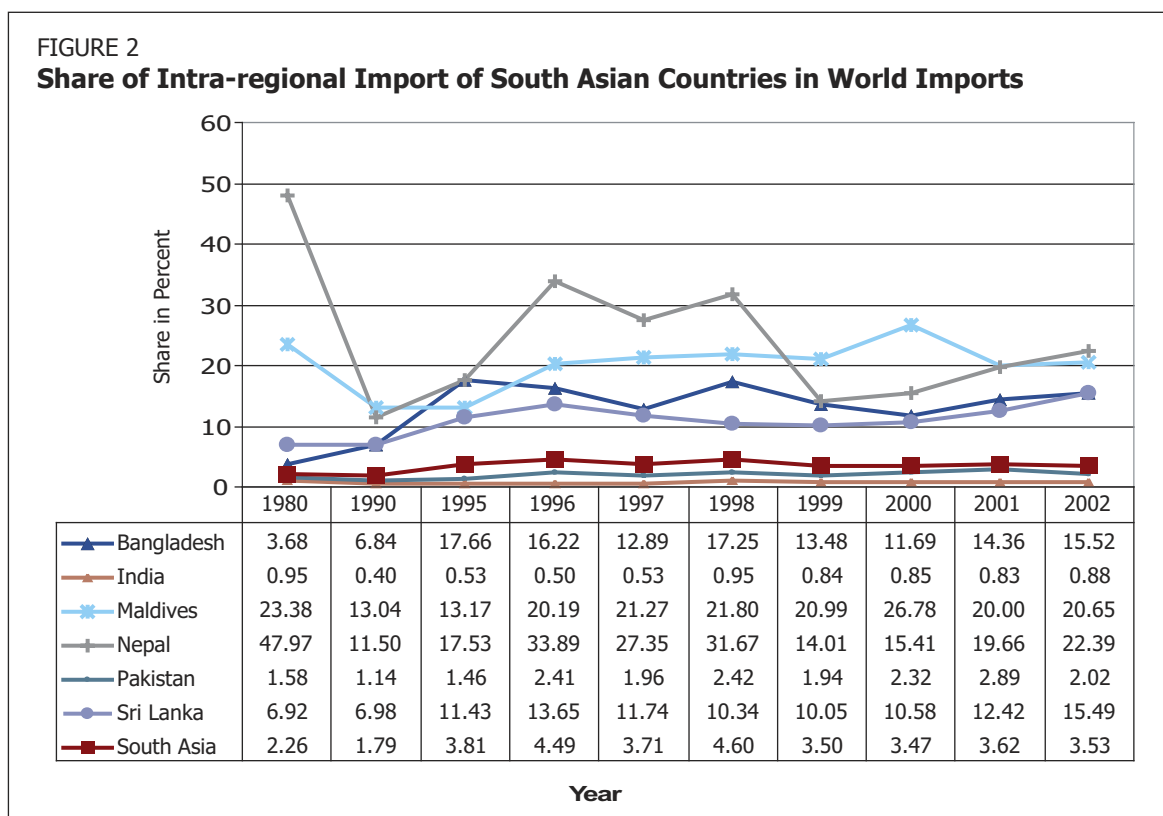
The intra-regional trade of SAMCs is

determined by the intra-regional exports and imports (See Figure 3).

The intra-regional trade of SAMCs has fluctuated between 3–4 percent during the 1990s and during the first three years of the new millennium. The intra-regional trade is the highest for Nepal followed by the Maldives. Since 1999, the intra-regional trade of only Nepal and Sri Lanka shows an upward trend. Otherwise all other SAMCs do not show any increasing trend. A look at the trade values will reveal that India's trade with SAMCs dominates the intra-regional trade.

6. IMPACT ASSESSMENT

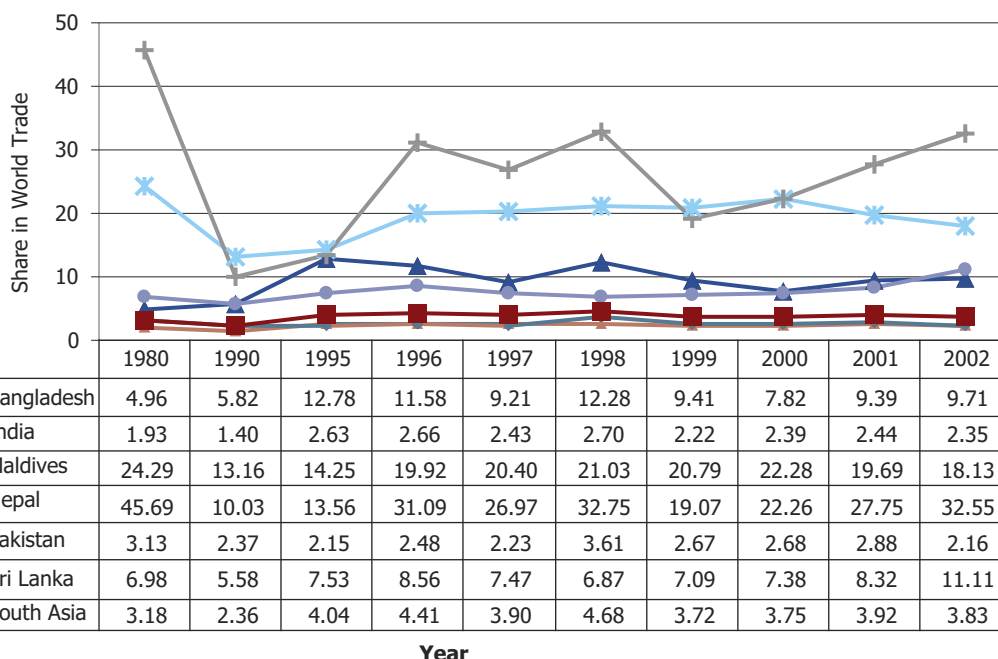
We have noted earlier that the SAMCs initiated trade liberalisation at the multilateral inter-regional level first under the Bangkok Agreement (July 1975) and subsequently, under a multilateral regional level under SAPTA/ SAARC since December 1995. At the bilateral level on the basis of long



Source: Estimated from IMF, Direction of Trade Statistics Yearbook (various issues).

FIGURE 3

Share of Intra-regional Import of South Asian Countries in World Imports



Source: Estimated from IMF, Direction of Trade Statistics Yearbook (various issues).

historical ties, India has been having a free trade agreement with Bhutan since 1972 and a partial free trade agreement with Nepal since 1960.

India accounts for an overwhelming share in the South Asian regional trade and has offered duty-free imports from both Nepal and Bhutan bilaterally under its free trade agreements with these two countries. It has also offered the largest number of concessions multilaterally under SAPTA. Therefore it may be useful to examine the impact if any, on its imports from these countries.

An analysis of India's import shares in Figure 2 clearly reveals a miniscule share of less than one percent. The import share trend also does not show any improvement.

Since the above analysis is too aggregative and has limited time series to throw sufficient light on India's bilateral import shares (particularly in more recent years), we turn to examine India's trade value with other SAMCs. Tables 5-7 show India's exports, imports and trade balance with SAMCs. It

will be seen that India has the largest trade imbalance with the Maldives, followed by Bangladesh. It will be seen that India's trade balance in the case of countries with which it has a free trade agreement, viz. Nepal and Bhutan, the trade imbalance is lower as compared to countries with which no such bilateral agreement exists (for example Bangladesh, Maldives and Pakistan). Of particular significance is that India's trade imbalance with Sri Lanka, which was quite marked before ILFTA came into operation (prior to 2000), has come down perceptibly since the signing of the free trade agreement. This is reflected in terms of declining export/import ratios (see Table 7). The data reveal that just a few years back the ratio was less than one with Nepal and Bhutan reflecting India's trade deficit with these countries. It is only in recent years that India has started having trade surpluses with these two countries, largely following increasing developmental exports to the latter.

TABLE 5
India's Exports to South Asian Countries

US\$ Million

Country	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004
Bangladesh PR	868.96	786.46	995.64	636.31	935.04	1,002.18	1,176.00	1,740.75
Bhutan	21.98	13.33	9.56	7.57	1.08	7.6	39.05	89.49
Maldives	10.36	8.74	8.38	7.3	24.61	26.88	31.59	42.34
Nepal	165.72	170.05	122.41	151.23	140.84	214.46	350.36	669.36
Pakistan IR	157.22	143.15	106.1	92.95	186.83	144.01	206.16	286.94
Sri Lanka DSR	477.41	489.23	437.13	499.27	640.14	630.89	920.98	1,319.20
Total	1,724.39	1,632.20	1,692.02	1,427.83	1,954.41	2,050.38	2,784.90	4,293.55

TABLE 6
India's Imports from South Asian Countries

US\$ Million

Country	1996-1997	1997-1998	1998-1999	1999-2000	2000-2001	2001-2002	2002-2003	2003-2004
Bangladesh PR	62.23	50.81	62.4	78.15	80.51	59.12	62.05	77.63
Bhutan	33.78	13.44	6.13	18.01	21.09	23.92	32.15	52.37
Maldives	0.17	0.24	0.05	0.4	0.19	0.4	0.33	0.37
Nepal	64.07	95.16	144.85	188.63	255.08	355.94	281.76	286.04
Pakistan IR	36.16	44.45	214.45	68.21	64.03	64.76	44.85	57.65
Sri Lanka DSR	42.84	30.21	37.68	44.23	45.01	67.38	90.83	194.74
Total	242.31	245	493.7	418.7	492.49	589.04	530.43	709.32

TABLE 7
India's Export/Import Ratio with South Asian Countries

Bangladesh PR	13.96	15.48	15.96	8.14	11.61	16.95	18.95	22.42
Bhutan	0.65	0.99	1.56	0.42	0.05	0.32	1.21	1.71
Maldives	60.94	36.42	167.60	18.25	129.53	67.20	95.73	114.43
Nepal	2.59	1.79	0.85	0.80	0.55	0.60	1.24	2.34
Pakistan IR	4.35	3.22	0.49	1.36	2.92	2.22	4.60	4.98
Sri Lanka DSR	11.14	16.19	11.60	11.29	14.22	9.36	10.14	6.77
Total	7.12	6.66	3.43	3.41	3.97	3.48	5.25	6.05

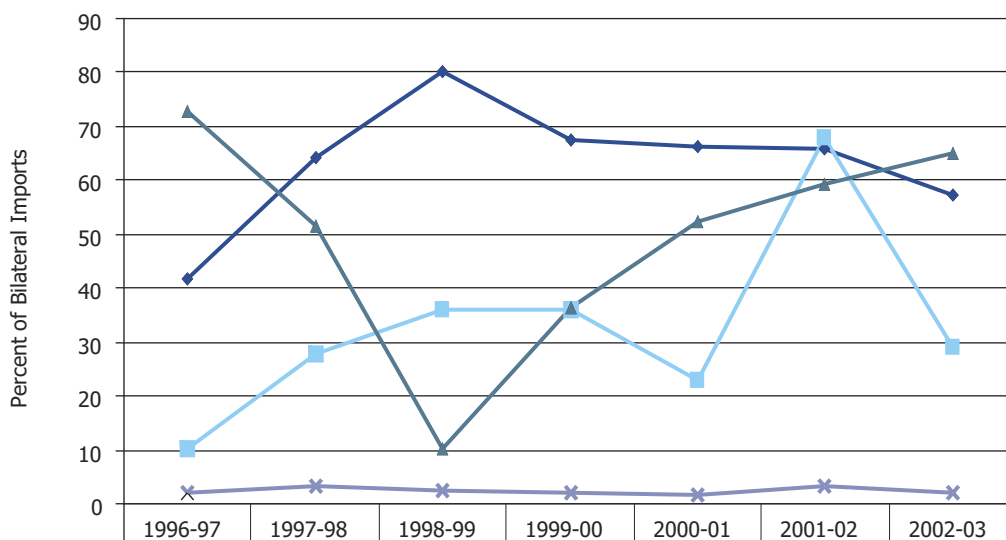
Source: Estimated from Director General of Commercial Intelligence and Statistics, Kolkata.

Next we would like to see whether India's preferential imports in relation to its bilateral imports have gone up with the offer of preferences under SAPTA. This is expected to happen since the products offered preferences are expected to increase faster than those that have not received concessions. Since India already has free trade with Nepal and Bhutan, we leave out these countries and look at the

preferential imports from the four remaining (S-4) South Asian countries. Figure 3 presents the trend.

Figure 4 presents India's preferential imports (PI) as a percent of total bilateral imports and the related data. It will be observed that while India's PI share from Bangladesh increased up to 1998-99, it started declining since then in spite of

FIGURE 4
India's Preferential Imports from S-4



◆ Bangladesh	41.91	64.22	80.34	67.63	66.19	65.96	57.07
■ Maldives	10.25	27.84	35.94	36.01	22.85	68.09	29.24
▲ Pakistan	72.75	51.54	10.07	36.42	52.44	59.29	65.21
× Sri Lanka	2.21	3.45	2.46	2.03	1.84	3.31	2.24

Source: Indra Nath Mukherji (fn. 33), 12.

a substantial increase in the number of products offered concessions by India to the latter as a LDC. In case of Maldives, while the share increased up to 2001-02, it declined in the next year. In case of Pakistan, the trend is clearly one of declining share till 1998-99 *but an increasing share since then*. It is notable that even though India's PI from Pakistan declined in value terms in the last year of this study; in terms of import share the trend is an increasing one. India's PI from Sri Lanka has been both marginal as well as static. The reason for stagnation in India's PI from Sri Lanka is the result of Indo Lanka Free Trade Agreement (ILFTA) being in operation since March 2000. This has made SAPTA concessions largely irrelevant for these two countries given their rapid trade expansion under ILFTA as we examine below.

The composition of India's bilateral preferential trade under SAPTA underwent

modest diversification during the period 1996-97 to 2002-03. To illustrate, India's PI from Pakistan showed some diversification since the share of mineral products declined and the share of chemicals improved. India's PI from Maldives also diversified with the share of live animals declining and that of textiles increasing. A product-wise analysis of India's PI shows the emergence of some new products in India's imports from Bangladesh, Pakistan, Maldives and Sri Lanka.

It is of interest to note that some products that were offered a zero duty concession by India to Bangladesh recorded an increasing share in the former country's bilateral imports. These include: medicines-other, insulating wires, toothpaste, analgesics, surgical catgut, vaccines for MMR, etc. However, the weight of these products being low, this is not reflected in the overall trend in India's preferential imports from Bangladesh.³⁴

³⁴ Ibid, 40

TABLE 8

India's Import Value and Percent Share in Bilateral Imports of Products under Different Categories Offered Concessions: 1996-97 to 2001-02

Categories	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Bilateral Total Imports (US\$'000)	43985.16	30145.90	37702.95	44223.86	45010.19	67170.05	695908.45
Negative List: D(ii)	16.00	15.66	8.15	10.08	9.03	5.93	7.89
Zero Duty: FI	6.98	3.51	9.69	10.78	24.19	19.13	3.7
Residual: SLR	71.81	65.72	75.58	71.79	59.79	68.35	85.62
Tea	0.12	1.98	1.81	4.56	3.89	3.63	1.42
Textiles	1.52	0.81	3.77	2.25	2.71	2.18	1.3
Garments	0.00	0.01	0.51	0.83	0.30	0.10	0.09
All Categories	96.43	87.70	99.51	100.29	99.91	99.32	100.02

Source: Data Compiled from Director General of Commercial Intelligence & Statistics, Ministry of Commerce Database, and Government of India.

Table 8 presents the import value and percent share in bilateral imports of products under different categories offered concessions under ILFTA.

It will be observed that the share of duty free imports in total bilateral imports increased rapidly from 7 percent in 1996-97 to nearly 20 percent in 2001-02. There was a sharp decline in this share in 2003-04, but this was more than made up by continually increasing the share of products under the residual category, which were being increasingly liberalised and made duty free in three years (by 2002-03).

India's preferential exports to Sri Lanka under different categories is presented in Table 9. It will be seen that India's preferential exports

to Sri Lanka also expanded rapidly. But there was no perceptible increase in export shares for products under the duty free or residual categories. It is also to be seen that in 2002-03 as much as 48 percent of India's exports to Sri Lanka were under the Negative List as compared to only eight percent in India's total preferential imports from Sri Lanka.

The question that could now be raised is whether India's growing imports from Sri Lanka also led to a diversification of the former country's export base. The answer to this is in the affirmative. This is reflected in the emergence of as many as eighty new products in India's imports from Sri Lanka following trade liberalisation. Some new products in

TABLE 9

India's Export Value and Percent Share in Bilateral Exports of Products under Different Categories Offered Concessions by Sri Lanka, 1996-2002

Categories	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Bilateral Total Exports (US\$ '000)	479736.47	488501.89	43444.04	499072.52	640206.22	628939.72	9210822.48
Negative List: D (ii)	43.36	37.30	32.46	36.60	36.66	38.28	48.53
Zero Duty: FI	0.84	0.88	1.55	0.97	0.78	0.83	0.83
Residual: SLR	39.17	44.07	52.82	51.76	49.19	43.84	38.65
Phased: F II	12.66	12.46	12.47	10.23	12.68	11.50	11.09
All Categories	96.03	94.71	99.30	99.56	99.31	94.45	99.1

Source: Data Compiled from Director General of Commercial Intelligence & Statistics, Ministry of Commerce Database, Government of India.

India's import basket under the duty free category included a number of chemical products such as P-xylene, benzaldehyde, trisodium phosphate, calcium carbonate, and other phosphates. It also included consumer durables such as washing, bleaching and dyeing machines. Under the residual category, the new products included articles of stone, unrefined lead/lead alloys, wire bars and refined copper, prefabricated building, etc. Some new textile products included yarn, sorted rags, cordage, rope, other knitted crocheted fabrics, etc. Among garments, some new products included men's and boy's shirts, other gloves of cotton, etc.³⁵

7. REVEALED COMPARATIVE ADVANTAGE AND TRADE COMPLEMENTARITY

The success of regional integration schemes depends on, among others, factors such as the pattern of comparative advantage and trade complementarity. The prospects for regional trade expansion are likely to be weak for countries that have either comparative advantage in similar products, or trade structures that exhibit low trade complementarity. A study by Kemal *et al* – suggests that the pattern of revealed comparative advantage is quite similar across SAMCs. For example, the export structures of Bangladesh, Nepal, and Pakistan indicate that these countries have a comparative advantage in food and live animals, basic manufactures and miscellaneous manufactured goods. Sri Lanka too has a comparative advantage in food and live animals and miscellaneous products. Further, India, Pakistan and Sri Lanka have revealed a comparative advantage in 'crude materials except fuels.' Besides, except for India, all other SAMCs have revealed a comparative advantage in a very narrow range

of products. Moreover, none of these countries have a comparative advantage in the capital-intensive value added products.³⁶

In spite of the commonality in the export interest of SAMCs, commodities having some potential for increasing intra-regional trade have been identified in the above-mentioned study. For example, Bangladesh's export potential is observed in a variety of fish products, vegetables, tea and mate, jute fibres, fertilisers, leather, textile yarn, cotton fabrics woven, made up articles of textile materials, floor coverings, etc. India's export potential is more diversified and has been identified in meat, rice, fruits and nuts, coffee, spices, animal feed, oilseeds, stone and gravel, iron ores and concentrates, crude vegetable materials, a number of chemical and pharmaceutical products, pig iron and flat rolled products, machinery and transport equipment, etc. Nepal has export potential in oilseeds and oleaginous fruits. Pakistan's potential exports to the region consist of sugar, molasses, honey cotton, and surgical instruments. Sri Lanka's export potential to the region includes synthetic rubber, raw or processed textile fibres, rubber articles, wood manufactures, residual petroleum products, etc.³⁷

In another study, Mukherji also identified a number of products with high potential trade between pairs of SAMCs on the basis of supply capabilities and market size. Some of the products with India as a supplier and Bangladesh as a market, included cotton not carded or combed, petroleum oils, and denim fabrics of cotton, etc. Bangladeshi products with high export potential for the Indian market included urea, anhydrous ammonia, bovine and equine leather, etc. Again as a supplier to the Sri Lankan market, the potential export products of India included petroleum oils, diamonds non-industrial, denim fabrics

³⁵ For details, see Indra Nath Mukherji, Tilani Jayawardena and Saman Kelegama, 'Indo-Sri Lanka Free Trade Agreement: An Assessment of Potential and Impact', in Paper Presented at Fifth Annual Conference of South Asia Network of Economic Research Institutes, Colombo, 15-17 August, 2003. See an abridged version of the paper on website: http://www.saneinetwork.net/pdf/SANEI_II/work_in_progress_Indo_Sri_Lanka.pdf. (visited 15 May 2005).

³⁶ A.R. Kemal, Musleh-ud-Din, Kalbe Abbas, Usman Qadir, 'A Plan to Strengthen Regional Trade Cooperation in South Asia', in T.N. Srinivasan (ed), Trade, Finance and Investment in South Asia, (New Delhi : Social Science Press 2002), 248.

³⁷ Ibid, 253.

of cotton, etc. On the other hand, Sri Lanka's potential export products to the Indian market included diamonds, non-industrial nes., parts and accessories of automatic data processing machines, diamonds-non-industrial-unworked. Pakistan's export potential for the Indian market included instruments and appliances used in medicine, petroleum oils from bitumen, cotton not carded or combed, etc.³⁸

8. TRADE IN SERVICES

With the rapid expansion of services in global trade, its increasing share in the national income of many countries, and its growing linkages with other sectors in the national economies, it has become clear that any trade liberalisation without the inclusion of services would be incomplete. Realising this, the Uruguay Round of Multilateral Trade Negotiations of the WTO brought services within the fold of multilateral trade negotiations in January 1995 under the General Agreement on Trade in Services (GATS).

In none of the RTAs in South Asia examined above, have services figured in regional trade liberalisation even though this sector has been growing the fastest in SAMCs

as may be seen from Table 10 below. The share of the services sector has been increasing the fastest in all SAMCs; this necessitates that RTAs consider liberalising this sector as well. It must also be noted that improved trade in services facilitates improved goods trade. Both manufacturing and services play a complementary role in improving the productivity and growth in a national economy.

The RTAs in SAMCs have not as yet brought in services in their regional trade liberalisation. Only BIMST-EC provides for FTA in services and trade in investments. The negotiations on the respective agreements are to commence from 2005 and will be concluded in 2007.

Table 11 below reveals the revealed comparative advantage of SAMCs in different sectors covering transport, travel and other services. It will be seen that while Pakistan and Sri Lanka have comparative advantage in transport services, Maldives has this advantage in travel and tourism, while India's advantage lies in 'other services', which are essentially IT, and IT-enabled services. This points to the possibilities of co-operation among SAMCs in their respective areas of comparative advantage.

TABLE 10
Sectoral Composition of Origin of National Income in South Asian Countries (percent)

Region / Country	Agriculture			Industry			Services		
	1980	1990	2000	1980	1990	2000	1980	1990	2000
Bangladesh	50	29	25	16	21	24	34	50	51
India	39	31	25	24	28	27	37	41	48
Nepal	62	52	40	12	16	22	26	32	37
Pakistan	30	26	26	25	25	23	46	49	51
Sri Lanka	28	26	20	30	26	27	43	48	53
South Asia	41.8	32.8	27.2	21.4	23.2	24.6	37.2	44	48

Source: World Development Indicators CD-ROM 2002.

³⁸ For details of products, see Indra Nath Mukherji, 'Charting a Free Trade Area in South Asia', Above, n15....., 113-20.

TABLE 11
RCA of South Asian Countries in Services

TRANSPORT	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bangladesh	0.41	0.57	0.57	0.57	0.54	0.49	0.43	0.49	0.34
India	1.14	1.17	0.92	0.68	0.56	0.45	0.39	0.49	n.a
Maldives	0.30	0.28	0.28	0.30	0.30	0.25	0.25	0.22	0.21
Myanmar	0.08	0.13	0.11	0.09	0.20	0.16	0.11	0.11	0.13
Nepal	0.33	0.43	0.28	0.47	0.38	0.53	0.51	0.54	0.44
Pakistan	1.82	1.66	2.20	2.27	2.41	2.67	2.51	1.49	1.30
Sri Lanka	1.67	1.89	1.93	1.96	1.86	1.87	1.27	1.85	1.83
TRAVEL	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bangladesh	0.11	0.17	0.29	0.23	0.21	0.20	0.21	0.23	0.21
India	1.19	1.22	1.02	0.81	0.67	0.57	0.48	0.42	n.a
Maldives	2.84	2.87	2.94	2.95	2.93	3.01	3.11	3.19	3.28
Myanmar	2.14	2.52	2.00	1.94	2.03	1.54	0.76	0.69	0.42
Nepal	0.82	0.66	0.54	1.08	0.85	1.02	1.17	1.16	1.89
Pakistan	0.19	0.16	0.20	0.20	0.17	0.19	0.20	0.14	0.14
Sri Lanka	0.86	0.68	0.77	0.81	0.91	0.86	0.53	0.98	1.06
OTHER SERVICES	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bangladesh	1.35	0.44	0.39	0.34	0.36	0.40	0.36	0.40	0.59
India	0.85	0.80	1.06	1.26	1.46	1.56	1.66	1.64	n.a
Maldives	0.03	0.02	0.03	0.02	0.02	0.03	0.03	0.03	0.04
Myanmar	1.65	1.84	1.48	1.41	1.47	1.15	0.58	0.52	0.33
Nepal	1.33	1.43	1.62	0.76	0.80	0.86	0.60	0.37	0.38
Pakistan	0.67	0.80	0.75	0.83	0.75	0.60	0.60	0.54	0.37
Sri Lanka	0.73	0.75	0.68	0.65	0.63	0.65	1.21	0.63	0.61

Source: IMF: Balance of Payments Yearbook, 2004.

Given the initial success of ILFTA, the scope of the Agreement is being extended to the Comprehensive Economic Partnership Agreement (CEPA). A Joint Study Group (JSG) on CEPA has recommended the inclusion of both investment and services. The JSG noted that the economic potential of India and Sri Lanka remain under-exploited because of the many inadequacies in the basic infrastructure including health, education and trade-related services. The JCG recommended that the two countries enter into negotiations that cover all services and modes of supply

under the GATS framework and conclude an agreement that will cover a wide spectrum of services. The study suggested the binding of market opening in telecommunications, computer and e-services. It sought increased tourism trade through liberalisation of the cluster of related services and visa formalities. It called for special priority to market access for provision of transport and logistic services. Further, it suggested facilitating mode-3 trade in infrastructure services and mode-4 trade in health and other services through Mutual Recognition Agreements (MRAs) on

professional qualifications.³⁹ The study stated that 'the two countries would benefit from two-way trade in IT and knowledge-based services in which India has already established a presence in the global market, but where Sri Lankan firms are beginning to establish positions in niches.'⁴⁰

A study by Taneja and others, reiterates some of the recommendations of JSG. It suggests that there is scope for Indian investment in Sri Lanka in sectors such as telecommunications, oil, construction, hospitals, software, rail transport, etc. It suggests the opportunities for joint tourist packages for tourists from third countries.⁴¹

The above study states that the offers of both India and Sri Lanka under GATS have been conservative and unbound. India's offer consists of professional services, telecommunications, finance, maritime transport services, etc. Sri Lanka's offer has been limited to only three sectors, viz. tourism, finance and telecommunications. The bilateral offers made by the two countries have been limited to telecommunications, energy, and finance in which their existing trade is limited. The two countries need to expand their offers to more focused sectors in which they have core competencies and to bind their commitments.⁴² An analysis of the revealed comparative advantage points to Sri Lanka's advantage in transport services whereas India's advantage is reflected in 'other services' which includes IT and IT-enabled services. Thus, the services offered for liberalisation should reflect the underlying comparative advantages.⁴³

As in the case of Sri Lanka, there is considerable service trade between India and

Bangladesh. In this case however, the flows are almost entirely unidirectional caused through Mode-4 movement of Bangladeshi nationals seeking healthcare or education in India. Given the absence of official statistics on the movement, an attempt has been made by Rahman to derive some estimates from field research. His estimates show that the total expenditure incurred by 40,000 Bangladeshi patients who visited India with a legal visa during 1998-99 was about US\$ 24 million. If another 10,000 patients who are likely to have visited without valid visa is added, the amount would rise to about US\$ 30 million. Expenditure incurred by 53,000 Bangladeshi students is estimated at US\$ 74 million. Thus the total expenditure incurred by Bangladeshi nationals exceeds US\$ 100 million annually. The overwhelming part of such payment goes unrecorded in the official bilateral balance of payments.⁴⁴

Bangladesh's import substitution in services is called for, to check the outflow of the country's scarce foreign exchange resources. For this to happen, Bangladesh needs to improve its education and health facilities. This can be facilitated by attracting Indian joint ventures or wholly owned subsidiaries in Bangladesh through mode-3 to build up the soft infrastructure in health and education. This has already started happening as we notice a number of well known IT companies such as NIIT and WIPRO setting up training centers in Bangladesh. Also well known hospitals such as Apollo are setting up hospitality services in Bangladesh to cater to the local population.

³⁹ Joint Study Group, India-Sri Lanka Comprehensive Economic Partnership Agreement, October 2003: 51

⁴⁰ *Ibid.*, 45.

⁴¹ Nisha Taneja, Arpita Mukherji, Sanath Jayanetti, Tilani Jayawardane, 'Indo-Sri Lanka Trade in Services: FTA II and Beyond', Indian Council for Research on International Economic Relations, Working paper 145, November, 2004: 47.

⁴² *Ibid.*, 45.

⁴³ *Ibid.* Table A7: Regional Trade Agreements Notified to the GATT/WTO and in Force by Date of Entry into Force as of 1 February 2005:58.

⁴⁴ Mustafizur Rahman, 'Bangladesh-India Bilateral Trade: An Investigation into Trade in Services.' in T.N. Srinivasan (ed.), n. 26 : 219-20.

VERTICAL INTEGRATION AND INTRA-INDUSTRY TRADE

Several studies have highlighted the lack of adequate trade complementarities and revealed comparative advantage across a uniform and limited range of products as reflections of inadequate possibilities of trade integration among SAMCs. It has also been stressed that these countries stand to gain more by integrating their economies with the industrial countries. These countries, it has been suggested, would gain more by economic co-operation in areas such as energy, infrastructure, environment, etc.

The above argument, however, needs to be suitably modified when we observe that most industrial countries also trade in similar products in the form of intra-industry trade. SAMCs too could vertically integrate their manufacturing processes, particularly in products characterized by high intra-industry trade so as to benefit from economies of scale and more value addition in differentiated products.⁴⁵

In spite of considerable liberalisation of trade by SAMCs, this region continues to be one of the most highly protected in the world. Table 12 shows this clearly. The simple and weighted average tariffs were the highest in India and the lowest in Sri Lanka. The level of preferential tariff reductions have been quite modest under SAPTA (except those under bilateral free trade agreements).

Apart from the high level of tariffs, the incidence of non-tariff barriers (NTBs) among SAMCs also remains high. This is illustrated in Figure 5. Here too, the incidence of NTBs is the highest in India followed by Bangladesh, Sri Lanka and Pakistan. With the decline in tariff barriers worldwide, the less transparent NTBs are increasingly taking their place.

In Bangladesh, the number of products in the control list (bans and restrictions) at the HS 4-digit level came down from 193 in Import Policy Order 1991-93 to 63 in Import Policy Order 2003-06 (constituting 5.1 percent of HS 4-digit tariff lines). Trade-related (protective) items accounted for two percent of HS 4-digit tariff lines. These fall under three product categories: agricultural

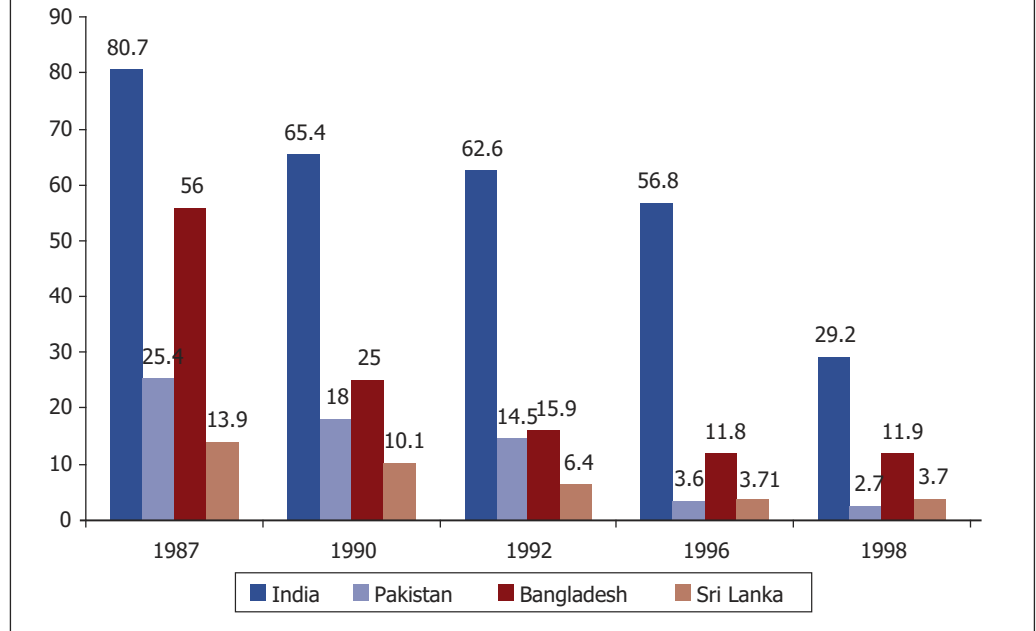
TABLE 12
Tariff Rates in South Asian Countries

Reporter Name	Tariff Year	Simple Average	Weighted Average	Standard Deviation	Minimum Rate	Maximum Rate	No. of Total Lines	No. of Domestic Peaks	No. of International Peaks
Bangladesh	2004	18.43	15.87	10.2	0	30	6792	0	3547
Bhutan	2002	16.61	18.18	10.94	0	100	5244	28	2499
India	2001	32.32	26.5	13.03	0	210	5113	64	4799
Maldives	2003	20.21	20.68	13.24	0	200	8996	149	5794
Nepal	2003	13.61	16.8	10.92	0	130	5348	38	822
Pakistan	2003	17.1	14.46	10.97	5	200	6084	48	3255
Sri Lanka	2001	9.25	6.68	9.29	0	100	6038	25	1264

Source: United Nations Statistics Division: Commodity Trade Statistics Database (COMTRADE).

⁴⁵ For a discussion on intra-industry trade see A.R. Kemal, above, n 27, I.N. Mukherji above, n 19.

FIGURE 5
Percentage of HS 8-digit Lines Subject to QRs in South Asia :
1987-1998



Source: World Bank: Trade Policies in South Asia: Vol. II: An Overview, 7 September (2004) 26.

products, packaging materials and textile products. Non-automatic licensing is also applied to a number of products.

Since 1998, India has done away with Quantitative Restrictions (QRs) for import from SAARC countries. Further, since April 2001, India phased out all QRs in imports. However, in May 2001 a 'War Room' was established in the Ministry of Commerce, and a list of 300 'sensitive' consumer goods published, imports of which have since been regularly monitored to preempt or minimise disruption of local production by competing imports.

By 2003, Pakistan had eliminated all traditional QRs and state controlled import monopolies.

A limited exception to the general removal of QRs is the continuation of a long-standing ban on imports from India of all products other than on a limited positive list

of 677 items (corresponding to about 1030 eight-digit HS tariff lines).

Sri Lanka abolished most of its QRs during its 1977 reforms. By 1998 only 3.7 percent of the country's tariff lines were still subject to traditional QRs. These applied to Sri Lanka's principal import substitution food crops namely, rice, potatoes, chilies, onions, tea, and spices. A number of industrial products too were subject to licensing such as, drugs and chemicals timber, motor vehicles, photocopiers, etc.⁴⁶

The SAFTA text states that the Contracting States shall notify the SAARC Secretariat all non-tariff and para-tariff measures to their trade on an annual basis. The notified measures shall be reviewed by a Committee of Experts to examine their compatibility with WTO provisions. The agreement also seeks to eliminate all quantitative restrictions, except those permitted under GATT 1994,

⁴⁶ Based on World Bank: Trade Policies in South Asia: Vol. II: An Overview, 7 September 2004: 15-25.

in respect of products included in the trade liberalisation programme. The SAMCs need to address both the tariff peaks and NTBs discussed above within the stipulated time frame so as to liberalise their intra-regional trade.

RATIONALISING/SIMPLIFYING RULES OF ORIGIN

Rules of Origin (RO) are the criteria to determine the nationality (origin) of goods being imported. RO are an essential adjunct to Preferential Trading Arrangements (RTAs). Unless provided for, RTAs could serve as merely conduits for trade deflection for products imported by Member states with low external tariffs to preferential markets of other Member states with high external tariffs. Unless devised properly, RO could itself take the form of either trade deflection from third countries (when RO are too liberal) or that of an NTBs (when the required discipline is too exacting).

The main objectives of RO have to be developmental. This can be promoted by preventing trade deflection, facilitating value addition through backward linkages, and promoting balanced regional trade.

The methods to assess substantial product transformation for eligibility of a product for preferences are as follows:

- Percentage test (value addition) criterion: when the value of domestic inputs to total FOB export value meets the prescribed minimum.
- Change in tariff heading (CHT) criterion, generally at the HS 4-digit level. This happens when the exported product undergoes such transformation as to be classified differently from the used imported material inputs.
- Manufacturing process test criterion: Under this criterion certain products need to perform the required processing so as to qualify as eligible products.

The SAPTA RO are currently subject to review. Even though the rules have undergone

some amount of relaxation, the need for a review has been felt and it is desirable that the revised formulation be put in place before the launching of SAFTA in January 2006. It has been suggested that SAFTA RO adhere to multiple criteria, as is the practice in most RTAs with product specific flexibilities.

While agreeing in principle, the need for multiple criteria in the formulation of RO, the following flexibilities could be incorporated, for example,

- Waiving the requirements of conversion at the 4-digit level where domestic value addition exceeds 40 percent of FOB value of finished exports.
- Dispensing with HS conversion requirement where the CIF value of non-domestic input is less than 10 percent of FOB value of finished product.
- Encouraging regional cumulation such that regional inputs are considered equivalent to domestic inputs for meeting the percentage test criterion.
- Depending on the level of value addition and the importance of products concerned in stimulating two-way trade, identified groups of tariff lines could be considered for conversion at the HS 6-digit level.

PROMOTING TRADE FACILITATION

Since many of the NTBs examined above are designed to protect human and animal health or to protect the environment, they are in the nature of regulatory requirements of all SAMCs and are WTO-compatible. A number of protective measures, under certain conditions are also WTO-compatible. However sometimes due to the way in which these requirements are enforced, they tend to take the form of NTBs, particularly when 'WTO plus' conditions are imposed. It is in this context that trade facilitation measures can contribute significantly to the promotion of intra-SAARC trade.

The following trade facilitation measures are among those that need to be urgently addressed, namely,

RTAs are a major and perhaps an irreversible feature of today's multilateral trading system. It is often simpler to negotiate or strike deals among a smaller group of compact members (whether contiguous or not), rather than with a diverse and heterogeneous group of 145 members in a global multilateral framework such as that of the WTO.

- Harmonising/simplifying trade documentation/customs procedures
- Fostering transparency: all laws, regulations, judicial decisions and administrative rulings relating to traded goods to be put on electronic media/paper.
- Standard setting and mutual recognition of standards through accredited testing laboratories.
- Origin verification procedure: A verification procedure to refine issuance of certificates of origin.
- Common training facility for personnel from SAARC countries engaged in trade facilitation to promote capacity building.
- Joint projects for development of ports and land customs infrastructure for facilitating movement of goods through shortest routes, whether through private investment or funding from regional development financial institutions. .
- A regional framework or treaty for promoting transit to promote unhindered movement of goods across borders.
- Setting up a time frame for the identification and where required, removal of NTBs that cause undue hindrance to the free movement of goods across borders.

BROADENING THE SCOPE

As noted, the scope of RTAs needs to be broadened in order to be meaningful. SAPTA/SAFTA have given a predominant emphasis to merchandise trade while excluding services trade and investment co-operation. The linkages between merchandise and service trade and investment flows is now well established. Further, with the multilateral reductions in MFN tariff rates, the emphasis has to shift from exclusive concern with reduction in tariff restrictions to the broader dimensions of standard setting, removal of NTBs and promoting a regional investment area, and trade facilitation. This changed focus has only

recently started attracting the attention of negotiators of RTAs in South Asia.

10. CONCLUDING OBSERVATIONS

Despite the presence of staunch advocates of multilateralism, RTAs are a major and perhaps an irreversible feature of today's multilateral trading system. It is often simpler to negotiate or strike deals among a smaller group of compact members (whether contiguous or not), rather than with a diverse and heterogeneous group of 145 members in a global multilateral framework such as that of the WTO. A plethora of criss-crossing RTAs—both regional and bilateral with different rules of origin could, on the other hand, make the task of customs administration quite complex. Yet, the numerous RTAs—both existing and planned or being negotiated, continues unabated. The possibility of being left out and becoming marginalised is causing those outside to join the bandwagon.

Both contrasts as well as parallels with other RTAs characterise South Asian regionalism. One major contrast is the relatively late entry to regionalism, unlike the industrial countries and other developing countries in Latin America and Africa. Bilateral disputes between two relatively developed countries have led to four wars. Further, India's overwhelming dominance in the region in terms of population, territory and gross national product also creates suspicion and distrust among the smaller neighbouring countries. Adding to this problem is the geographical dimension that while India has long borders with most of its neighbouring countries (excluding the two island economies), the latter have no common border with countries other than India. Besides, unlike the security basis of many regional groupings, this region does not have any common threat perception that could unite the members to forge a common position.

With the onset of globalisation however, and the end of cold war, many of the theories that stressed the primacy of security and political factors, are becoming increasingly

irrelevant. In South Asia too, the old mindset is changing slowly. This paper has highlighted the economic factors contributing to or hindering regionalism in this region.

In spite of globalisation, the South Asian region continues to be highly protected, sometimes more so within the region than in general.⁴⁷ Given the high initial tariffs, liberalisation even on a regional basis could create possibilities for trade creation provided such liberalisation is more rapid than at present and provided further, this is accompanied by parallel multilateral liberalisation. When this process advances, it will become obvious that the limited gains from tariff cutting exercises (generally on a protected product-by-product basis) would become largely irrelevant. This holds most true for the ongoing SAFTA negotiations, which propose to achieve a free trade area for all countries by 2016. By this time many of the competing RTAs in the region would already have attained this goal. To illustrate, by 2008 both India and Sri Lanka would have attained a free trade area (barring the negative list). BIMST-EC also plans to attain a free trade area by 2015.

Studies have pointed to the similarity in the revealed comparative advantage among SAMCs. In this context, the possibilities of vertical specialisation through intra-industry trade is the answer. In this case, the private sector needs to be given adequate incentives to set up enterprises across the borders. For this to happen, a congenial investment climate is called for, supported preferably, by a regional investment area.

From our analysis it appears that the bilateral route to regional co-operation is found to be more effective than the multilateral route through SAPTA, which

has been a slow and protracted process.⁴⁸ On the other hand, India's offer to Sri Lanka of early duty-free imports through the bilateral route, accompanied by Indian investment to the latter country has facilitated the moderation of an excessive trade imbalance between them. India's trade imbalance is much less with other countries with which it has free trade agreements (Nepal, Bhutan) as compared to those with which it does not have one (Bangladesh, Maldives and Pakistan). Currently, India is negotiating a free trade agreement with Bangladesh as well. If this happens, could India become a 'hub' in the region? Perhaps it could if it helps the 'spokes' to strengthen since the spokes put together also provide a support base for the hub. The offer of duty-free imports by India, as we have seen, has helped in opening up India's markets to both LDCs as well as non-LDCs in this region. India must ensure that appropriate rules of origin are in place, the domestic market does not become a dumping ground for cheap imports from third countries.

The second important dimension of RTAs in South Asia would be to address the NTBs that stand in the way of free flow of goods trade in the region. This is a major irritant in India's bilateral relations with its neighbouring countries. India needs to vigorously promote capacity building to enable small manufacturers/exporters to enter the Indian market. This needs to be accompanied by appropriate trade facilitation measures.

A third important dimension is the need to open up the services trade and to promote a common investment area so that the nexus between trade, services and investment is established. Perhaps the ILFTA is a good model for the region to emulate.

In spite of globalisation, the South Asian region continues to be highly protected, sometimes more so within the region than in general. Given the high initial tariffs, liberalisation even on a regional basis could create possibilities for trade creation provided such liberalisation is more rapid than at present and provided further, this is accompanied by parallel multilateral liberalisation.

⁴⁷ A classic example of regional discrimination in trade is the non-approval of the MFN principle by Pakistan in its trade with India. Pakistani importers are permitted to import from India on a positive list of 677 items, the others being banned.

⁴⁸ To illustrate, even though the CoE in its first Meeting held in July 1999 finalised the Terms of Reference for drafting the SAFTA treaty, further Meetings of CoE could not be held for almost three years due to the inconvenience of dates proposed by SAARC Secretariat for some Member Countries. The frequent postponements of SAARC Summits, mostly for political reasons, are also well known.

