

## BOOK CHAPTER

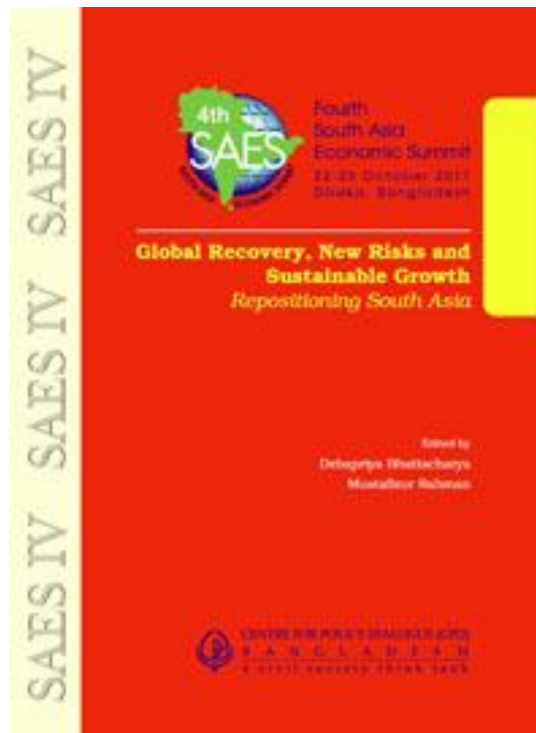
### Low intra-regional trade, rise of bilateral FTAs and the future of South Asia's trade

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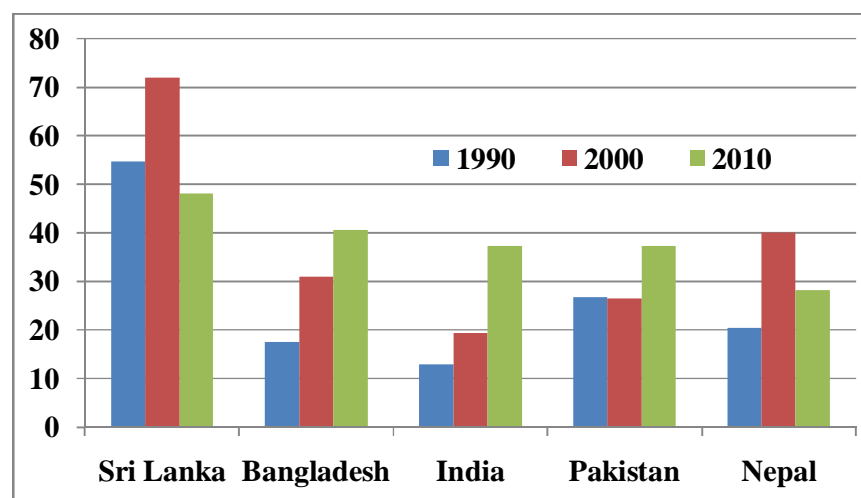
## **I. Introduction**

The nexus between free trade and economic growth is discussed comprehensively, among others, by classical (Smith, 1776, Ricardo, 1817), neoclassical (Heckscher, 1919 and Ohlin, 1933) structural (Lewis, 1954), new growth (Romer, 1986 and Lucas, 1988) and new trade (Krugman, 1979) schools. Nevertheless, there are many studies that recorded inverse or ambiguous relationship between the two variables. However, following the East Asian miracle which has been premised to large extent on export-led growth model (World Bank, 1993) supports for free trade has intensified. China's spectacular economic growth based on the same philosophy (Yingfeng, 2010) has heightened the phenomenon. After economic liberalization in the 1980s and 1990s, export promotion has been an important aspect of South Asia's growth dynamics (Paridaa and Pravakar, 2007).

Trade-GDP ratio, one of the key indicators of trade openness, indicates that most South Asian economies are relatively open to international trade (Figure 1). The region has experienced one of the fastest growth rates in trade in recent years. Table 1 show that the volume of trade in South Asia increased from \$53 billion in 1990 to \$646 billion in 2010 with India witnessing fastest trade growth in the region. However, very low intra-regional trade in South Asia, numbering only 3.3 percent in 2010, does not match with the region's overall progress as far as trade openness is concerned. This is despite the fact that the region has formed a free trade agreement under the framework of South Asian Free Trade Area (SAFTA) in 2006. Nevertheless, this low intra-regional trade share could undermine their actual trade volume if one discounts the region's very high level of informal trade which according to some accounts could be as high as their recorded trade (Taneja et al, 2004 and World Bank, 2006).

Another crucial development in regards to regional trade is the rise of bilateral FTAs and their disproportionate impacts. Given the deadlock in the global trading system as well as a less than expected progress of regional cooperation under the aegis of South Asian Association for Regional Cooperation (SAARC), most South Asian economies have been pursuing Free Trade Agreements (FTA) to manoeuvre their trade. In South Asia, there are at least seven dozens of bilateral FTAs either in operation or under negotiation (ARIC website, also see Table 4).

**Figure 1: Trade openness (Total Trade as % of GDP) in South Asia**



Source: IMF Directions of Trade Statistics

**Table 1: Key South Asian economies' trade volume and direction: 1990-2010**

	South Asia	World	South Asia	World	South Asia	World
	1990		2000		2010	
Bangladesh	0.2	5.3	1.0	14.6	4.3	42.4
India	0.5	41.8	2.0	93.0	9.8	573.7
Nepal	0.1	0.8	0.9	2.3	2.6	4.5
Pakistan	0.3	13.0	0.5	19.6	3.6	65.3
Sri Lanka	0.2	4.5	0.8	12.1	4.2	23.9
South Asia	1.0	52.7	4.8	122.5	21.1	645.9

Source: IMF Directions of Trade Statistics

Against this backdrop, this paper aims to answer two key questions concerning regional trade in South Asia. They are: a) why South Asian economies, even being relatively open in terms of trade and existence of the SAFTA since 2006, are not being able to increase intra-regional trade? b) has the rise of bilateralism undermined SAFTA and affected regional cooperation, particularly in terms of trade, among the South Asian countries? These two issues are discussed in Section II and Section III. The final Section concludes the paper.

## ***II. Reasons behind low intra-regional trade in South Asia***

It is generally argued that economic integration in South Asia could increase welfare of the region. Nevertheless, this enthusiasm is more prevalent among politicians and business

communities than academics. Economic integration process, by and large, begins with trade liberalization with necessary reforms in domestic markets. However, the picture is quite dismal in South Asia as far as trade, finance, and other integrations are concerned, despite the fact that most countries in the region liberalised their economies to large extent. The formation of SAARC Preferential Trading Arrangement (SAPTA) in 1995 and SAFTA in 1996 have had limited impact on intra-regional trade in South Asia (Weerakoon, 2010). Table 2 shows that larger countries in South Asia that constitute lion shares' of the region's GDP and trade volume have relatively lower share in regional trade than the smaller ones. In fact, smaller economies viz., Nepal, Bhutan and Sri Lanka (to some extent Bangladesh) have higher trade share with the region's largest economy, India.

**Table 2: Trade share among South Asian economies**

	Trade Share, South Asia (%)		Trade share, India (%)	
	2010	1990	2010	1990
Afghanistan	6.6	13.14	6.5	13.5
Bangladesh	10.1	4.1	9.8	3.6
India	1.7	1.2	Not applicable	Not applicable
Nepal	58.8	9.2	57.4	11.5
Pakistan	5.5	2.6	4.2	0.7
Sri Lanka	17.7	3.8	17.2	3.1

Source: IMF Directions of Trade Statistics

Economists and trade practitioners have identified a plethora of factors behind the poor state of intra-regional trade among SAARC member countries. Partly due to various tariff and non-tariff barriers the intra South Asian trade is much lower than their trade with other regions. Despite trade liberalization, the world's most populous region still has one of the conservative tariff regimes vis-à-vis other regions (Ahmed *et al*, 2010).<sup>1</sup> For instance, average tariff rates in South Asia are higher than in any other regions in the world (Raihan, 2012).

Non-tariff barriers, (NTBs) particularly measures other than border tariffs, in the form of antidumping measures, import licence, sanitary standards, *inter alia*, affect trade in goods,

<sup>1</sup> Indeed some argued that the region has the most restrictive agriculture trade policies.

services, and factors of production adversely. Table 3 shows the share of various NTB measures in South Asia.<sup>2</sup> The practices of NTBs often create political backlashes in the region. However, the phenomenon is not unique in the case of South Asia.<sup>3</sup>

**Table 3: Share of Specific NTBs to all NTBs in SAARC**

<b>Non Tariff Measures</b>	<b>Share (%)</b>
SPS, TBT and other measures	86.3
Tariff quota	9.8
Anti-dumping measures	7.4
License requirement	5.3
Countervailing measures	1.2

Source: ADB-UNCTAD (2008)

Some argued that even under free trade environment, benefits from trade is limited in South Asia as most economies in the region end up producing similar exportable commodities owing to their comparative advantages (Ahmed *et al*, 2010). In other word, there are limited complementarities in South Asia. Nonetheless, some trade economists argued that while similarities in the exports profiles is viewed as a reason for this low value of trade in the region, it might not be a valid one, given the rising income in South Asia. The intra-industry trade theory suggests that complementarity might actually increase trade in the presence of a rising income. There may be other important factors such as trade costs<sup>4</sup> (Banik and Gilbert, 2008).

Studies show that liberalisation of international transport services foster international trade as much as tariff liberalization does (Baier and Bergstrand, 2001). South Asia has one of the poorest infrastructures and restrictive border trade regimes in the world. Higher transaction and transportation cost affect the regional trade adversely (De *et al*, 2010).

<sup>2</sup> For country specific NTB measures and an extended analysis of this issue, see Rahman (2010).

<sup>3</sup> WTO Secretariat reports increase in new anti-dumping investigations, see WTO (2009).

<sup>4</sup> trade costs include transportation costs (both freight costs and time costs), policy barriers (tariffs and non-tariff barriers), information costs, contract enforcement costs, costs associated with the use of different currencies, legal and regulatory costs, and local distribution costs (wholesale and retail), See Anderson and Wincoop (2004).

Many experts believe that apart from economic factors, as discussed above, non-economic factors are no less responsible for the poor state of intra-regional trade in South Asia. Regionalism has been hostage to the hostile relations between the region's two dominant economies, viz, India and Pakistan (Burki, 2011). History weighs heavily when it comes to the region's trade and other economic relations. In 1948-49, for instance, 70 per cent of Pakistan's trading transactions were with India, while 63 per cent of India's exports went to Pakistan (Burki 2011). India imposed a trade embargo on Pakistan in 1949 when the latter refused to devalue its currency vis-à-vis the US dollar. This has been a water shed moment for both the nations' trade and overall economic relations. The divergence caused the two way trade to be declined strikingly defying the propositions of the 'gravity model of trade.' A less than congenial relation between New Delhi and Islamabad has had cost the trade dynamics of the whole region. By 1967 intra-regional trade came down to just 2 percent of the region's total trade (Chowdhury, 2011). Then the economic policies in the region were formulated based on the import substitution principles that further restricted free trade in South Asia until 1980s. Since 1990 the region has liberalised its trade regime but Indo-Pak animosity remains a barrier not only to augment their bilateral trade volume, it constraints trade, transport, finance and overall regionalism in South Asia.

Hence, the political aspects of trade barriers in South Asia are no less important. In fact, a number of recent studies show that trade volume in South Asia could increase from current low level to a much higher trajectory if the region's political leaders and policy makers are able to remove the existing trade barriers (Ahmed *et al*, 2010).

The next point to ponder is what the trade growth looks like under SAFTA in the near future. Two factors are critical in this regard. First, whether will SAFTA be at all economically attractive? Second, whether the rise of bilateralism undermines potential trade growth under SAFTA. The second question will be discussed in the subsequent section to some detail.

On the first issue, Baysan et al (2006) argued that SAFTA could divert trade owing to three factors: South Asian economies' relatively small share in relation to the world GDP and trade flows, political economy of the selection of excluded sectors and rules of origins. Similarly, Rodriguez- Delgado (2007) predicted a minor effect on region trade.

Using GTAP model Raihan and Razzaque (2007) explored the welfare effect of SAFTA and showed that there could be a substantial net welfare loss for Bangladesh. Raihan (2011) showed that under full implementation of SAFTA, India would be the largest beneficiary followed by Pakistan, Bangladesh and Nepal.

In a recent paper, using the global general equilibrium model Raihan (2012) showed that gains from trade facilitation in South Asia are much higher than the gains from mere reduction in tariff on goods. The author's broad conclusion is that in order to make SAFTA effective trade liberalization is a necessary condition, but not a sufficient one. Using gravity model Weerahewa (2009) showed that there exists a room to expand bilateral trade by reducing trade costs and time delays in South Asian countries.

Trade facilitation measures generally include efficiency of customs and other border procedures, quality and cost of transportation, among others. On the question of trade facilitation and trade growth, World Bank (2007) identified limited, among others, road density, rail lines, tele-density per capita, lengthy customs and port clearance times, poor transport and communications, regulatory constraints and higher transport cost as the reasons to hamper South Asian trade (also see Wilson et al (2003) and Djankov et al. (2006).

Finally, as discussed earlier the political impasse between India and Pakistan is a major hurdle to invigorate the regional trade. For SAFTA to be the catalysts for this process of integration, the two economies that remained the least integrated ion of the SAARC region- i.e., India and Pakistan will need to enforce an expanded trade liberalization programme (Weerakoon, 2008).

### **Rise of bilateralism, SAFTA and future of South Asian trade**

As discussed in the previous section, owing to a plethora of factors, both economic and non-economic, SAFTA has not made significant dent in raising intra-regional trade in South Asia. As a result, most economies in the region are pursuing bilateralism to augment their trade volume. Table 4 shows the proliferation of FTA in South Asia (both intra and extra regional). India and Pakistan's increasing focus on bilateralism, both intra- and extra- regional, is the key reason behind the explosive rise of FTAs. While Pakistan has either signed or is negotiating a large number of FTAs, it is rather upon India to lead the phenomenon given its

sheer size of market, trade and FDI. The economic rise of India in the post-1990s has made it a systematically important economy in the global economy. A number of South Asian economies, notably relatively smaller ones (Nepal, Bhutan and Sri Lanka in particular) rely heavily on India to source their imports as well as to export their commodities<sup>5</sup> (Weerakoon, 2010).

**Table 4: Free trade agreements Status by Country, 2012**

Country	Proposed	Under Negotiation		Concluded		Total
		Framework Agreement Signed / Under Negotiation	Under Negotiation	Signed but not yet In Effect	Signed and In Effect	
Afghanistan	1	1	0	1	2	5
Bangladesh	0	2	1	1	2	6
Bhutan	0	1	0	0	2	3
India	7	4	9	0	13	33
Nepal	1	1	0	0	2	4
Pakistan	11	4	3	3	6	27
Sri Lanka	2	1	0	1	4	8

Source: Asia Regional Integration Centre, ADB

New Delhi's approach to regionalism as far as its neighbourhood is concerned has been two pronged: First, given the deadlock in global trade system as well as a less than expected progress of SAARC and SAFTA, the region's largest economy has been perusing bilateralism in the form of FTA to manoeuvre its trade. Sri Lanka-India FTA (ISFTA) signed in 1998 being the prime example in this regard. India has signed a similar FTA with Bhutan.

New Delhi has offered asymmetric concessions to the bilateral FTAs that have been signed with Sri Lanka and other countries in its immediate neighbourhood. For instance, only 13 percent of Sri Lanka's exports to India were subject to the Indian negative list under ISFTA, the corresponding figure is 42 percent under SAFTA (Weerakoon and Thennakoon, 2008). The ISFTA has conferred significant benefits in terms of closing the bilateral trade gap as well as encouraging a higher inflow of Indian FDI in subsequent years (Weerakoon, 2009).

<sup>5</sup> This dependence is more so for landlocked relatively smaller economies. Bangladesh also depends on India to source some key commodities.



Under the respective bilateral FTA agreements with India, Bhutan and Nepal (and 97 percent of Sri Lanka's exports) have virtual zero duty market access to India (Weerakoon, 2009).

As a result, Bhutan, Sri Lanka and Nepal have experienced higher trade growth vis-à-vis India. Hence, bilateral market access to India for a number of smaller South Asian economies has evolved much faster than the trade growth under SAFTA and some experts, (Weerakoon, 2010), for instance, observed that SAFTA has already been overtaken by FTAs and other regional initiatives.

Further, partly owing to SAARC's less than expected progress and largely due to its own necessities New Delhi has heavily invested beyond the region of late. India has signed a comprehensive economic and strategic treaty with the United States. New Delhi's economic ties with East Asia (including China) under the aegis of the so-called "Look East Policy" and FTA with the Association of Southeast Asian Nations (ASEAN), a comprehensive economic cooperation agreement with Singapore (CECA), among others, have helped India's trade volume to rise markedly in recent years. India's trade volume vis-a-vis ASEAN+3 stood \$138 billion in 2010 from merely \$6.4 billion in 1990s and \$14.6 in 2000.<sup>6</sup>

Similarly, South Asia's second largest economy Pakistan has also signed a bilateral FTA with Sri Lanka. The country is also in the process to sign an FTA with Nepal. It has inked a major trade agreement with Afghanistan. Like New Delhi, Islamabad has accelerated trading relations with a number of East Asian and ASEAN member countries in the form of bilateral FTA, notably with China and Malaysia. Bangladesh, the late comer in this business, is also considering the possibility to sign bilateral FTA with a number of SAARC members, including India. There is also a plan to sign an FTA with Malaysia. While India witnessed highest trade growth with ASEAN+3, most South Asian countries also experienced upward growth in this regard in the past decade (Table 5).

So, another notable development is South Asian economies' increasing trade relations with ASEAN+3 economies. This is largely due to the region's steady economic growth and growing complementarities between the two regions (Deepika, 2010). Moreover, global centre of economic activities are now fast shifting from the Atlantic to the Pacific. According to Dany Quah, an academic from London School of Economics, the global centre of economic gravity that was once at a point deep in the middle of the Atlantic Ocean in the 1980s has

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<sup>6</sup> IMF Direction of Trade.

shifted east over the past 30 years, and could well shift even further over the next 30 years clustering around the border between China and India (Quah, 2011). As a result, South Asian economies could continue experiencing higher trade growth with East Asia.

**Table 5: South Asian economies trade share vis-a-vis ASEAN+3**

	Trade share, ASEAN+3 (%)	
	2010	2000
Bangladesh	29	23
India	24	16
Pakistan	29	19
Sri Lanka	27	23
Nepal	26	18

Source: Direction of Trade, IMF

Within South Asia, there could be some changes in comparative advantages owing to fundamental shift in the region’s exchange rate. India with its steady openness to international finance is experiencing long term appreciation in its exchange rate. On the other hand, most other countries have seen either large depreciations or low appreciations in recent years. This could help some economies (for instance, Bangladesh’s RMG sector) to access to the growing India market, apart from bilateral FTA mechanisms.

Now the point to ponder is whether the intra regional and extra regional FTAs undermine regionalism in South Asia. FTAs are likely to have both trade creation and trade diversion effects and the net impacts depend on which effect dominates. Nevertheless, given the development of FTA-led trade growth is relatively new in the region, there is very little quantitative research has been conducted to verify if these pacts divert or create trade or undermine SAPTA led regionalism. So, while this section captures the trend in South Asia’s trade following the proliferation of bilateral FTAs, it has limitations in explaining the net impact (efficiency, welfare, trade creation and diversion etc) of the rise of bilateralism.

#### ***IV. The Way forward***

We have discussed two critical issues concerning South Asia’s trade. First half of the paper shed light on the potential causes of relatively low intra-regional trade in South Asia. The second part discussed the causes and implications of the rise of bilateral FTA as far as South

Asian trade is concerned. While tariff and NTBs remains significant trade barriers in South Asia, there is much doubt if the region can increase their trade share in the near future owing to lack of complementarity, high trade cost and disproportionate welfare effects on individual countries. While it is necessary to further reduction in tariffs and removal of the NTBS, recent research shows that there is also a need for broad trade facilitation in South Asia to make a real dent in terms of trade growth.

The political barriers to trade and regionalism in the region, particularly owing to India-Pakistan animosity, are equally important. This has caused the decline of intra regional trade in the long run. Moreover, there is little sign of any fundamental or paradigm shift in India-Pakistan relations in the short run. This along with the deadlock in multilateralism and regionalism, the existing FTA-induced bilateralism is likely to dominate over SAFTA-led regionalism, deferring the ASEAN or EU type trade facilitation and regionalism in South Asia.

This development highlights two emerging trends in South Asia: Firstly, the relatively small economies', notably Sri Lanka, Nepal and Bhutan, trade share vis-à-vis India is rising fast. The recent development in India-Bangladesh relationship could translate into better trade engagement between the two countries. Moreover India's steady appreciation of real exchange rate could have some sectoral and micro effects in terms of trade growth (such as RMG of Bangladesh) in the region. Secondly, the larger economies, particularly India and Pakistan (Bangladesh to some extent) are experiencing greater trade relationships with East Asia. In fact, smaller economies of the region have also witnessed favourable trade growth with China and other East and Southeast Asian economies. This is largely due to the region's increasing complementarities with East Asia and the global economy's shifting centre of gravity centering China and India.

Finally, while this paper explains the trend in South Asia's trade following the rise of bilateral FTAs, it is also bound with limitations in explaining the net impact (efficiency, welfare, trade creation and diversion etc) on South Asian regionalism amidst the rise of bilateralism.

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