

## SAFTA: An Instrument For Peace & Prosperity

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### Background

The early history of preferential trading within the South Asian Association of Regional Cooperation (SAARC) cruised along closely parallel with the Association for South East Asian Nations (ASEAN), which was founded in 1967 but the ASEAN Preferential Trade Area was launched only twelve years later i.e. in 1977. Even then, the effective sharing of trade preferences remained negligible. In the same vein, though SAARC was founded in 1985 it had little success in promoting trade preferences among members during the first decade of its existence. The South Asian Preferential Trading Arrangement (SAPTA) amongst the SAARC member countries was signed in 1993 in Dhaka, however the actual exchange of preferences remained extremely limited.

Reacting to the negotiations for the North American Free Trade Agreement (NAFTA) in 1989, the ASEAN members signed the ASEAN Free Trade Area (AFTA) agreement in 1992. Though the objective of the AFTA agreement was to create a free trade area among member-countries by the year 2003, the exchange of preferences had been minimal. Much of the liberalisation by AFTA members has proceeded along non-discriminatory lines. The SAARC members, on the other hand, have made efforts for a serious exchange of trade preferences. The signing of the South Asian Free Trade Area (SAFTA) at the 12<sup>th</sup> SAARC Summit held in Islamabad on January 6, 2004 paved the way for its implementation by January 1, 2006. In addition, there have been several bilateral Free Trade Agreements (FTAs) within the region (similar to those by the ASEAN member-countries), India has FTAs with Bhutan, Nepal and Sri Lanka. Similarly, FTAs are being negotiated between Pakistan and Sri Lanka, and between Bangladesh and Pakistan.

### Regional Integration

The post World War II era has witnessed the advent of multilateralism along with waves of regionalism. The establishment of the General Agreements on Tariffs and Trade (GATT) in 1948 was the genesis of a rule-based

multilateralism under the aegis of which eight rounds of negotiations were held. These rounds culminated into the formation of the World Trade Organisation (WTO) in 1995.

The history of regionalism on trade and economic cooperation is as old as the multilateral trading system itself. Since late 1940s, many European nations started realising the importance of close cooperation among geographically contiguous countries. The European Economic Community (EEC) was formed in 1958 and today 25 countries are under the umbrella of the European Union (EU). However, the first sign of regionalism, in the sense of regional trade agreements/arrangements that we are witnessing today, was got off in 1980s when US signed a free trade agreement (FTA) with Canada.

Asia has been the latest region to catch up with the trend, and its countries are exerting renewed efforts to both deepen and expand regional and sub-regional economic integration, as is reflected by a remarkable scale of negotiating activities underway.

Since 1995, the number of notifications of FTAs to the WTO has dramatically increased. More than 220 regional FTAs have been notified to GATT/WTO (including the period prior to 1995), reflecting a new dynamism in regional economic integration efforts among developing countries.

### Free Trade Areas in South Asia

In South Asia, sub-regional integration is taking place against a less amicable political background, including high-level MFN tariffs. SAPTA was an attempt to use a large political entity, SAARC, to host a preferential tariff agreement among the seven-member countries—India, Pakistan, Sri Lanka and the four LDCs i.e. Bangladesh, Bhutan, Maldives and Nepal. Albeit SAPTA was established in 1993 the first round of concessions came into effect in December 1995, with the latest round completed only in December 2002. The LDC member

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countries were offered large concessions (62 percent) *vis-à-vis* the three non-LDC countries. The depth of tariff cuts was mostly restricted to 10 percent to non-LDCs.

SAARC's intra-regional trade as a percentage of its total trade is one of the lowest among regional groupings (under 5 percent), mainly because of two factors: first, most South Asian countries have a comparative advantage in similar products, and second, political tension between the two largest countries of the region - India and Pakistan has stalled the progress<sup>1</sup>.

The World Bank (2005)<sup>2</sup> has reported that out of eight countries of the South Asia there is no country which has not engaged in some regional trading agreement. (Table-1)

It reports that average number of RTAs per country in the region stood at four, while maximum number of RTAs per country was nine. Individual SAARC members have, however, pursued sub-regional integration through bilateral FTAs. India has a free trade regime with Nepal and Bhutan and has entered into negotiations with Bangladesh. It negotiated an ambitious FTA with Sri Lanka that is now being deepened into a "Comprehensive Economic Partnership Agreement." Sri Lanka itself negotiated an FTA with Pakistan, another SAARC member. In 2004, Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand signed the "Framework" agreement of Bay of Bengal Initiative for MultiSectoral Technical and Economic Cooperation (BIMSTEC), which straddles ASEAN and SAARC.

Along with these bilateral agreements, SAARC countries agreed to a Framework Agreement on SAFTA in January 2004 to supersede SAPTA. Over 12 rounds of negotiations, the four contentious issues: rules of origin; list of exclusions; technical assistance; and creation of a

fund for compensation of the LDCs for the loss of trade-based revenue were finally agreed on December 01, 2005. Implementation of the new tariff regime offers three sets of deadlines: India and Pakistan will complete SAFTA implementation by 2012; Sri Lanka, as a "small economy", is granted one year more, until 2013, to bring its tariffs down to zero to five percent; and Bangladesh, Bhutan, Maldives and Nepal, with the status of LDCs have a longer deadline, until 2015. The Agreement provides for the elimination of quantitative restrictions (QRs), but it does not cover trade in services yet.

## The SAARC Intra-regional Trade

It is sometimes argued that countries within the SAARC region trade "too little" with one another in relation to what one would predict on the basis of their proximity and incomes levels. A look at the official data till late 1980s or early 1990s reveals that the countries in South Asia do not trade as much with one another as other countries with similar income levels and proximity do. For example, based on the gravity equation, Frankel and Wei (1997)<sup>3</sup> found the coefficient of their South Asia bloc (defined as including Indian and Pakistan) variable to be negative. This means that *ceteris paribus* a country within South Asia trades less with a trading partner in South Asia than with an outside partner. Likewise, Dhar and Panagariya (1995)<sup>4</sup> found the coefficient of the variable representing common border to be negative in the gravity equation for India.

Panagariya (2002)<sup>5</sup> elaborated three reasons for low intra-trade in SAARC countries:

- (1) The low level of trade has been essentially the result of autarkic policies of the region. But, once the countries in the region began to liberalise, their intra-regional trade expanded rapidly and demonstrated an

**Table 1: Preferential Trade Arrangements in SAARC Countries**

Country	Regional PTAs	Bilateral PTAs
India	SAARC 1985; SAFTA 2004; Bangkok Agreement 1975; BIMSETEC 2004; ASEAN*; GSTP**1989	Afghanistan 2003; Bhutan 1995; Bangladesh*; Chile*; China+ Egypt* GCC+; Indonesia+; Mauritius+, MERCOSUR 2005; Nepal 1996; SACU*; Singapore 2005; Sri Lanka 1998; Thailand 2003.
Pakistan	ECO 2004; GSTP** 1989 SAARC 1985 SAFTA 2004	China 2005; Malaysia*; Mexico+; Sri Lanka 2005; Thailand+; USA+
Sri Lanka	Bangkok Agreement 1975; BIMSTEC 2004; GSTP**1989; SAARC 1985; SAFTA 2004	Egypt*; India 1998; Pakistan 2005; Iran 2004; Singapore*; USA+
Bangladesh	SAARC 1985; SAFTA 2004; Bangkok Agreement 1975; BIMSTEC 2004; GSTP**1989	India*
Bhutan	SAARC 1985; SAFTA 2004; BIMSTEC 2004	India 1995
Nepal	SAARC 1985; SAFTA 2004; BIMSTEC 2004	India 1996
Maldives	SAARC 1985; SAFTA 2004	
* Negotiations in Progress +Under Study **inter-regional trade agreement		

upward trend for every country in the region. The total trade amongst SAARC countries rose from US \$ 2.6 billion in 2000 to US \$ 5.7 billion in 2004, almost doubled during this short period. (Table-2) With the region's share at less than one percent in the World GDP and the countries having comparative advantage in similar products, intra-regional trade would no longer appear to be "too low" (p.5).

- (2) Another reason for low level of intra-regional trade, as per the official trade figures, understates the extent of intra-regional trade even in the years of heavy protection in India and elsewhere in the region. According to some recent studies, there has been considerable amount of so-called "informal" trade among member countries of the region. For example, when we add the informal trade, intra-regional trade of Bangladesh in 1995 jumps from 17.7 to 21.8 percent. For Sri Lanka, the jump is from 11.4 to 14.4 percent in the same year. In another study (Nisha Taneja, CUTS, 2005)<sup>6</sup> documented total informal trade in the South Asian region is about US\$1.5bn, which is 72 percent of formal trade for corresponding years for which estimates are available. India's informal trade with Nepal and Bangladesh is almost as large as formal trade; with Pakistan, it is 87 percent of formal trade; with Sri Lanka it is almost one-third' and with Bhutan it is three times. Interestingly, of the US\$525mn India's informal trade with Pakistan, almost half is traded officially first to Dubai and then to Pakistan via Iran and Afghanistan.
- (3) There is nothing in the economic theory that says that preferential trade between countries with low existing levels of trade is beneficial. Bhagwati and Panagariya (1996)<sup>7</sup>, while rejecting the argument that if two countries trade a lot with each other, they are "natural trading partners" and trade diversion due to tariff preferences between them is not of serious concern, offered a systematic analysis of why one cannot infer anything as regards the welfare implications of tariff preferences from the existing levels of intra-union trade, whether high or low. Their critique finds a place in the trade literature and also their assertion that high initial volume of intra-regional trade make PTAs more likely to be welfare improving is no longer common.

As is argued above, it is neither low volume of initial intra-regional trade nor the production complementarities in the countries of the region, which are responsible for the lowest intra-regional trade among all regional groupings. The reason lies in the not-so-good political relations between the two largest SAARC members i.e. India and Pakistan that have been/is stalling intra-regional progress in entire South Asian region. Unless a reasonable political and diplomatic understanding is created between the two

**Table 2: Intra-regional Exports of SAARC Countries, in Million US\$, 2000-2004**

To SAARC from	2000	2001	2002	2003	2004
Bangladesh	89	92	74	109	125
Bhutan	0	0	0	0	0
India	1,795	2,051	2,550	3,792	4,262
Maldives	14	17	14	16	16
Nepal	223	244	279	265	302
Pakistan	283	265	229	341	495
Sri Lanka	190	158	256	350	507
SAARC	2,593	2,827	3,402	4,873	5,706

*Sources: Compiled by ADB; taken from International Monetary Fund Direction of Trade Statistics, CD-Rom and CEIC database*

nations and political bosses and policy makers realise the tremendous potential of bilateral trade there is little scope for improvement in the formal intra-regional trade. Moreover, unless the leaders of both the countries recognise centuries old ethnic and cultural ties, including willingness of the people to have deeper and close two-way relationships and cooperation we shall miss the bus for good.

### SAFTA: A Peace Dividend

Regional trading blocs can be an instrument for peace and prosperity. As famous economist J M Keynes (1919) remarked, "A Free Trade Union, comprising the whole of Central, Eastern and South-Eastern Europe, Siberia, Turkey, and (I should hope) the United Kingdom, Egypt and India, might do as much for the peace and prosperity of the world as the League of Nations itself".

In principle, trade and commerce have been the most effective way of establishing peace between rival nations. History offers great many examples to support this viewpoint. The World War II witnessed the worst enmity between the Allied forces led by UK and US, on the one hand, and the Axis powers, led by Germany, on the other.

The bitter memories of the Nazis atrocities were vivid amongst the people, especially of Poland, Holland and Russia. It took several decades after the War to mend relations between the people of Britain and those of France. The formation of the EU giving rise to higher levels of economic well being resulting from enhanced economic cooperation is instrumental in receding the enmities borne out of the World War II in people's minds, especially the next generation that came of age by the 1970s.

It is hard to believe that Thailand was on the opposite side in the Vietnam war; Vietnam invaded Cambodia in 1975; Vietnam and China fought in 1979; and Thailand had a border skirmish with Laos as recently as 1988. Regional co-operation has come a long way since.

### Box 1: SAFTA - Conflict Resolution and Way to Peace and Prosperity

Co-operation among states, despite its collective pay-offs, is seldom easy to achieve. Given the smaller number of states at the regional level, geographical proximity, common historical experiences and, possibly, even shared political cultures and identities, it may not be unreasonable to assume that regional agreements- be they economic or political- are easier to negotiate than multilateral ones. The 1990s certainly saw a spurt in a variety of regional preferential agreements across all continents and South Asia was also not unaffected by this phenomenon.

The South Asian countries share a common language, religion and culture. Ethnic trading network play a critical role in facilitating (informal) trade flows. This is particularly so where the same ethnic community is divided into two national boundaries: for example, the division of Bengal region into Bangladesh and West Bengal state of India and the division of Punjab into Indian and Pakistani states of Punjab. The largest single ethnic group engaged in Indo-Lanka (informal) trade is the hill-country Tamils who migrated from Southern India (overwhelmingly from the state of Tamil Nadu) to Sri Lanka in the late 19<sup>th</sup> and early 20<sup>th</sup> centuries to mainly work as laborers in the plantation sector of Sri Lanka. The trade between India and Nepal is controlled by the Marwaris who migrated from India to Nepal about 125 years ago. Ethnic and kinship ties across the border facilitate information flows on goods and quantities to be traded. Such ties enable non-anonymous trading and ensure that goods are delivered across the border and payments are made. Thus, ethnic and kinship ties are the institutions through which traders minimise risk and reduce their transaction costs of (informal) trading. (Nisha Taneja, CUTS, 2005). This informal trade, if added to formal trade through the PTA, the intra-regional trade of Bangladesh in 1995 jumps from 17.7 to 21.8 percent and for Sri Lanka from 11.4 to 14.4 percent (Pitigala et.al, mimeo, July2000) The opening of rail-road routes across borders between India and Pakistan have created enormous goodwill and cooperation between the people of two nations which has been reported/recorded by the media across the border several times recently.

The cross border cooperation projects are another big source of cooperation and economic development amongst neighboring countries as reported in a study for the Middle East. "The peace process in the Middle East is expected to release limitations on free economic relations and therefore open prospects for economic benefits from cooperation. Cooperation projects have a potential for the improvement of the well being of all parties involved because of the scale economies they permit, the complementarities between the economies, and the externalities they induce (multiplier effects, attraction of foreign investments, diminution of gaps, etc...). On the other hand, a considerable amount of constraints restrict the establishment of such cooperation ventures: the gaps between the economic structures of the countries leading to a fear of "economic dominance", the gaps in social structures, the conflicts with other objectives in each country." (Raphael Bar -El, 2005, Peace Economics, Peace Science and Public Policy, vol 11 Issue 2, p.14). Iraq-Pakistan-India gas pipelines project, if comes into operation, it would tremendously enhance cooperation and mutual benefit between the nations.

In a similar vein, the formation of SAFTA between India and Pakistan along with 5 other South Asian nations can provide an all-time opportunity to forge a sustained and peaceful political and economic relations between the two nations based on mutual respect and cooperation much similar to what the European nations have developed under the umbrella of EU.

History provides ample evidence that no neighbouring countries have ever survived and progressed on prolonged belligerent relations. "History repeats itself" is the saying going around for time and again. The famous economist Wilfred Pareto (1889) wrote, "customs unions and other systems of closer commercial relations (could serve) as means to the improvement of political relations and the maintenance of peace".

The drive for economic integration often begins with political objectives. Like France and Germany in the 1950s, the newly established democracies of the Southern Cone formed MERCOSUR in the mid-1980s in the hope of dampening the traditional military hostility between two major regional powers: Argentina and Brazil. The Southern African Development Community (SADC) originated in the 1980's as a coalition opposed to apartheid in South Africa and has more recently turned to creating a FTA. Some observers note that African

customs unions and FTAs are active in areas such as conflict resolution as in trade liberalisation. Finally, many see relaxed tensions between India and Pakistan as the real payoff from the SAFTA agreement regardless of what happens to trade barriers in the region (World Bank, Global Economic Prospects, 2005).

RTAs also can provide a forum for institutions to bargaining and negotiations in order to ease tension before it could erupt in conflict. European integration, ASEAN, and MERCOSUR are often cited as venues for improving political-military relations. However, RTAs do not ensure positive political outcomes. High protection of Northern manufactures and trade restrictions on cotton were, in part, responsible for the U.S civil war (1861-65). And one reason Bangladesh seceded from Pakistan was the common external tariff structure, which deprived it an access to cheaper inputs from the global markets and diverted trade to Pakistan (Schiff and Winters 2003).<sup>8</sup>

Many current studies also point out that RTAs that expand trade flows appear to have a substantial dampening impact on conflict. Mansfield and Pevehouse (2000)<sup>9</sup> attempt to identify empirically the role of RTAs in ameliorating conflict. They found that, on an average, the likelihood of the outbreak of a militarised interstate dispute declines by around 50 percent if both belong to

the same RTA. However, only RTAs that expand trade flows appear to have a substantial impact on conflict. In Africa, for example, RTAs that address the management of cross-border resource issues (e.g. water) are more effective in reducing military conflict than other RTAs.

The SAARC was formed by seven South Asian countries viz. Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka for increasing political-economic cooperation. Over time, the economic focus of SAARC was gradually sharpened leading to the signing of the SAPTA in 1995. Nonetheless, nothing substantial happened but talks continued which resulted ultimately in the signing of SAFTA in 2004. With the implementation of SAFTA from July 2006, a new dawn is in the offing, as for too long bilateral trade between India and Pakistan has been hostage to political compulsions.

Both India and Pakistan are moving closer though at an extremely slow pace. There are apprehensions in Pakistan that under the free trade their economy will be swamped by a much larger Indian economy. Even China has a surplus in its trade balance with Pakistan, but that doesn't seem to be so bad. In the case of bilateral trade with India, Pakistan's response has been to stick to a positive list, which decides on specific items. This goes against the spirit of FTAs, where trade is generally allowed in all commodities other than those in a negative list of sensitive ones.

Since the other members in SAFTA are following the negative-list approach, the success of the agreement will depend on Pakistan coming on board. Similarly, despite both countries being members of the WTO, only India has accorded the most favoured nation (MFN) status to

Pakistan while Pakistan has directly linked its refusal to reciprocate India's granting of MFN status due to the Kashmir dispute.

It would be futile, though, to expect Pakistan's political antagonism or its fears of being swamped by a much larger Indian economy to disappear overnight. What we can hope for is that once Pakistan realises the benefits of increasing trade, its suspicions will recede. A series of (successful) deals, for example, molasses-for-tea deal or a sugar deal, should remove Pakistani fears of free trade. Furthermore, its willingness to expand the positive list to 1013 from existing 773 items is also a pointer to the right direction. A small one, perhaps, but a beginning nonetheless.

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