

Regional Trade Integration in South Asia: Rationale, Impediments and the Way Forward

Ejaz Ghani and Musleh-ud Din*

Brief No. 7, July 2006

INTRODUCTION

Like others, the South Asian developing economies are opening up with a view to accelerating their economic growth through greater trade and investment. In this context, a major initiative is the signing of the South Asian Free Trade Agreement (SAFTA) among the seven Member States of the South Asian Association for Regional Cooperation (SAARC), namely, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka (see Box 1). As implementation of SAFTA began on 1 July 2006, this policy brief underlines the importance of regional trade integration in South Asia as elsewhere, spells out the factors which have so far hampered trade cooperation in the region, and outlines trade policy measures that will contribute to greater economic integration in South Asia.

Box 1 SAFTA: Scope and coverage

The SAFTA agreement covers a wide spectrum of trade related issues including:

1. Trade liberalization through reduction in tariff and non-tariff barriers;
2. Institutional arrangements for consultations and dispute settlement;
3. Harmonization of standards, reciprocal recognition of tests and accreditation of testing laboratories of Contracting States and certification of products;
4. Simplification and harmonization of customs clearance procedures, and import licensing regimes; and
5. Transit facilities for efficient intra-SAARC trade.

The trade liberalization programme of SAFTA envisages tariff reduction by the non-least developed Contracting States from existing tariff rates to 20 per cent within 2 years from the date of coming into force of the agreement, and to 0-5 per cent within a time frame of 5 years beginning from the third year from the date of coming into force of the agreement. The tariff reduction by the least developed Contracting States from existing tariff rates will be 30 per cent within 2 years from the date of implementation, and to 0-5 per cent within a time frame of 8 years beginning from the third year from the date of coming into force of the agreement.

Source: SAARC Secretariat, *Agreement on South Asian Free Trade Area*.

REGIONAL TRADE INTEGRATION: RATIONALE

In the last two decades, the trading system gave rise to the proliferation of bilateral and regional trade agreements (RTAs). The number of such agreements more than quadrupled since 1990 to around 230 in 2004, and trade between these RTA partners now makes up almost 40 per cent of total trade (World Bank, 2005).

A large body of theoretical and empirical literature has investigated the role of regional economic integration. The *Customs Union* theory (Viner, 1950), predicts that customs union schemes can promote new trade among members, but they can also divert trade from more efficient producers outside the scheme. More specifically, regional integration can result in trade creation by allowing low-cost foreign producers freer access to the domestic market, reducing domestic prices, and displacing higher-cost domestic producers. However, it can also result in trade diversion by allowing less efficient producers that are RTA members to displace more efficient producers from the rest of the world. Regional economic integration is likely to yield net economic benefit when it leads to trade creation rather than trade diversion.

In as far as an RTA leads to trade creation, it is expected to spur competition in the domestic markets. Increased import competition results in lower prices for consumers, more product variety, higher quality, and increased incentives for innovation. By promoting a more efficient allocation of resources, import competition increases productivity, living standards, and long-run growth of the economy. Empirical research has shown that the welfare consequences of trade liberalization through regional trading arrangements generally tend to be positive.¹

The arguments for promoting regional economic integration in South Asia, as elsewhere, go beyond the traditional trade creation argument. To begin with, RTAs are often viewed as a way for nations to lock in and institutionalize trade policy

¹ See, for example, Berthelon (2004), and Carstens (2004).

* Ejaz Ghani and Musleh-ud Din are Senior Research Economist and Chief of Research, respectively, at the Pakistan Institute of Development Economics (PIDE). The views presented here are those of the authors and do not necessarily reflect the views of the United Nations. The technical and financial support of the UN Economic and Social Commission for Asia and the Pacific and the International Development Research Centre, Canada, respectively, are gratefully acknowledged. The authors would like to thank, without implicating, Dr. Yann Duval for valuable comments on an earlier draft.

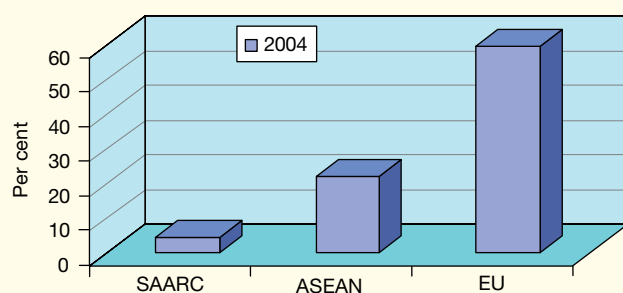
reforms.² The improved policy credibility may also encourage both domestic and foreign investment by reassuring investors that policy will not be reversed in the future.³ Second, an RTA may act as a stepping stone to multilateral trade liberalization by providing an opportunity to experiment with trade liberalization on a limited scale. Third, increased economic ties in the region may create stake-holding in the domestic economies, reduce the risk of conflict, and thus enhance regional security.⁴

It must be pointed out here that regional economic integration initiatives are often subject to criticism mainly on two counts. First, critics focus on the welfare loss associated with trade diversion. However, the likelihood of trade diversion can be minimized by keeping external tariffs low. Second, critics argue that RTAs may stall the process of multilateral trade liberalization, which is deemed as the first best policy. But the debate on this argument remains inconclusive.

IMPEDIMENTS TO REGIONAL TRADE INTEGRATION IN SOUTH ASIA

Despite efforts to strengthen regional economic cooperation, intra-regional trade in SAARC region continues to be small and on average accounts for only 5 per cent of the total trade. Several factors are believed to be responsible for weak trade ties in the region, as explained below.

**Intra-regional trade of selected regional groupings
(as a percentage of total trade)**



Source: <http://stats.unctad.org/handbook/>

To begin with, the success of regional integration schemes hinges, among other things, on the pattern of comparative advantage and the extent of trade complementarity within an RTA. More specifically, prospects of regional trade expansion are likely to be limited for countries whose

production and trade structures are characterized by identical pattern of comparative advantage and low trade complementarities, as has been observed in the case of South Asia (Din and Qadir, 2003). It must, however, be noted that static comparative advantage determines the pattern of trade only in the short run. If trade is opened up as a result of an RTA, there are possibilities of changes in comparative advantage, and the pattern of trade will be governed by the dynamic evolution of comparative advantage in a longer term perspective. So it is likely that a large number of products not previously traded would eventually become a part of trade.

Despite recent trade policy reforms, the trade regimes in South Asia are still considered restrictive, especially in sectors where potential for regional trade exists. A major reason for the failure of the SAARC Preferential Trading Arrangement (SAPTA) to spur intra-regional trade was that most of the products of export interest to the regional countries were excluded from preferential treatment (Kemal, 2004). Consequently, the region is also facing the problem of cross-border smuggling, which is very much prevalent at common borders of Bangladesh, India and Pakistan.

Lack of cross-border transit points and integrated transport networks across the region are also potential hindrances in the intra-regional trade. Moreover, complicated customs clearance involving excessive checking and paperwork, and non-transparent administrative procedures hamper international trade in general.

The political conflicts as well as differences in economic perceptions have been strong impediments to intra-regional trade in South Asia. On one hand, India and Pakistan, the two largest economies of the region, have not been able to realize the full potential of their bilateral trade owing to various political compulsions. On the other hand, the smaller South Asian countries have also been rather skeptical towards regional integration initiatives, not least because of their apprehension that a large trading partner may dominate the region economically to the detriment of their domestic industries.

MEASURES TO ENHANCE REGIONAL TRADE INTEGRATION

The following measures, some of which may be implemented as part of SAFTA, will contribute towards strengthening economic ties in the region thus helping to achieve the shared goal of development and prosperity.

Reducing tariff barriers

Regional countries need to reduce high tariffs on the specific industries of each partner country which are applied to safeguard the interests of some of the local business communities at the cost of low competition and high domestic prices. In particular, high and specific duties on textile, clothing and agricultural products should be reduced to make available the cheaper goods in the domestic market, thereby improving

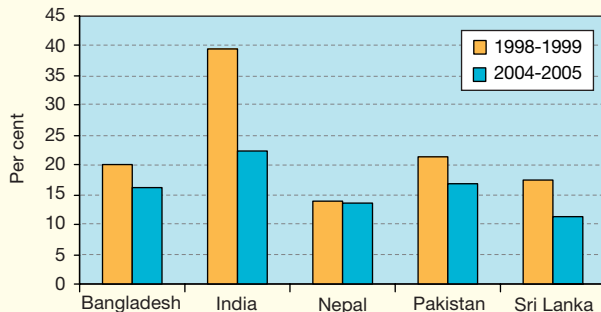
² Fukase and Winters (1999) argue that ASEAN membership is likely to strengthen the members' commitment to reform and thus enhance their external credibility.

³ Foreign investment may also be encouraged due to increased market size within an RTA.

⁴ Schiff and Winters (1998) maintain that increased trade among members of an RTA can build mutual trust and thereby reduce tensions among trading nations.

consumer welfare. This will also lead to enhanced trade within the region.

**Simple average applied tariff rates
in selected SAARC countries**



Source: Baysan T., A. Panagariya and N. Pigala (2006).

To reduce the complexity of the tariff structures, duties and exemptions provided to domestic producers need to be removed. Some studies have pointed out a tendency to use anti-dumping duties as a tool for restricting imports in some South Asian countries.⁵ There should be mutual revision of anti-dumping policies on a regional basis. At the same time, small countries including Bhutan, Maldives and Nepal need to build their capacity to deal with anti-dumping investigations on their exports and to improve their technical expertise on using safeguard measures.

To minimize trade diversion and the attendant welfare loss, the preferential removal of trade barriers in the region to enhance regional integration may be accompanied by a long-term plan for reduction in the level of external protection.

Facilitating trade

Reduction in tariffs alone is not sufficient to promote economic ties in the region. Improvements in the customs as well as tax and other administrations must complement tariff reduction policies. This process should be designed and implemented in close consultation with the stakeholders: businesses, farmers, investors, traders and others. What is needed is a regulatory environment that facilitates trade through reduction in the transaction costs associated with bringing goods and services across borders.

Trade facilitation involves a wide range of initiatives, including, for instance, reforms in the regulation and harmonization of standards, promoting efficiency in customs, and improvement in regional transport infrastructure. The regional countries need to adopt a coherent strategy to harmonize their policies, focusing in particular on transport and transit systems, and customs procedures. Domestic regulatory procedures and institutional structures based on international best practice models (e.g., of ASEAN) can improve transparency and introduce professionalism in border clearance procedures.

Streamlining regulations on technical barriers and liberalizing transport and telecommunications regimes can also facilitate trade. Collective action to raise capacity in trade facilitation in terms of upgrading ports, and introduction of information technology for processing trade documents would lower transaction costs and expand trade across the region.

Building trust and confidence among trading partners

Confidence-building measures are needed to create the right atmosphere for greater economic ties in the region. Indeed, the region is dominated by two large economies (India and Pakistan) and these countries must lead the way towards regional economic integration in South Asia. Actions of these economies have a strong influence on policies of other South Asian countries. Both countries need to work together to ensure smaller regional countries that their interests will be safeguarded and their apprehensions about the domination of larger economies will be addressed at the regional level.

In this respect, SAFTA's provision to compensate the least developed Member States for customs revenue loss promises to be a useful mechanism for building the confidence of smaller Member States (see Box 2).

Box 2

Mechanism for compensation of revenue loss for LDC Member States

SAFTA has devised a mechanism for compensation of revenue loss to least developed member countries (Bangladesh, Bhutan, Maldives and Nepal) for a period of four years from the date of coming into force. The payment of revenue compensation shall be on the basis of quantified loss of customs revenue on bilateral basis, which will be assessed through a clearly laid out formula that takes into account the CIF value of import of non-sensitive items covered under trade liberalization programme of SAFTA, annual trend rate of growth of customs revenue, and applied rate of basic customs duty under SAPTA covered for reduction under trade liberalization programme of SAFTA. The extent of compensation for each of the LDC Contracting State shall not exceed the following percentage of the basic customs duty collected on imports of non-sensitive items from concerned non-LDC Contracting States in the base year (average of calendar years 2004 and 2005).

- First year – 1 per cent;
- Second year – 1 per cent;
- Third year – 5 per cent;
- Fourth year – 3 per cent; and
- Fifth & sixth year – 5 per cent [applicable only in the case of claims by Maldives].

Source: SAARC Secretariat (2006).

Easing of travel and visa restrictions would also promote business contacts within the region, leading to ushering of new possibilities for economic cooperation. Finally, there is a need to create awareness about the potential benefits of regional

⁵ See, for instance, Kemal et. al. (2002).

economic cooperation. This will make various regional economic cooperation initiatives more acceptable to the public thus making it easier for governments to engage in such initiatives.

Exploring potential in new areas

The SAFTA agreement provides a useful framework for strengthening trade ties in the region⁶ and implementing many of the measures suggested above (see Box 1). However, effective implementation of SAFTA will require a strong willingness of all members for greater economic integration as well as a favourable political environment in the region. Also, continuous dialogues and interaction along with sincere efforts towards protecting the interests of smaller Member States are essential for the success of SAFTA and other regional initiatives.

For sustained economic cooperation in the region, there is a need to explore potential in new areas. For instance, Kemal et al. (2002) highlight the importance of developing vertical specialization through regional production sharing arrangements. These arrangements would allow the regional trading partners to achieve economies of scale by concentrating on various segments of the value chain in a production process. Such arrangements could be facilitated through regional cooperation on foreign investment and competition policies.

V. CONCLUDING REMARKS

Moving the process of regional trade integration forward requires concerted efforts aimed at reducing tariff barriers, trade facilitation, and building the confidence of small regional countries. SAFTA provides a useful basis for addressing many

⁶ Some South Asian countries are members of other regional groupings such as BIMSTEC that includes Bangladesh, India, Myanmar, Sri Lanka and Thailand.

of these issues in South Asia, but strong and constant political will from all members will be needed to ensure effective implementation of this agreement.

More generally, South Asian and other countries need to adopt collective approaches to safeguard the interests of their region. Collective positions help improve the bargaining power of individual countries and can be very effective in multilateral negotiation forums such as WTO. Closer cooperation can also help the regional economy absorb external shocks.

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