

**“Preferential Trade Agreement among SAARC Nations; Desirability, Feasibility and Implementation – A Literature review”**

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**Abstract:**

*This paper aims at presenting a survey of the literature on desirability, feasibility and implementation of a Preferential Trade Agreement (PTA) amongst SAARC Nations. It begins by defining preferential trade Agreements as per World Trade Organization (WTO), thereafter moving on to its interpretation as per various literature on the subject. Next section identifies the benefits from such arrangements. Further against the backdrop of identified factors as pre-requisites for a Successful Preferential Trade Arrangement, paper presents both optimistic and pessimistic predictions relating to South Asian Free Trade Agreement(SAFTA) before arriving at a conclusion.*

**Keywords:**

Regional/Preferential trade Agreement, South Asian Free Trade Agreement (SAFTA), Trade complementarities, Trade intensity.

**Introduction**

The literature provides the evidence that free trade in the world promotes maximization of resource utilization and human welfare, however, formation of regional trade agreements (RTAs) and trading blocs is second best option. To exploit full potential of comparative advantages, countries gradually move towards openness, trade facilitation and trade liberalization leading to the creation of a Regional Trade Agreement (RTA). Moreover, economies of scale are another reason for economic integration because a small nation cannot utilize its full production capacity due to small domestic market.

Since the early 1990s there has been a dramatic increase in the creation of new regional and preferential trade agreements as well as a revival of many existing agreements. Today, virtually all countries are members of a regional trade agreement or in the process of negotiating membership, and several are members of more than one agreement.

The issue of economic cooperation among the countries of South Asia too has been the subject of widespread attention and interest. Contemporary developments in world economics has pointed towards the increasing regionalization of world trade and increased trade within regional trade blocks. This, along with the success stories of major regional trade blocks worldwide, prompted the South Asian economies to think in terms of developing closer ties through economic linkages and establish a regional economic grouping. To achieve such advantage, South Asian Association for Regional Cooperation (SAARC), group of eight nations, was formed in 1985.

There is ample evidence in literature supporting economic integration amongst the developing countries. The South Asian nations too realizing the benefits of cooperation came into the agreement, popularly known as the South Asian Free Trade Area (SAFTA) in the year 2004. This is a Free Trade Agreement among the South Asian Nations and a foundation for a common market. It replaced the SAARC Preferential Trading Agreement (SAPTA). It was also a step to increase the regional economic presence at the global level.

Several studies have been undertaken to determine the economic feasibility of regional block in South Asia. Some researches argued against the establishment of a regional trade union (Chanda, 2009; ADB and UNCTAD, 2008; Pitgala, 2005; Krueger et al., 2004), wherein the prospects of intra-regional economic cooperation is considered as an important factor behind

the process of South Asian regional economic integration (Govindan, 1994; De Rosa & Govindan, 1996; Pigato et al., 1997).

## **1. Understanding The Preferential/ Free Trade Agreement & Its Rationale**

Trade liberalization can take several forms. The simplest way to liberalization is for a nation to cut tariffs unilaterally but, more usually, nations lower their import barriers at the same time as their trade partners. Such liberalization can be in the form of a multilateral agreement such as the various GATT/WTO Rounds – or an agreement among a smaller group of nations. This latter type of agreement is referred to as a preferential trade agreement (PTA).

Nearly all PTAs are regional treaties between nations to reduce or eliminate policy-imposed trade barriers. Formal RTAs may cover an array of arrangements ranging from small margins of tariff preference to full scale economic integration. All PTAs or RTAs fall within the scope of GATT 1994 Article XXIV.

**GATT** defines a free trade area as follows:-

*"For the purposes of this Agreement:*

*A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce .... are eliminated on substantially all the trade between the constituent territories in products originating in such territories."* This Article exempts Member states from the Most-Favored Nation (MFN) principle by treating mutual imports preferentially through the formation of a PTA.

According to Robson (1968) all of the forms of integration share two fundamental features; first, they facilitate expanded specialization and exchange between a group of independent countries by means of the elimination or substantial reduction of barriers to trade among them; secondly they entail discrimination against non-members of the group He further suggests that states are often motivated by the economic benefits of such an integrated process and this integration process occurs over a certain period of time.

Panagariya (2000) describes PTAs as an arrangement between two or more countries in which goods produced within the union are subject to lower trade barriers than the goods produced outside the union. Preferential trade agreements (PTAs) aim to reduce or eliminate policy-imposed barriers to the flow of goods, services, capital, labor etc. (Baier et al. 2008).

*Thus the defining characteristic of a PTA accordingly is that lower tariffs are imposed on goods produced in the Member countries than on those produced outside.*

### **1.1 Gains from Preferential/ Free Trade Agreement**

The effective benefits of Regional Agreements have been debated intensely against the RTA and FTA objectives which include: market access; investment attraction; strengthening domestic policy reform and positive signaling to investors; increased bargaining power vis-à-vis third countries. Economic theory suggests that FTAs can generate both positive and negative impacts, in the form of changes in the patterns of trade of member countries (static effects) and structural change of production in the member countries (dynamic effects).

Studies discussing trade integration gains and explaining the theoretical implications of preferential trade agreements are based on the pioneering study of Viner (1950). Viner's study was the first to identify concrete criteria to distinguish between the possible advantages and disadvantages of economic integration. Viner's so called "*static analysis*" of economic integration has divided possible effects of economic integration into the well known trade creation and trade diversion effects.

Balassa (1962) listed the principle dynamic effects of integration as large-scale economies, technological change, as well as the impact of integration on market structure and competition, productivity growth, risk and uncertainty, and investment activity. The same

view is shared by Kreinin (1963& 1964) who claimed that potential gains from economic integration are especially pronounced in small and medium-sized member countries. This can be explained by the fact that if integration or trade in general takes place between a small country and a larger one – whether they are developing or developed countries - the small country will tend to gain more because its exports will now be demanded by a larger pool of consumers. This will be especially relevant to the case of a small developing country if it integrates with a larger developed country with higher purchasing power.

According to Brada and Mendez (1988) integration is assumed to raise investment and reduce risks. This can be explained by the fact that a larger market will raise the expected return on investments and reduce uncertainty by enabling firms to lower their costs as a result of increased economies of scale, and a bigger pool of consumers.

As identified by El-Agraa (1994) the principal potential sources for economic gain from economic integration are:

- Enhanced efficiency in production made possible by increased specialization.
- Increased production levels due to better exploitation of economies of scale made possible by the increased size of the market.
- An improved international bargaining position, made possible by the larger size, leading to better terms of trade.
- Enforced changes in efficiency brought about by intensified competition between firms.
- Changes affecting both the amount and quality of the factors of production due to technological advances.

Proceeding to a common market leads to further sources of gain as a result of:

- Factor mobility across the borders of member states.

Establishing an economic union also results in:

- The co-ordination of monetary and fiscal policies.

Baldwin (1997) suggested that expanding the markets in the context of regional economic integration will not only enable small industries to grow but it would also weed out inefficient industries through the reallocation of resources and supply consumers with a wide variety of goods and services.

*To sum up Regional trade agreements can therefore help countries build on their comparative advantages, improve their industrial efficiency, and act as a platform to integrate into the world economy.*

## **2. Pre Requisites To Successful Preferential Trade Arrangement:**

Conceptual research and existing literature mandates presence of certain factors/elements to support creation and ensure successful PTA(Preferential Trade Arrangement).Bandara and Yu(2001) identified these factors as primarily (a) geographical proximity;(b) high pre-PTA tariffs; (c) high level of intra-regional trade; (b) the existence of trade complementarities; and (e) differences in economic structure based on competitiveness and (f) less political tensions among member countries. Examining these conditions helps to analyze the desirability of forming a PTA within a certain region.

Bergstrand et al. (2010) identify three systematic relationships between the “timing” of PTA events and different economic characteristics. Specifically, natural trading partners (countries closer to each other in terms of physical distance), pairs of countries with larger gross domestic products (GDPs),and pairs of countries whose economic size is similar ,have a higher probability of forming a PTA – or enlarging an existing PTA–sooner than countries that do not share these three characteristics.

### 3. Preferential Trade Arrangement In South Asia

The South Asian nations too realizing the benefits of cooperation came into the agreement, popularly known as the South Asian Free Trade Area (SAFTA) in the year 2004. This is a Free Trade Agreement among the South Asian Nations and a foundation for a common market. It replaced the SAARC Preferential Trading Agreement (SAPTA). It was also a step to de-marginalize the regional economic presence at the global level.

There is a large body of literature on PTAs in Europe, North America, South America and South East Asia. However, the literature on the South Asian regional grouping is limited. While many of the studies on PTAs in other parts of the world are quantitative, quantitative studies on SAARC are very limited. In comparison with quantitative assessments of PTAs in other parts of the world, the effects of South Asian economic integration have not been investigated extensively. While there are many qualitative studies on SAARC and SAPTA, quantitative studies on economic integration in South Asia are very limited with few exceptions.

Bandara and Yu (2003) suggest a few possible reasons for this limitation. Firstly, many trade analysts have not paid much attention to this region until recently since it is not important in terms of trade, investment and growth. Secondly, finding data on trade and other variables related to countries in this region is very difficult. Thirdly, the volume and value of illegal trade is very high in the region and published data do not reflect the real picture of the trade structure in the region. Finally, non-tariff barriers on trade are very important in this region compared with many other regions in the world. However, the recognition and quantification of non-tariff barriers are difficult.

Despite these constraints, there are several empirical and analytical studies that have generated a debate over the desirability of SAFTA. Some pertinent researches argued against the establishment of a regional trade union (Chanda, 2009; ADB and UNCTAD, 2008; Pitgala, 2005; Krueger et al., 2004), wherein the prospects of intra-regional economic cooperation is considered as an important factor behind the process of South Asian regional economic integration (Govindan, 1994; DeRosa & Govindan, 1996; Pigato et al., 1997)

Against the backdrop of the identified factors this paper is an attempt at presenting the survey of literature on the desirability, feasibility and implementation of a Preferential Trade Arrangement in South Asia. The study takes a comprehensive look at the optimistic and pessimistic predictions relating to SAFTA before arriving at a conclusion.

Kemal et al. (2000) have estimated the complementarity indices for all five leading South Asian countries using time series trade data and found that there is a lack of strong trade complementarity in the bilateral trade structures of South Asia. Lack of trade complementarities raises the questions on the future prospects of SAFTA.

Using trade data and a global computable general equilibrium (CGE) model Bandara & Yu (2001) have tried to determine the prospects of South Asian RTA against the backdrop of identified prerequisites. Their study indicates that the following factors do not warrant a South Asian FTA.

#### *High pre-PTA tariffs*

South Asian countries have long maintained high tariff rates and other protection measures despite their recent efforts to liberalize trade. In the three large countries in the region (Bangladesh, India and Pakistan), tariffs are still higher than Southeast Asian countries. Panagariya (1999) provides a comparison of tariff of the countries in this region with countries in the South East Asian region.

### *Level of intra-regional trade*

Despite difficulties of obtaining reliable data on South Asian intra-regional trade, mainly because of illegal cross-border trade, available published trade data indicate that the level of intra-regional trade in South Asia is insignificant. Compared to the high level of intra-regional trade in other regions in the world, the low level of South Asian intra-regional trade is not an encouraging sign for the regional integration

### *Differences in Economic Structures and Competitiveness*

Countries in South Asia have an almost identical pattern of comparative advantage in a relatively narrow band of commodities and that these countries do not have comparative advantages in a wide range of capital goods and advanced manufactured products. The lack of trade complementarity in bilateral trade flows and the similarity of the pattern of comparative advantage in the region have been the main constraints for the growth of intra-regional trade.

Jayatillake (2001) has addressed the question of desirability of SAFTA using a global computable general equilibrium (CGE) model. The study examines six conditions highlighted in the PTA literature above for the successful implementation of a PTA. Examining the conditions in South Asia in the context of these prerequisites indicates that the conditions required for creating a successful, trade promoting PTA might be lacking in the region. Besides study further uses standard Global Trade Analysis Project (GTAP) model to evaluate the effect of SAFTA. Two opposite policy simulations are performed, i.e. a unilateral trade liberalization scenario and a preferential trade liberalization scenario. The results show that while the impact of preferential trade liberalization is very small the impact of unilateral liberalization is significant. Under preferential liberalization small countries would lose and India would be the sole significant winner. Hence, the economic analysis indicates that SAFTA would not benefit the region economically.

Pitgala (2005) too addresses the issue of whether the South Asian countries possess the requisite conditions to become a successful trading block. The study uses three definitions of the 'natural trading block' hypothesis, i.e. the trade volume, geographic proximity and the complementarity approaches and makes a comprehensive study supported by empirical evidence. The trade volume approach, suggests that members of a regional agreement should trade disproportionately with each other in order to be a successful bloc. Based on this characterization, the South Asian economies fall short.. The evidence from the South Asian countries does not support the 'geographical proximity' hypothesis (reflected by the trade intensity index (TII)) either, with the South Asian countries demonstrating an increased tendency to trade with industrial countries due to cultural ethnic or religious affiliations. The third criterion, i.e. the complementarity criterion (measured with the complementarity index) tests how well the structures of exports and imports match, i.e. whether a country imports what its trading partner exports. Here again, the measured degree of complementarity amongst countries was very low.

Krueger (2004) puts forward a largely pessimistic view which indicates that although potential gains exist from SAFTA, the South Asian region does not meet most of the theory-based criteria for successful trade agreements.

Examining the Economic case for SAFTA through qualitative assessment Baysan and Panagriya (2006) conclude that The following qualitative arguments fail to provide a strong case in favor of SAFTA. Firstly, the economies are relatively small as compared to the rest of the world both in terms of GDP and trade flows. The economic size of the region remains small: less than one-twentieth of the world in terms of GDP. Secondly, the level of protection amongst SAARC countries is very high with the exception of Sri Lanka. If a country participating in a regional arrangement were not open they are likely to suffer from welfare losses due to trade diversion. The third reason which makes the economic case for SAFTA weak is political economy of selection of the excluded sectors and rules of origin (ROO) issue.

The prospects and challenges of preferential trade liberalization and regional integration in South Asia have studied by Ali, E. & Talukder D. K.(2009) by analyzing regional and international trade structures of South Asian countries through conventional trade measures such as commodity composition and direction of trade, and bilateral trade shares. Findings indicate that, with the existing low level of bilateral and intra-original trade shares and low trade with South Asian countries, the gains from free trade arrangements in this region are likely to be minimal. The region accounts for a very insignificant share of world trade but persistent high levels of tariff barriers. Thus, preferential trade liberalization is more likely to bring about trade diversion than trade creation leading to more gains for large countries and more losses for small countries.

Focusing on the analysis of South Asia Association for Regional Co-operation (SAARC) trade, Rajeev Jain and J. B. Singh (2009) attempts to analyze the merchandise trade performance of SAARC region and also the trend in intra-SAARC trade. A brief analysis of trade baskets of SAARC countries shows that export baskets of major SAARC countries are significantly similar. Reflecting that they may be competing with one another in same industries in the international market.

Radha Raghuramapatruni (2011) attempts to analyze the performance of SAARC as a regional block, the trend in the intra-SAARC trade, intensity of India's trade with the other members of the SAARC and a brief analysis of the trade basket of the four potential members of the SAARC utilizing the Trade Intensity Index and Revealed Comparative Advantage Index concludes that SAARC countries are mainly exporting agricultural commodities and agro-based products as evident from the RCA indices. With trade being competitive and identical, more diversification of goods is extremely essential to tap the untapped market potentialities.

However, there do exist studies that argue either in favor of SAFTA or do not out rightly negate the feasibility of an RTA in South Asia. It is worthwhile to note some of the important studies in this area that have commented on the potential for growth of intraregional trade in South Asia and the possible factors influencing such growth. Wickramasinghe 2001; CUTS2005; Burki 2004 studies on South Asian trade indicates significant trade complementarities across the region, highlighting, in particular, the presence of such complementarities in the services sector. Additionally, the literature suggests that increased trade flows are likely to enhance technical efficiency, improve resource allocation and allow countries to create niches by specializing in different products within a given industry thereby advocating the case of South Asian FTA.

Examining the progress of SAPTA and the prospects of SAFTA using trade data for 1996 to 2002 Hirantha (2003) has used a gravity model. The Gravity model results are quite in contrast with the previous studies and show strong evidence of trade creation in the region under SAPTA with no trade diversion effect as far as trade with non members is concerned. Hence, the study supports the proposition that further regional integration will bring about substantial benefits to SAARC region.

RIS (2004) reports the result of studies conducted in the framework of gravity model. It suggests that complete elimination of tariffs under SAFTA may increase the intra-regional trade 1.6 times. It further suggests that in the dynamic framework the gains from liberalization are at least 25% higher than the static gains.

Raihan and Razzaque (2007) using Computable General Equilibrium (CGE) modeling estimate the trade creation and trade diversion effects of SAFTA. They show that a full implementation of SAFTA will lead to welfare gains for India, Sri Lanka and rest of South Asian countries, though Bangladesh suffers from welfare loss. Bangladesh's welfare loss is mainly driven by the negative trade diversion effect. Simulation results also suggest that the negative trade diversion effect can be undermined by some associated unilateral trade liberalization measure. It is also important to note that trade diversion for Bangladesh and possibly for other LDCs

under SAFTA is inevitable. Bangladesh and other LDCs in South Asia will have to raise their export share into the Indian market substantially in order to increase welfare through positive terms of trade effect. Export diversification in this regard is very important.

Asian Development Bank study (2009) data on South Asia show so much untapped economic opportunity: of the region's total trade volume of \$517.5 billion in 2007, only 4% was Intraregional trade. Given the advantages of proximity, and the similarity in production structures and levels of technology, plus the familiarity of cultures, it is likely that a more pronounced set of benefits will accrue from intraregional trade and investment, taken alongside their extra regional counterpart. South Asian economies share these advantages of contiguity, proximity, and familiarity that make regional economic cooperation and integration less troublesome, thereby not completely negating the possibility of formulating an effective RTA.

Bhattacharya & Das (2012) have used the stochastic frontier gravity model to show that when FTA among SAARC countries becomes fully operational, smaller members will gain maximum benefits compared to larger members. The analysis further predicts that intraregional trade among the SAARC countries is low at present, which implies the existence of sufficient potential to enhance intraregional trade. However, such a low figure is not unusual in the early stages of formation of such trading blocs, as a similar trend was observed for several years in the case of ASEAN.

However Das (2007) has found that the evidence of trade complementarities in South Asia is mixed. India's and Pakistan's exports are complementarities to the imports of some South Asian Countries such as Bangladesh and Sri Lanka. Other economies show efficiency in only a small number of export areas and cannot be considered complementarities to India's imports, or any other country's imports. Increase in Trade Intensity Index for India seems to be due to trade reforms as part of economic reform resulting in the increase in economic growth. The declining values of trade intensity for other countries suggest low trade complementarities among themselves as well as continuing barriers to intra-SAARC trade. Lacking in complementarities in trade, South Asian economies compete in their export markets in a narrow range of products, particularly in textiles and apparel and other light manufactured goods. Thus, the prospects of regional integration are seriously inhibited by this trade structure.

While analyzing the desirability and feasibility of a regional block in South Asia, equally important are the implementation issues. As evidenced in literature, the growth of intra-SAARC trade has been slow due to a number of structural, Political and economic constraints hindering the smooth implementation of an RTA.

Rajeev Jain and J. B. Singh (2008) have concurred with the fact that trade potential does exist for South Asia however concluded that "SAARC countries need to put in place adequate physical infrastructure which hampers their global competitiveness even in those sectors where they have revealed comparative advantages. SAARC countries will need to take concrete steps for harmonization of customs and other procedures, mutual recognition of certificates and standards and trade facilitation measures.

According to Ali, E. & Talukder D. K. (2009) trade policies of individual countries are shaped more by political considerations than economic factors. Therefore, implementation of a free trade area and deriving benefits from it will be challenging. The study emphasizes on building modern border customs crossings and developing sophisticated telecommunications links would be crucial to such an effort.

Desai (2010) has identified various deficiencies in SAFTA's design which have affected its functioning and effectiveness. Adoption of the- negative lists approach has resulted in keeping more than one-half of current trade from being affected by tariff reduction commitments made under SAFTA. Moreover, as there is no formal and binding provision requiring members to

shrink their respective negative lists by an agreed date, there is a tendency to perpetuate such lists. Secondly, SAFTA's unhurried and back-loaded schedule for tariff reduction over a 7–10 year period has also reduced the incentive for members to initiate tariff cutting in early years since the benefits from tariff reductions are likely to be realized only in later years. Moreover, SAFTA remains confined only to the trade in goods and it has not vigorously attempted to bring into its scope the trade in services and investments. In addition to such problems, the pace of trade liberalization and expansion in the region remains heavily governed by inter-state relations among SAARC members, particularly those between India and Pakistan.

Yann Duval and Chorthip Utoktham(2011) have tried to use Trade cost as a measure of progress in intra regional trade have identified that Intra-SAARC trade costs are found to be very high, amounting to two-and-a half times the Intra-ASEAN trade costs. SAARC is the only region investigated for which intraregional trade costs are not significantly lower than its extra-sub regional.

Asian Development Bank study (2009& 2012) suggests that Past conflicts and present-day tensions continue to hinder regional cooperation, such that the immense potential for regional integration—and its subsequent trade, investment, and growth opportunities—remains untapped. A significant factor that has contributed to low levels of trade in the region is the high transaction costs between countries (and within countries), despite geographic proximity. Furthermore, trade facilitation measures become vital with South Asian countries engaging in product fragmentation and entering niche markets. Trade and transport facilitation becomes vital in maintaining a smooth production cycle and in catering to shorter delivery cycles.

As per EXIM working paper(2014) these include, among others, high and escalating trade cost, including restrictive customs procedures, administrative and technical barriers; informal trade; poor intra-regional connectivity; supply side constraints and weak of productive capacity; inadequacies of trade-related infrastructure, trade finance, and trade information, which need to be addressed.

### **Conclusion:**

In sum, there exists a debate in the literature on the possible gains of SAFTA. Studies using different methodologies arrive at different results regarding desirability and feasibility of SAFTA .Quantitative studies that have estimated the impact of SAFTA have used mainly three types of models, i.e gravity models; general equilibrium models; or partial equilibrium models. The studies employing gravity models predict that the impact of a South Asian FTA will be small for India and much larger on the smaller countries. Second, amongst studies using CGE models to SAFTA, find that the unilateral trade liberalization yields larger gains than SAFTA. The third types of studies have employed partial equilibrium models conclude that liberalization would yield welfare gains through increased trade within the region.

On the whole, it can be said that the pessimism with respect to gains from SAFTA arises mainly because of lack of economic conditions for success of RTA, which are trade complementarities and differences in competitiveness of the countries. Empirical literature suggests that the existence of complementarities is needed to enhance the probability of a regional trade arrangement to be net trade-creating, rather than net trade-diverting. The statistical measures such as the complementarity index argue that the higher the observed value of the index between partners, the more likely is it that a proposed regional trade agreement will succeed.

Optimistic view on SAFTA relies predominantly on the assumption of complete elimination of tariff amongst the member states and full implementation of SAFTA terms which would result in welfare gains for the smaller member nations. South Asian economies share the advantages of contiguity, proximity, and familiarity that make regional economic cooperation and integration less troublesome, thereby not completely negating the possibility of formulating an effective RTA.

The literature also identifies certain implementation constraints which have slowed down the pace of growth of intra-SAARC trade. These include, among others, high and escalating trade cost, including restrictive customs procedures, administrative and technical barriers; informal trade; poor intra-regional connectivity; supply side constraints and weak of productive capacity; inadequacies of trade-related infrastructure, trade finance, and trade information, which need to be addressed.

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