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SAFTA Issues for weaker economies

SAFTA requires expanded coverage.

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The distribution of gains from SAFTA among South Asian countries is a matter of concern. This Issue Paper argues that regardless of whether the free trade agreement on the whole is welfare-enhancing or not, the LDC Members stand to lose out under the current framework of SAFTA. It contends that that the weaker economies suffer trade diversion and revenue loss as they open up to the region. As the LDCs have a highly concentrated export basket, even a small number of goods on the sensitive list of trading partners will reduce their gains from regional trade. The author suggests that services trade be brought under SAFTA for trade creation and welfare gains for the weaker economies. He also recommends regional cooperation on transit that will particularly help landlocked countries like Bhutan and Nepal reduce their transport costs and thereby promote their export trade.

Countries that form a regional trading arrangement (RTA) are usually heterogeneous as reflected in their size in terms of geographic area, population and gross national output, economic structure as manifested in the composition of goods and services produced and traded, and policy intervention mechanisms in place by way of fiscal and financial trade-related measures. The varied characteristics of the members greatly influence their gains from an RTA. Countries under the Agreement on South Asian Free Trade Area (SAFTA), vividly portraying their inherent dissimilarities, point towards a somewhat uncomfortable scenario of unequal distribution of potential gains from the regional cooperation scheme. While all SAFTA members are low-income developing countries, four of them, viz., Bhutan, Bangladesh, the Maldives and Nepal, are least-developed countries (LDCs) facing a number of overriding problems that constrain their economic growth and development. Consequently, to what extent these relatively weaker economies can benefit from SAFTA constitutes an important question.

TRADE DIVERSION

Research and analyses on the relative gains to individual members indicate a high probability that in a regional integration scheme involving only low-income countries (i.e. South-South cooperation), the poorest members will lose.[1] This outcome is ingrained in the comparative advantage of members relative to each other within the RTA and to the rest of the world as a whole.[2] As an example, consider the relative comparative advantages of Bangladesh and India in manufacturing. Most people would consider that India has a comparative advantage relative to Bangladesh, but not relative to the world. Under SAFTA, given the comparative advantage, India will export manufactured goods to Bangladesh and, as such, tariff preferences exchanged within the trading bloc may result in trade diversion for Bangladesh as some of the manufactures previously imported from the rest of the world will be replaced by supplies from India. But for India, there will be gains since it exports to Bangladesh under protection from competition with the rest of the world.

In addition, let us consider Bangladesh as an unskilled labour-abundant country and thereby having a comparative advantage in labour-intensive items such as readymade garments, as reflected in its exports to the rest of the world. Considering Bangladesh also has a comparative advantage in garment making relative to India, the situation becomes such that India enjoys comparative advantage in manufacturing in general, relative to Bangladesh and not to the rest of the world, while Bangladesh possesses comparative advantage in garment making relative to both India and the rest of the world. Now, under a free trade area, Bangladesh's garment exports to India will be trade creating as the latter actually imports from the least-cost supplier. However, the outcome for Bangladesh will be trade diversion as Indian suppliers replace imports from the rest of the world.

The source of gains from trade among countries is, however, different in the case of multilateral trade liberalization. The primary source of gains from such liberalization is the reduction of home tariffs, while in RTAs, it is tariff reduction by trading partners.[3] That is, the preferences to be received from partners become crucial under a regional arrangement—just like what mercantilists would want. This is because tariff concessions offered to partners are like transfer of income (in terms of foregone tariff revenues). It is likely that advanced developing members such as India will increase their exports to weaker economies once the regional preferences are exchanged, and the increase in the imports from partners amounts to trade diversion for weaker members. In this example, exporting countries will gain by receiving a better price in the markets of weaker members but the latter will lose more than what the former gain. This is because exporting countries' additional transfers result from increased exports, which are more expensive compared to the imports they replace.[4]

Two important issues determine the extent of trade diversions. Considering an extreme case, if all exports before the formation of an RTA are sourced from members within the trading bloc, there cannot be any trade diversion. However, the small volume of SAFTA intra-regional trade raises the potential for large trade diversions. About 20 percent of Bangladesh's and more than half of Nepal's imports originate from developing countries within SAFTA, mostly India.

The other important factor for a potentially large trade diversion is the relatively high most-favoured-nation (MFN) tariffs in Bangladesh and Nepal. The higher the MFN tariffs the more competitive advantage it provides to members to cause trade diversions. A recent simulation exercise shows that a SAFTA scenario of 100 percent tariff cuts by members lead to a net-welfare loss of US$184 million for Bangladesh. However, when Bangladesh cuts its MFN tariffs by 50 percent along with the full tariff liberalization for SAFTA members, it stands to gain US$84 million.[5] It needs to be pointed out, however, that even when the advanced developing members are globally efficient, high MFN tariffs would prevent weaker economies from maximizing the gains from trade creation as the suppliers may decide not to reduce their prices by the full amount of tariff preferences granted under the regional arrangement.

There have, therefore, been suggestions for SAFTA members to reduce MFN tariffs significantly. The relatively weaker economies find this option difficult. They recognize the need for providing protection to some of their domestic industries and are also dependent on the ensuing tariff revenues. It is true that if tariff concessions are to be given even to advanced members, the revenue losses cannot be prevented. However, opening up to the region could only lead to significant competitive pressure for domestic industries, particularly when countries such as India and Pakistan have a well-developed manufacturing base and produce most of the product ranges supplied from the rest of the world.

SENSITIVE LISTS

The perceived need for supporting domestic industries, along with the urgency of protecting tariff revenues, has resulted in sensitive lists that shield products from tariff liberalization. Along with LDC members, developing members too have put a large number of items on their sensitive lists. Around 25 percent of Harmonized Tariff Schedule (HTS) of Bangladesh and Nepal are on their sensitive lists, while the corresponding figures for India and Pakistan are 14 and 23 percent, respectively.[6] The presence of such large proportions of products on the sensitive list somewhat undermines the regional cooperation initiative in South Asia. As the export baskets of

LDCs lack diversity, even a small number of goods on the sensitive list will reduce their gains from regional trade.[7] Besides, the issues of non-tariff and para-tariff barriers are also prominent in South Asia.

SERVICES

SAFTA is built on trade in goods, though services can also lead to trade creation. South Asian countries, particularly India, are likely to have a clear comparative advantage in services trade over the rest of the world. Opening up areas such as health, education, tourism, information technology, and electricity generation and cross-border transmission (generally considered to be non-tradable services) can also lead to welfare gains for the weaker economies.

It is widely recognized that much of the services trade involving education and health takes place through informal channels.[8] Liberalization in these sectors will enhance consumer welfare with the scope of trade diversion being extremely low. Most South Asian countries are endowed with natural conditions ideal for tourism. Bhutan, India, Nepal and Sri Lanka, in particular, are popular tourist destinations, and an effective and extended regional cooperation may result in large gains, including for Bangladesh where tourism is not as significant.

TRANSIT TRADE

Another potential area of cooperation is transit trade. While transit through Bangladesh will help integrate North-Eastern Indian provinces well into the Indian economy, for landlocked countries like Bhutan and Nepal, access to ports in Bangladesh through the Indian territory can promote their international trade. Geographical location is now considered to be an important determinant of international trade and, for landlocked countries, transport costs have been shown to be excessively high, thereby undermining their trading potential.[9] Against this backdrop, regional cooperation can lead to enormous benefits for the landlocked South Asian countries. Also, when the issue of transit trade is kept out of the regional arrangement initiative, it means that one important area of natural comparative advantage for the countries in the region is overlooked.

INVESTMENT

It is often argued that enhanced SAFTA cooperation will lead to the flow of investment from relatively stronger economies to weaker ones. However, it needs to be pointed out that if the relatively advanced developing country suppliers can make supplies available to the regional centres by producing goods from their own countries, investment flow may not necessarily take place. Also, within the region, there could be a greater tendency of investment being concentrated in places traditionally known to be commercial centres, particularly when wages in different South Asian countries do not differ much. This is true both in the case of investment flow originating within the region as well as from outside South Asia. There are empirical findings suggesting that regional integration, on average, contributes to attracting foreign direct investment, but the benefits are unlikely to be distributed evenly.[10]

CONCLUSION

The existing literature and empirical evidence seem to suggest that weaker economies within a South-South RTA are likely to lose out irrespective of whether the regional arrangement on the whole is welfare-enhancing or not. Trade diversion is the principal cause of this adverse implication for the poorer countries. When stronger economies tend to replace most imports from the rest of the world for a weaker economy, foregone revenues coupled with trade diversion become the worst consequences for the latter. While protection for some domestic industries and the need for tariff revenues have resulted in a list of 'sensitive products' for members, the depth of the product range 'not-for-liberalization', along with the existing behind-the-border measures, greatly restrict the scope of intra-regional trade flows. Downward adjustment of MFN tariffs can reduce the scope of trade diversion for weaker economies, but it is difficult for these countries to switch to other fiscal instruments for raising revenues.

Therefore, SAFTA, as it stands today, probably remains a paradoxical means for achieving development for LDCs of the region. To exploit maximum benefits out of the RTA, greater cooperation involving services and transit trade should seriously be taken into consideration. Also, there has to be political will on the part of the advanced developing members for ensuring that the weaker economies do benefit from the regional integration process. This would require providing generous treatment to all LDC goods immediately, including those in the list of sensitive products.

Advanced developing countries, in collaboration with their weaker counterparts, may also devise fiscal and financial incentive packages so that regional and international investors find it attractive to invest in the latter countries. On the other hand, the LDC members of SAFTA should continue with their concerted efforts, in terms of policy reforms and addressing supply-side bottlenecks, so that they can benefit from a bigger regional market. In fact, South Asian countries will have to be involved in a far more extended cooperation if the poorest among them are to make use of SAFTA for their economic growth and development. ■

ENDNOTES

1 The empirical literature suggests that RTAs involving relatively high-income countries promote convergence of per capita income levels. Ben-David (1993, 1996), for example, showed that within the European Union (EU) lower-income countries (such as Ireland, Portugal and Spain) registered a more rapid growth than the larger and richer countries. On the other hand, Venables (2003), referring to the East African Common Market, among others, as an example of South-South integration, pointed out how the greater divergence within the members eventually led to the collapse of the cooperation scheme. In general, North-South trading blocs that involve the rich industrialized and poor countries are regarded as beneficial to the poorer countries.

2 An illustration of this can be found in Venables (2003), based on which the South Asian example is drawn.

3 This is well-demonstrated in Panagariya (1998).

4 A numerical illustration of this point can be found in Hoekman *et al.* (2002).

5 See Raihan and Razzaque (2007).

6 SAFTA members make a distinction between sensitive items for LDC and non-LDC members. For example, India's sensitive items for non-LDC members comprise about 17 percent of its HTS as against 14 percent for LDCs. Among others, Bhutan and the Maldives (which are LDCs) currently consider, respectively, 3 percent and 13 percent of their product range to be sensitive. The other developing country, Sri Lanka, has included about 20 percent of its tariff lines in the negative list (Raihan and Razzaque 2007).

7 This has become particularly evident since the conclusion of the 2005 World Trade Organization (WTO) Hong Kong Ministerial. Many analysts view that the duty-free access for 97 percent of LDCs' tariff lines does not mean any meaningful market access given the high concentration of their exports on a few items. In light of this, the depth of the sensitive lists of SAFTA members is most likely to severely restrict the trading capacity of the LDCs.

8 Rahman (2000) finds that annual payments made by Bangladeshi nationals to access education and health services in India could be about US$100 million, an overwhelming proportion of which goes unrecorded in the official balance of payments.

9 According to Redding and Venables (2004), *ad valorem* transport costs of 20 percent on both final output and intermediate goods can reduce the domestic value added by 60 percent when intermediate goods account for 50 percent of costs. The implication is that due to unfavourable geographical location, some countries will experience much lower gains from trade, and foreign firms might be reluctant to move or relocate their production to those countries that are far from their main export markets even when wages in those countries are low.

10 For example, see Yeyti *et al.* (2003).

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South Asia Watch on Trade, Economics & Environment (SAWTEE) is a regional network that operates through its secretariat in Kathmandu and 11 member institutions from five South Asian countries, namely Bangladesh, India, Nepal, Pakistan and Sri Lanka. The overall objective of SAWTEE is to build the capacity of concerned stakeholders in South Asia in the context of liberalization and globalization.

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