How Promising is SAFTA?

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1. Introduction

Despite the rise in multilateral trade during the last two decades, regional trading agreements (RTAs) have gained increased prominence. Repeated failures of multilateral negotiations, especially at various ministerial meetings of the World Trade Organization (WTO), has led to an increase in the number of RTAs. Also, increased internationalization of markets (i.e., globalization) and the fear of losing out to other inefficient producers have put pressure on individual countries to become part of any RTA. The South Asian Free Trade Area (SAFTA) covering an area consisting of seven countries, namely, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, is an RTA that has come into force with effect from 1 July 2006 after prolonged deliberations.

The purpose of this policy brief is to analyse whether SAFTA is likely to emerge as a success story in terms of greater flow of goods and services in the South-East Asian subregion. We base our analysis on a few economic criteria of the SAFTA member countries. These economic factors are essential for sustaining a successful FTA.[1]

2. Why more trade?

Success of an FTA is measured in terms of increased flow of goods and services. The more the economies trade among themselves, the greater the tendencies for further economic

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[1] There are four different forms of regional trading agreements, namely, FTAs, custom unions, common markets and economic unions. In forming an FTA, members remove trade barriers among themselves but keep their separate national barriers against trade with outside nations. In a custom union, members not only remove trade barriers among themselves but also adopt a common set of external barriers. In a common market, members allow full freedom of factor flows (migration of labour and capital) among themselves in addition to having a common union. In an economic union, members unify all their economic policies, including monetary, fiscal and welfare policies, while retaining the features of a common market.

integration. Since trade affects growth, a greater flow of goods and services is likely to see less opposition in the way of economic integration.

Trade affects growth in three primary ways. First, trade encourages the flow of resources from the low productive sectors to high productive sectors, leading to an overall increase in output. Export growth may affect total productivity growth through dynamic spillover effects on the rest of the economy (Feder, 1983). The possible sources of this positive dynamic spillover include more efficient management styles, better forms of organization, labour training and knowledge about technology and international markets (Chuang, 1998). Second, with unemployed resources, an increase in export sales leads to an overall expansion in production and a fall in the unemployment rate. As production increases, because of increases in the scale of operations (economies of scale), firms become more efficient (Helpman and Krugman, 1985). Third, international trade also enables for the purchase of capital goods from foreign countries and exposes an economy to the technological advances of the developed countries. Recent theoretical work suggests that capital goods imported from technologically advanced countries may increase productivity and thereby growth, since knowledge and technology are embodied in equipment and machinery and therefore transferred through international trade (Chuang, 1998).

3. Criteria for a successful FTA

Despite these positive aspects, free trade is opposed mainly because workers and producers associated with the inefficient industries stand to loose out. Considerable lobbying pressure is applied by the inefficient producers who demand more protection. As tariffs are not allowed under an FTA framework, individual Governments try to protect their respective economies by imposing non-tariff barriers (NTBs), such as antidumping measures, import licences and sanitary standards. The answer to a successful FTA therefore lies in controlling those factors which act against FTAs, and nurturing the factors which help in forming and sustaining an FTA. Some of the factors that affect the formation of an FTA are considered below.

Intra-industry trade: An FTA is more likely to be formed when trade happens in similar commodities, that is, intra-industry trade. The likelihood that industry association will demand more protection is less in cases of intra-industry trade. In the presence of intra-industry trade (for example, India exporting Tata Indica cars to the United States and at the same time importing Ford cars from that country), adjustment costs associated with removing trade barriers are lower. In this case, jobs lost due to customers shifting to more efficient foreign suppliers may, to a large extent, be offset by job-enhancing expansion in foreign demand for similar, differentiated goods produced domestically. The political opposition to liberalizing and expanding intra-industry trade tends to be far less when compared with trade involving dissimilar items, that is, inter-industry trade.

Economic characteristics: Economies that are similar in terms of size are better candidates for forming an FTA. Similarities are measured in terms of economic development and geographical proximities. The more similar are the economies, the greater is the likelihood of intra-industry trade. This is because geographically close economies with similar levels of economic development have access to similar kinds of technology. Consequently, they tend to produce more or less similar items and tend to trade in similar commodities (closely differentiated products as in the monopolistic competition type market structure). As the literature on the gravity model of trade demonstrates, similarities in economic structure and geographical distance between respective economies are powerful determinants of trade (Linneman, 1966; Frankel, 1997). Trade increases with economic size and the proximity of the trading partners.

Prices: Low technology intensive items, such as leather footwear, garments, gems and jewellery and textile products, which are typical of any developing country's export profile, are very sensitive to movements in price, i.e., they are price-elastic. When it comes to forming an FTA, countries analyse whether such an arrangement would enable them to realize a greater demand for their exports. From the demand-side perspective, it can be argued that sustained demand growth cannot be maintained in a small domestic market, since any economic impulse based on expansion of domestic demand is bound to be exhausted. However, export markets do not exhaust quickly. FTAs not only provide a platform for a greater market share but also enable countries to produce efficiently. As the literature on monopolistic competition suggests, a way to produce exports competitively is to take advantage of economies of scale in production, which can be realized from a greater market share resulting from an FTA (Helpman and Krugman, 1985; Leamer, 1984).

Government policies: More liberal government policies are likely to be beneficial for an FTA. There is a general consensus in the literature that trade volume, for both exports and imports, increases following external sector liberalization (Agosin, 1991; Kohli, 1991). Higher trade volume, resulting from external sector liberalization, is expected to increase the likelihood of FTA formation.

4. How well SAFTA members fit these criteria?

Given the discussion about the aforementioned criteria necessary to form an FTA in general, it is of interest to examine the future prospects of SAFTA.

Economic characteristics: When comparing in terms of economic structure, namely, savings as a percentage of GDP, demographic profile and labour mobility, SAFTA member countries have many similarities (see table 1). The industrial sector constitutes roughly a fourth of GDP in all countries, while the share of agriculture varies from 20.1 per cent in Sri Lanka to almost 40.8 per cent in Nepal. Although a majority of the population still lives in rural areas, all of these countries are becoming increasingly urbanized. Except for the Maldives, saving as a proportion of GDP is also similar across these countries. These countries also share a similar demographic profile. The more similar are the economies, the more similar is their export profile. Greater economic cooperation among SAFTA members holds important implications in the form of larger market and economies of scale in production. These factors might act as further incentives for the smooth functioning of SAFTA.

Table 1. Economic structure of SAFTA member countries, 2004

Characteristics	*Bangladesh*	*Bhutan*	*India*	*Maldives*	*Nepal*	*Pakistan*	*Sri Lanka*
Agriculture, value added (% of GDP)	21.04	33.23[a]	21.13	NA	40.28	22.35	17.81
Industry, value added (% of GDP)	26.60	39.47[a]	27.15	NA	23.04	24.93	26.79
Fertility rate (total live births per woman)	2.99	4.18	2.88	4.11	3.54	4.31	1.94
Foreign direct investment, net inflows (% of GDP)	0.79	0.15	0.77	1.95	0.26[a]	1.16	1.26
GDP growth (annual %)	6.27	4.90	6.90	10.81	3.47	6.38	5.36
Infant mortality rate (per 1,000 live births)	56.40	67.40	61.60	35.40	58.60	80.20	12.00
Population aged 0-14 (% of total)	35.91	38.93	32.49	41.32	39.49	38.86	24.45
Population aged 15-64 (% of total)	60.53	56.52	62.32	55.22	56.89	57.32	68.42
Population aged 65 and older (% of total)	3.32	4.11	5.03	3.83	3.78	3.32	6.50
Rural population (% of total population)	75.37	91.17	71.47	70.73	84.58	65.54	78.95
Gross saving (% of GDP)	30.56	NA	22.87	36.04	26.80	23.05	18.63

Source: World Bank, World Bank Development Indicators, available at: <http://publications.worldbank.org/WDI/>, accessed in September 2006.

[a] Figures for the year 2003.

Trade: Trade in the SAFTA region is currently low. There are reasons for lower intra-SAFTA trade. Most of the SAFTA member countries have a lower trade-GDP ratio and have initiated external sector liberalization (that is, bringing down tariff barriers), starting only in the 1990s. A large number of NTBs currently exist in the region. These NTBs include antidumping measures, procedural requirements, sanitary and phytosanitary standards, certification and technical standards (Banik, 2001). The encouraging point is that most of these economies have started to open up and have also registered healthy GDP growth. During the period 2003-2004, all SAFTA countries, except Nepal, witnessed strong economic growth in the range of 5-9 per cent as well as 4-5 per cent per capita GDP growth. As McCombie and Thirlwall (1997) and Paulino and Thirlwall (2004) pointed out, robust economic growth encourages a more liberalized trade regime. With a similar export profile, trading partners are better off with less restrictions. Because countries in the SAFTA region share a similar export profile they also face the same types of NTBs; hence, they share a similar negotiating stance for removing these barriers. Recent trade data suggest that intra-SAFTA trade is on the rise. Most of the Governments in SAFTA are undertaking considerable external sector liberalization (ESCAP, 2006). Therefore, there are indications that the currently low level of intra-SAFTA trade is likely to flourish in the future.

Symmetry in economic activity: South Asian countries exhibit symmetric economic activity (Banik, Biswas and Saunders, 2006). Symmetric economic activity implies that long-run movements in real output are synchronized. Such co-movements of outputs may be due to the dependence of common factors such as geographical proximity and similar industrial profile. When countries share a similar industrial profile and are located closely, then the demand shocks in one country may affect other countries in the region. This could also arise if these economies all share a common trade linkage with major import markets. For example, if all of these countries engage in trade with the European Union, then changes in the European Union's economic performance would have a similar effect on all the countries concerned and cause them to behave synchronously. In this case, economic trends would become more similar because all the sectors and therefore all the countries would be affected in a similar way. Another reason for the presence of common economic trends and hence co-movements of output could be explained through intra-industry trade. As far as the trade structure is representative of the output structure, the cycles should become more synchronized because they would be affected by common shocks. This is the argument of Kenen (1969) who stated that when countries trade in similar commodities, this increases the synchronicity of their output. Countries in South Asia in general have a similar export profile. Symmetry in economic activity also implies that there is a lesser contradiction in terms of formulating internal and external macroeconomic policies. In fact, this aforementioned economic characteristic of South Asian countries will enable them to go beyond the FTA framework and work for deeper economic integration, such as forming a common market and economic union.

5. Challenges

The challenges in the way of deeper economic integration in South Asia arise from the fact that currently there exists a lack of complementarities in tradable items produced in this region. Despite reforms in the external sector, trade among South Asian countries is still restrictive, especially considering the sectors where opportunities for trade exist (Ghani and Din, 2006). The comparative advantage of these countries lies in the low technology intensive items such as agricultural products, leather footwear, textile and clothing. As the level of economic development in some regions, such as Nepal ($241) and Bangladesh ($395), is still low, the proportion of income spent on differentiated products is less and intra-industry trade has yet to pick up. Besides, India share a porous border with Bangladesh and Pakistan, giving rise to a considerable amount of cross-border smuggling. In addition, further inroads towards smoother functioning of SAFTA are not being made, as the current framework does not cover trade in services. Unfortunately, no comprehensive economic cooperation agreement (CECA) exists between India and any of its South Asian neighbours that will allow trade in services to pick up in this area. Coming up with a CECA is necessary in view of the fact that about 50 per cent of the value added to South Asian GDP originates from the services sector.

6. Conclusion

As is evident from the above discussion, the SAFTA region has many characteristics for sustaining a successful FTA. We based our analysis on a few economic criteria. In general, we found that there are favourable indications for the SAFTA economies to flourish into a successful RTA. In fact, South Asian countries have many characteristics that would enable them to go beyond the FTA framework and work for deeper economic integration, such as the formation of a common market and economic union. However, this would be conditional upon working on the current challenges facing South Asian countries. Formation of an FTA would be expected to create relative advantages for the member countries. Greater economic cooperation among SAFTA members holds important implications in the form of a larger market, economies of scale in production and improved resource allocation.

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