Chapter 1

INTRODUCTION TO GLOBAL TRADE AND TRADE BLOCS

1.1 INTRODUCTION

The world today is more unified and global than ever before. Gone is the time when countries were trading partners first with their neighbours and then with far-off countries. Today when a country trades with other countries it's more on a global scale where it has to compete against every other country in trying to capture new markets and retain its current exportable markets. With this increased globalisation and trade, countries have joined strategically so as to work together to have the maximum benefits from trade. This has given rise to groups of countries forming a trading bloc of their own. Slowly over time these trading partners came to realise the full potential of their partnerships. As a result, this gradual economic and trade integration was joined with political stability and unification.

Today, there are a number of region-based trading blocs worldwide. The largest and the most successful of these blocs both economically and politically is the European Union followed by NAFTA, MERCOSUR and ASEAN.

1.2 THEORY OF ECONOMIC INTEGRATION

A Hungarian economist named Béla Balassa wrote the theory of Economic Integration in the 1960's. The term Economic Integration is used to describe how different aspects between economies are integrated. As economic integration increases, the barriers of trade between trading markets diminishes. The most integrated economy that truly exemplifies this theory is the European Union and its Euro zone. The degree of economic integration can be categorised into six stages.

1.2.1 Preferential Trading Area (PTA)

This is a trading bloc, which gives preferential access to certain products by reducing tariff but not abolishing them completely. Preferential Trading Area is established through trade pact. For SAARC this agreement is better known as SAARC Preferential Trading Agreement.

1.2.2 Free Trade Area (FTA)

This is for a trading bloc, which has agreed to eliminate tariffs, quotas and preferences on most goods between the members of the trading bloc. This is the result of Free Trade Agreement signed between individual nations or larger trade blocs. For SAARC this agreement is better known as South Asian Free Trade Agreement (SAFTA). A point to be noted here is that though the SAARC countries are signatories to the SAFTA, they may still have separate Free Trade Agreement within themselves, for example, India-Sri Lanka Free Trade Agreement. A Free Trade Area is thus a region in which obstacles to unrestricted trade have been reduced to a minimum.

1.2.3 Customs Union

A Customs Union is a Free Trade Area with a common external tariff. The countries that are members to such a trade pact set up a common external trade policy but may in some instances have different import quotas. Establishing such a trade pact helps to enhance economic efficiency and establish closer political and cultural ties since this pact is not based on trade between the member countries but on the external trade facilities they can enjoy together. SAARC is yet to implement such a plan. Current examples include the European Union and MERCOSUR.

1.2.4 Common Market

A Common Market (sometimes called the Single Market) is a Customs Union where policies on product regulation, freedom of

movement of factors of production, etc are implemented by all member states based on common thinking and policy making. It tries to envision more efforts geared towards removing the physical borders, technical standards, fiscal barriers, etc from among the member states. To implement such a policy the members need to formulate common economic policies. The Common/Single Market is currently enforced only in European Union and CARICOM.

1.2.5 Economy and Monetary Union

This is an advanced form of the Common Market where economic union is added with monetary union, i.e., a single currency between nations. An Economy and Monetary Union is established through a currency-related trade pact. An example of such a union is again the European Union.

1.2.6 Complete Economic Integration

This is the final stage of Economic Integration. This involves synchronisation of all economic policies and development of a supranational state that takes decision on behalf of all member states. As can be seen, completion of this stage is highly improbable. The only practical example that can be seen is the United Kingdom, where there is full integration between England, Scotland, Wales and Northern Ireland. But then again if we take the example of European Union, all members of the EU are democratic and thus haven't reached a stage where they can rely on their representatives in the EU Parliament to make common policies for all of EU. Work on a common constitution started for all of EU but it failed amid protests and difference arising out of various issues. In the next page, the Figure 1.1 shows different degrees of economic integration and Table 1.1 shows the current situation of the different trading blocs and where they stand in regard to reaching economic integration.

1.3 SOUTH ASIAN ASSOCIATION FOR REGIONAL COOPERATION (SAARC)

The SAARC was formally inaugurated as an association of seven states on December 1985. It was initially established as a regional cooperation in five distinct fields, namely agriculture, rural development, telecommunications, meteorology and health and population activities. Today this cooperation has expanded to encompass more activities including trade.

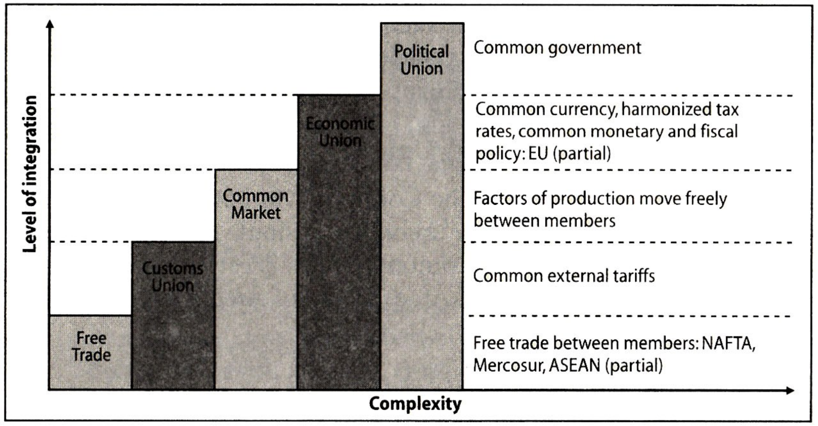


Fig. 1.1: Degrees of Economic Integration

Table 1.1 Current Scenarios of the Trading Blocs

Regional Bloc	Free Trade Area	Customs Union	Common Market	Economy & Monetary Union
EU	In force	In force	In force	In force
CARICOM	In force	In force	In force	In force
AEC (AU)	In force	In force	Proposed (2009)	Proposed (2009)
CSN	Proposed (2014)	Proposed (2014)	Proposed (2019)	Proposed (2019)
GCC	In force	In force	In force	Proposed (2010)
NAFTA	In force			
ASEAN	In force			
SAARC	In force			
EurAsEC	Proposed (2019)	Proposed (2019)	Proposed (2023)	
CACM	Proposed (2019)	Proposed (2019)		
PARTA	Proposed (2012)			

It may be mentioned that according to Article I of the SAARC Charter, the objectives of the Association shall be: (i) to promote the welfare of the peoples of South Asia and to improve their quality of life; (ii) to accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realise their full potential; (iii) to promote and strengthen collective self-reliance among the countries of South Asia; (iv) to contribute to mutual trust, understanding and appreciation of one another's problems; (v) to promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields; (vi) to strengthen cooperation with other developing countries; (vii) to strengthen cooperation among themselves in international forums on matters of common interests; and (viii) to cooperate with international and regional organisations with similar aims and purposes.

SAARC as an organisation has been comparatively slow in taking advantage of the various benefits that usually comes with the establishment of such organisations. One of the primary reasons has been the political tension that lies between the member states including India, Pakistan, Bangladesh and Nepal. There has been numerous occasions when India had problems with the latter three nations in a political scale. Concurrently, this political instability has slowed the process for economic integration and a more success at the regional cooperation.

Recent years have seen an improvement for SAARC as a whole. Political stability between nations and easing of tension have helped to realise many of the aims that are slowly starting to have positive effects on the member states. Looking at such developments over the history of SAARC, the following paragraph may bear testimony to the aforesaid view:

- The seventh SAARC summit in 1993 was marked by an agreement by the member states to liberalise trade between the member nations, namely, the SAARC Preferential Trading Agreement.
- In December 1995, the SAPTA was formally put into operation after the completion of talks between member states. SAPTA carried with it preferential tariff concessions to

promote and sustain mutual trade and economic cooperation among member states.

- In January 2004, an agreement was reached at the twelfth SAARC summit regarding the framework for an agreement on the South Asian Free Trade Agreement (SAFTA). This would help to further reduce tariff between the SAARC members, ultimately bringing it down to 0% customs duty on practically all products of the region by end of 2012.
- In January 2006, the SAPTA was transformed into SAFTA. All participating members ratified and signed the agreement in July 2006. This agreement is seen as just one more step to a full-fledged South Asia Economic Union.
- In April 2007, during the 14th SAARC summit two important proposals were made. The first was to initiate a common passport for SAARC countries that can be extended to visa-free access. The second was to commence a common currency among SAARC countries. By introducing a common currency the people of South Asia will be relived from the hegemony of foreign monetary policy. During this summit there was an agreement to establish a South Asian University whose campus will be located in New Delhi, India. Also, in order to prevent the scarcity of foods in critical situations the countries agreed to establish a SAARC food bank.
- In August 2008, the 15th SAARC summit was held in Colombo, Sri Lanka. In Colombo declaration the significant agreements were to help each other protect against terrorism, establish SAARC development foundation and South Asian Regional Standard Organization. Moreover, the newest member of SAARC, Afghanistan was included in SAPTA.
- The 16th SAARC was scheduled to be held in the Maldives. But because of the global financial crisis the country showed disinclination. Later on, Bhutan had agreed to be the host country for the 16th SAARC Summit which was held in Thimpu, Bhutan on 28th to 29th April, 2010.

1.3.1 SAFTA Agreement

The Framework Agreement on South Asian Free Trade Area (SAFTA) was signed in January 2004 during the SAARC Summit

in Islamabad. It was planned that from January 2006, members would begin implementing the agreement by phasing out tariffs over a period of 10 years. Of particular note here is that tariffs will be reduced in two phases from present levels to 0-5 percent, with least developed countries (defined in SAFTA to include the Maldives) having a longer period to phase in the lower rates. Under Article 7.1c, Sri Lanka is afforded six rather than five years to reduce tariffs from 20 percent or below to 0-5 percent. Under Article 12, Maldives will continue to be treated as an LDC even if it graduates from LDC status.

The implementation of the SAFTA agreement, as it now stands could be hindered and its possible benefits weakened by a number of issues and problems: sensitive lists, poor regional infrastructure, inconsistencies with other agreements, trade facilitation problems, and non-tariff barriers. Note also that India's size and geographic reach greatly influence trade arrangements in SAARC. India shares borders with all SAARC countries, except Afghanistan, Maldives and Sri Lanka — but is closer to all three than other countries in South Asia. India's bilateral trade agreements with four SAARC countries cover trade and other areas of economic cooperation. It is a member of all regional and sub regional groupings that include other SAARC members, accounts for a large share of intra-regional trade, and is the major trading partner for most SAARC members. Thus, most trade-related issues involve India.

The landlocked countries of Nepal and Bhutan conduct no significant trade with SAARC members other than India and Bangladesh, and the Maldives is far from other SAARC members. Transport between capitals is limited and movement of persons is restricted. In fact, some business meetings occur in Dubai to avoid travel and visa procedures. Sri Lanka and Maldives, however, do provide visas on arrival.

SAFTA member states have committed to a ten-year phase out of tariffs beginning in January 2006. Reductions will proceed in two stages as delineated below but at a different pace for the Least Developed Members (LDM) and Non-Least Developed Members (NLDM).

In the first two years:

- LDMs will reduce tariffs to a maximum of 30%. Tariffs already below 30% will be reduced by 5% annually.
- NLDMs will reduce all tariffs to a maximum of 20%. Tariffs already below 20% will be reduced by 10% annually.

In the second phase of implementation

- LDMs will reduce tariffs to between 0 and 5% over 8 years at a rate of no less than 10% annually.
- NLDMs will reduce tariffs to between 0 and 5% by the third year for products from LDMs and over 5 years for the remainder at a rate of no less than 15% annually. Sri Lanka is allowed 6 years to complete this phase.

Inter-regional trade under SAFTA is unlikely to begin immediately, as the member countries are yet to prepare specific rules for individual products under the rules of origin that determine tariff line. Besides, the trade disputes between India and Pakistan and non-issuance of customs notification for SAFTA implementation by four of the seven countries of the south Asian regional forum may delay trade under the South Asian Free Trade Area deal. It is estimated to take some time to make specific rules for individual products for all the member countries. Without the settlement of rules of origin it is not possible to kick-off inter-regional trade in the bloc. As per the SAFTA, a rule of origin paper determines the origin of goods of a member country, which shall apply to products eligible for preferential treatment under the deal. Thus although SAFTA's trading programme has begun on papers on the onset of July 2006, it will take some time to actually come into effect.

This delay arose when Pakistan refused to grant a Most Favoured Nation (MFN) status to India, though it reached a decision on trading with India on the basis of a small list of 773 items. When asked about the reasons why such disputes arise before implementation of the free trade deal, SAARC officials stated, "The SAFTA agreement was prepared hurriedly. So, there were many issues with going ahead with the agreement." Separation of tariff reduction procedure for (LDM) and (NLDM) countries may

cause another dispute to the trade liberalisation programme under SAFTA.

Earlier, three other member-countries including Bangladesh, India and Pakistan had already issued their tariff concession notification on June 29, 30 and July 1 respectively. As per the notification, Bangladesh has given 2.50 percent tariff concessions on 4741 products, defined at 8-digit level for the first two years, to least developed and developed countries. India has allowed 33.33 percent tariff concession on 4481 products for Least Developed Countries (LDC) and 10 percent tariff concession for non-LDM. However, the notification India should allow duty-free access to 8 million pieces of garment products for Bangladesh is yet to be issued.

After 2006, SAARC member countries will allow preferential treatment not only to specific products but will gradually withdraw duties on all products those included in the reserved or sensitive list. The time frame for such withdrawal will be different from country to country. Non-Least Developed Members, (NLDM) such as India, Pakistan and Sri Lanka were agreed to complete the processes of duty withdrawal by 2008. In contrast, as least developed members, Bangladesh, Nepal and Bhutan will complete such process within ten (10) years, by the end of 2015. Rate of reduction of duty will also vary so that the LDMS do not lose much as regards revenue generated from duty. As per contract, the LDMs will reduce duty at 2.5% per year while the NLDMs will reduce at 5% per year.

Consequently the entire gamut of the environment may turn congenial for developing a duty free region in Asia like that of the European Union, or at the least, like that of ASEAN. As a result external trade is expected to rise and production in different sectors may increase manifold to cater to the needs of the expanded market. At present, except India, all SAARC Countries are constrained to expand their industrial production due to the limited size of market, thus cannot harvest the fruits of economies of large scale production and therefore cannot reduce their cost of production.

It is an obvious fact that to be competitive, there is no alternative to large scale production. Although, the SAARC countries are engaged in producing more or less similar products, the comparative advantage differs based on the level of development. This difference mainly originates from difference in the wage rates. As compared to India, Pakistan and Sri Lanka, the wage rate is lower in almost all sectors in Bangladesh, Nepal, Bhutan and Maldives.

Therefore, if duties are reduced or done away with completely, the products from labour intensive industries of LDMs may get access to India, Pakistan, and Sri Lanka. In comparison, technology based capital intensive industries in India, Pakistan and Sri Lanka can export their products to the LDMs. This may also help SAARC countries to channel their "investable" resources to sectors/products, in which they have comparative advantage and this in turn, will have a positive impact on production, technology and per capita labour productivity in the whole region. Consequently, GNP and per capita income of the member countries will rise. What has been narrated above relate to the prospects of duty free region. Whether these prospects can be transformed into reality will depend on the sincerity, integrity of purpose and importance attached with taking of necessary and appropriate steps to strengthening the SAARC by the member countries.

As per contract all member countries should take concerted efforts and the necessary measures to implement the agenda of SAFTA at the same speed and time. Otherwise, due to mutual mistrust everything will turn into a fiasco.

Intra-regional trade among SAARC countries is only 2.5% of their total trade, so there is tremendous scope of increasing such trade, at the same time the impediments confronting such trade should be sorted and necessary steps be taken to remove them.

If there is no consensus of opinion between Pakistan and India as regards to reduction or withdrawal of duties the other member countries cannot enjoy the benefits of SAFTA because duty withdrawal is applicable to all the member countries. Although 1st July has elapsed, neither Pakistan nor India has published any gazette notification reducing duties. Pakistan has declared that it will not allow any duty concession to any Indian product until settlement/resolution of the existing political problem between them. Pakistan wants to carry on with its external trade with India

with 722 items of products as it had been done earlier, without granting the state of most favoured nation to India. India may follow the suite making SAFTA virtually a non-operational institution.

The most predominant factor to make SAFTA non-operational is India's over sensitivity to protect its own products. Imbued with this conservative spirit, India imposes a myriad of non-tariff barriers to the products of other SAFTA members. If these non-tariff barriers are not removed, only concessional/withdrawal of duty cannot bring forth any desired result. Non-tariff barriers like standardisation certificates, health certificates and the like, imposed by India, act as hindrances towards exporting of duty free goods to India.

Bangladesh had been facing serious problems in exporting many products to India due to such non-tariff barriers. Besides, the possibility of imposition of countervailing tax by India cannot be underrated. Imposition of such tax on *Hilsha* fish, *Sarees*, hides and skim ceramic products by India impedes the progress of Bangladeshi export to India over and above. Export of dry cell battery and other products to India has come to a halt due to institution of anti-dumping suit by India. It may deserve mentioning here that in 2005-06, India's export to Bangladesh literally doubled in comparison to 2002-2003 while Bangladesh's export to India had been halved within the same period.

As an importer of Indian products, Bangladesh ranks as the 7th largest destination. If informal trade is taken into account, it is the third largest market for India. Hence, imposition of tariff barriers to restrict Bangladesh's export to India is not only unjust and in-expedient but also unethical.

So, duty concessions or withdrawal, although necessary, is not sufficient for free and expanded trade regime. All other blocks and barriers need to be removed simultaneously. Conservative mentality of India, along with imposition of political pre-conditions by Pakistan, may not make it possible to increase the intra-regional trade to US$1400 crores by 2010 from the current level of US$700. Bangladesh does not stand to gain too much from SAFTA, due to its narrow export base and absence of necessary production. But what is the harm in dreaming of a better future?

1.4 INTRA-REGIONAL TRADE IN SAARC

South Asia, home to more than one-fourth of the world's population, remains Asia's most backward region in terms of economic and human development. The South Asian region (India, Pakistan, Bangladesh, Nepal, Bhutan, Sri Lanka, Maldives and Afghanistan) have been growing at over 6% annually in the past ten years. As existing or acceding members to the WTO, South Asian countries have undertaken significant liberalisation of their economies, including external trade policies. This has resulted in a substantial increase in the trade openness index (trade as a share of GDP) for the region. However this overall picture conceals an important element, the low intra-regional trade among the countries. After spending many years forming the South Asian Agreement for Regional Cooperation (SAARC) with trade as a key ingredient, South Asian countries trade substantially less among themselves than that with countries outside the region. Intra-regional trade accounts for less than 4% of the region's total trade, and this share is even lower for Pakistan and India, the two largest economies in the region. As a stark contrast, the trends in nearly all other regional groupings, such as ASEAN, NAFTA and EU, intra-trade accounts for 23 (ASEAN) to 60% (EU) of total trade by these regions.

Trade in the SAFTA region is currently low (Table 1.2 and Table 1.3). According to Newfarmer and Pierola (2006) South Asia's intra-regional trade as a percentage of its total trade volume has barely changed from around 2% in 1980 to 3% in 2004. Exports from South Asia have increased from only US$17 billion in 1980 to US$120 billion in 2004, in contrast to exports in East Asia growing from US$80 billion to nearly US$1 trillion within the same period. Considering factors other than trade costs (something we will be dealing with later), lower intra-SAFTA trade can be attributed to a number of reasons.

Low purchasing power is a key factor that resulted in a smaller regional market. Although one of the fastest growing regions in the world (GDP growth rate averaging around 7% over the last two years), measured in terms of per capita GDP (adjusted for PPP) these economies are quite small. For instance, until 2001, South Asia housed one-fifth of the world's population but contributed less than one twentieth of the world income in terms of GDP

Table 1.2 Intra-regional Total Trade, 2004 (in US$ Million)

	Bangladesh	Bhutan	India	Nepal	Maldives	Pakistan	Sri Lanka
Bangladesh		0.23 (0.14)	105.21 (127.87)	0.066 (0.129)	0.017 (0.402)	44.663 (142.37)	10.21 (9.57)
Bhutan*	0.49 (0.69)		109.51 (135.94)	0.596 (0.558)	–	–	0.003 (0.002)
India	1.59 (58.75)	83.88 (70.40)	–	736.91 (342.88)	42.18 (0.57)	505.07 (91.95)	1344.1 (361.31)
Nepal*	6.11 (4.85)	1.37 (0.568)	341.80 (954.91)	–	–	994.25 (3.30)	1.19 (1.99)
Maldives	(0.01)		0.457 (65.83)	–	–	. (220.0)	15.12 (68.46)
Pakistan	197.65 (45.08)	0.351 (0.379)	158.34 (454.41)	3.04 (3.71)	1.94 (0.061)	–	134.70 (45.66)
Sri Lanka	13.38 (7.71)	0.011 (0.0001)	385.80 (1360.08)	0.275 (0.078)	60.08 (19.84)	39.25 (108.06)	–

Note: *Figures are for year 1999; Numbers in brackets are net imports while those outside brackets are net exports.

Source: Comtrade Database, United Nations Commodity Trade Statistics Database.

Table 1.3 Total Trade (in US$) of South Asian Countries, 2004

Country	Import	Export
Bangladesh	11,372,744,850	8,267,482,023
Bhutan	182,077,408	115,950,052
India	108,247954,259	79,834,064,105
Maldives	641,816,856	169,740,947
Pakistan	17,948,583,563	13,379,014,624
Sri Lanka	7,880,453,497	5,485,135,246
Nepal*	1,347,482,240	524,294,592

Note: *Figures are for year 1999.

Source: Comtrade Database, United Nations Commodity Trade Statistics Database.

(Panagariya 2003). There might not be enough demand for major Indian exports like transport and machinery, gems and jewellery, leather products, garments, etc. because of lower purchasing power of other SAARC nations. On the other hand, from a supply side perspective, some of the economies like Nepal, Bhutan, and

Bangladesh are small, and suffer from supply constraint to meet demand generated by big economies like India. The second reason for low trade can be attributed to the presence of high tariff barriers. A reflection of high tariff barriers is a lower trade GDP ratio in many of these SAFTA member countries. In terms of their openness criteria—measured in terms of trade as a percentage of GDP—Maldives and Sri Lanka are more liberalised compared to India and Pakistan (Table 1.4). On the whole, after the Middle East and North Africa, South Asia as a region is least integrated with the world economy. This is particularly true in case of agricultural products, where tariffs levied on developing-country exports were frequently twice as high as those on the industrialized countries. The simple average of the applied duties in non-agricultural goods ranges from 10% in Sri Lanka to 21% in Bangladesh. In India, this tariff is approximately 20%. In agriculture, the level of protection is even higher and ranges from 25% in Pakistan to 100% in India (Panagariya 2003). Higher tariffs within the region have neutralized the benefit of common cultural affinity, common geography and the advantage of common borders that India shares with other SAARC nations. In addition, policymakers find it difficult to reduce tariffs for domestic reasons. India provides an apt example of this. The average land holdings size for the Indian farmer is around 1.4 hectares or 10,000 square meters (Brummer 2006). These marginal farmers work in the land of big farmers. Under the condition of lower tariffs, large-scale farmers take a loss and may stop production. That leaves marginal farmers jobless, further worsening an already unequal income distribution. Recognizing the need to lower tariff barriers, Indian policymakers are currently putting emphasis on educating the rural population to enable a smooth transition (in terms of contribution to national income) from agriculture to the manufacturing and services sectors.

The third reason is low technology, labour-intensive tradable items (Table 1.5). For items such as textiles, animals, leather, etc., too much disintegration in production is not possible. Disintegration of production itself leads to more trade, as intermediate inputs cross borders several times during the manufacturing process (Feenstra 1998). For example, automobile parts and finished vehicles are both included in trade between the United States and Canada—something clearly missing in the present context.

Table 1.4 Trades as Percentage of GDP

Year	India	Bangladesh	Nepal	Pakistan	Sri Lanka	Maldives	Bhutan
1995	23.13%	28.20%	59.49%	36.13%	81.63%	170 %	79 %
1996	22.18	29.77	58.45	38.33	78.87	165	80
1997	22.88	30.01	64.03	36.85	80.13	170	81
1998	23.98	31.60	56.70	34.01	78.49	168	81
1999	25.27	31.85	52.56	32.31	78.75	170	80
2000	27.38	33.20	55.71	28.12	88.63	161	76
2001	26.38	36.88	55.80	30.37	80.89	157	71
2002	29.92	33.32	46.23	30.53	78.89	152	62
2003	30.77	34.24	44.24	32.84	78.04	153	62
2004	38.22	36.27	46.14	30.30	81.72	178	93
2005	43.61	39.62	44.06	35.25	76.27	n.a.	87
2006	48.77	44.21	45.28	38.60	74.78	n.a.	77

Source: World Bank, 2008.

Table 1.5 Main Tradable Products in the Context of SAARC Nations[1]

India	1. Textiles 2. Gems and Jewellery 3. Chemicals	Sri Lanka	1. Textiles 2. Vegetables 3. Plastics	Bangladesh	1. Animals 2. Leather 3. Textiles
Pakistan	1. Textiles 2. Vegetables 3. Leather	Maldives	1. Animals 2. Textiles 3. Foodstuffs	Nepal	1. Textiles 2. Metal 3. Chemicals

Note: [1]Commodities represent top three exports for the year 2002. Name of respective SAARC member countries are reported in parenthesis.

Source: *Industrial Commodity Statistics Yearbook*, United Nations, 2004.

Concurrently, going by the metric of extent of trade, South Asian nations might not qualify for a successful RTA. In fact, because of this low intra-region trade factor, Panagariya (2003) commented that forming an RTA in South Asia would result in more trade diversion than trade creation. Trade creation happens when a more efficient producer of one country displaces the less efficient producers of another member country within the Free Trade Area (FTA). On the other hand, trade diversion results in displacement of more efficient producers outside the FTA—losing market share to less efficient producers within the FTA. For example, when Bangladesh allows Indian cement to be imported duty free and this leads to the more efficient Indian cement industry to out compete the less efficient Bangladesh cement industry, it results in trade creation. On the other hand, duty free access to Indian television manufacturers to Bangladesh resulting in displacement of more efficient Japanese television manufacturers who remain subject to duty, results in trade diversion. As these economies in South Asia previously had a relatively steep tariff structure, the extent of trade diversion was expected to be high. However, with falling tariffs there is a lesser chance of trade diversion.

1.5 A COMPARISON OF SAARC AND ASEAN

India's effort for economic liberalisation and globalisation has come at a time when the expressway of global economy has already become slow and congested. This also holds true for the entire South Asian region. In comparison, ASEAN was conceived in the context of linking non-communist economies of the region with global capitalism. To preserve the so-called purity of this political and economic framework of cooperation, the region's geographical identity was even mutilated by excluding the Indo-Chinese countries. ASEAN entered into the global economic expressway when the growth was fast and smooth.

In looking at ASEAN and SAARC comparatively,[1] it has to be kept in mind that ASEAN countries were at a very preliminary level of capitalist growth when they sought integration into the

[1] *SAARC at Crossroads* by S.D. Muni, Professor, Jawaharlal Nehru University, New Delhi.

global capitalist economy. They had no interests of their own to protect and no terms to dictate. But in the South Asia's case, particularly in the case of India and Pakistan, significant indigenous capitalist economic interests had grown over the years and as a result, the two are finding it hard to adjust and harmonise themselves with the powerful economic interests at the global level. ASEAN had the added advantage over SAARC in that the member countries were smaller in size and their decision-making systems, both political and administrative, were generally more centralised and efficient. However, having involved itself in the process, it is clear that South Asia will soon be able to define and project its own forms of productive interaction with the international economic forces.

SAARC was set up in response to an increasing sense of crisis in terms of economic stagnation and political instability in the region. In contrast, ASEAN was initially formed to hold back the spread of communism from Vietnam into Southeast Asia. In the case of ASEAN, Japanese investment is recognised to have taken a major role for the economic development of the region and its economic integration. In contrast, there is no strong driving force for any further integration within the SAARC organisation.

In the past, the diplomatic relationship between India and Pakistan has been a major issue for SAARC. Intra-regional trade has been low also due to the fact that for India, doing business with other South Asian countries is less profitable compared to doing business with the developed countries and the Southeast Asian countries. However, recent improvements in diplomatic relationship between India and Pakistan will be a good sign for future development within SAARC.

The strategic focus of ASEAN shifted from the initial international politics against communism to trade liberalisation. The strategic focus of SAARC is not very clear — the key weaknesses of the association. One must ask the question, what are the challenges facing these trade blocs? ASEAN faces obstacles to further their regional integration in the shape of similar trade and industry structures (with the exception of Singapore) among member nations. This has made intra-regional trade less attractive for ASEAN countries. This issue notwithstanding, Japanese investment

in the manufacturing sector has contributed to overcoming these problems, creating new opportunities of intra-regional trade. In the case of SAARC, the diplomatic relationship between India and Pakistan has been a major challenge. It is why the people in Pakistan drink tea imported from Kenya.

The combined positive impact on SAARC of domestic economic and political liberalisation in South Asia and the global trend of expanding regionalism is evident. A preferential trading arrangement (SAPTA) has been agreed to and the target for raising it to the level of a Free Trade Agreement has already been set in motion. Business interests are identifying and executing areas of mutual cooperation, either individually or under the regional umbrella of similar institutional arrangements like the SAARC Chamber of Commerce and Industry.

In recent years, bilateral trade in the region, has been growing manifold but have failed to achieve its full potential. All of India's smaller neighbours are seeking increasing access to the sizable and lucrative Indian market for their products. The "big" is no longer awful and ugly; instead it is becoming beautiful. India, on its part is trying to accommodate its smaller SAARC neighbours. India's agreements with Nepal and Bangladesh on the question of river waters; its duty concessions to Bangladesh, Nepal and Sri Lanka; solution for the Chakma problem between India and Bangladesh; and the responsive Bangladeshi attitude towards India on the issues of internal security and stability as well as transit rights for the inaccessible Northeast region, are instances of the positive turn in the dynamics of regional relations.

Neither has Indo-Pakistan relations remained totally unaffected by these regional dynamics. There is now greater pressure within Pakistan for opening normal channels of trade and economic interaction with India, even as the core Pakistani establishment continues to harp on the Kashmir issue. A five-volume study carried out by the Ministry of Commerce, Government of Pakistan, offered positive recommendations while asking India to reduce subsidies on its agricultural products to create a level playing-field for Pakistani businessmen. It also proposed that the two countries improve transport and communication links. India and Pakistan are also co-ordinating their approaches in the field of textile trade to meet international pressures. The two are also working on the idea of cooperation on the sale of surplus Pakistani hydropower to India. Notwithstanding such positive signals, SAARC is not yet immune and insulated from the adverse impact of the India-Pakistan divide.

In January 1997, when Mr. Gujral visited Sri Lanka, he requested the Sri Lankan Foreign Minister to act as the co-ordinator for sub-regional cooperation among India, Sri Lanka and the Maldives. He also asked Pakistan to join with India in evolving projects for sub-regional cooperation. Pakistan, perceived these moves as an attempt to isolate it within SAARC, had reacted unfavourably and its apprehensions were not totally unjustified. The Kathmandu Working Group and its agenda on sub-regional cooperation had been kept out of the formal SAARC framework. This was perhaps to avoid a situation where Pakistan could object and thwart the move since the SAARC Charter requires unanimity on any action taken. This invites the question, if sub-regional cooperation will erode SAARC and emerges as its alternative; will Pakistan remain isolated and alone?

Some of the SAARC members, namely Sri Lanka and Maldives were unhappy with this development as well. Here, again, it is useful to draw a comparison with ASEAN, which originated and successfully executed the idea of sub-regional cooperation in the form of "growth triangles" (of limited areas cutting across territorial boundaries) for fast and intensive market-sector and private sector driven growth. It is not seen as inconsistent with the wider regional agenda of ASEAN, as the growth and dynamic development of parts eventually add to the strength of the entire ASEAN.

Unfortunately in South Asia, Pakistan is not geographically contiguous with any other SAARC member except India, with which it has been shying away from co-operating bilaterally. But then, Pakistan can join hands with other SAARC members to co-operate on specific areas, such as with India, Sri Lanka and Maldives on tourism or with India and Nepal in air transport. India and the other countries need to explain to Pakistan that the idea of sub-regional cooperation has been kept out of the formal SAARC framework to keep it flexible and open-ended. The enthusiastic welcome to South Asian sub-regional cooperation offered by Thailand, which wants to join hands with India, Myanmar and Bangladesh in developing sub-regional cooperation, in fact opens new opportunities where SAARC members can forge co-operative ties with ASEAN members.

Overall, there is no doubt that, under the thrust of post-Cold War shift in domestic, regional and international affairs, SAARC is poised to make an advance. While bilateral political issues will continue to persist in the SAARC dynamics, their role in deterring regional cooperation will hopefully decline. The pace of progress meanwhile will depend upon hard-core economic cost-benefit issues. The main political factor that seems of consequence now is that of governmental changes and political instability within SAARC countries.

In the long run however, forces of economic dynamism will generally acquire the autonomy required to keep the SAARC momentum uninterrupted by political and administrative break-downs in any of the member countries. Until this happens, SAARC will neither open itself to bilateral and contentious issues, nor will it, like ASEAN, have the confidence to establish parallel forums to deal with political and security issues affecting the region.

1.6 ASIAN ECONOMIC COOPERATION AND INTEGRATION

The building blocks for deeper regional integration in Asia are already in place. In East Asia, ASEAN is trying to move its integration process one step forward by creating an ASEAN Economic Community in Southeast Asia. The recent decision of ASEAN and the three Northeast Asian countries, namely, The Peoples Republic of China (PRC), Japan, and Korea, to transform ASEAN+3 into an East Asian Summit, can facilitate the building of an East Asian Community especially since ASEAN has already started the process of forming separately an RTA with PRC, Japan, and Korea, while the three are also doing the same among themselves.

In South Asia, the decision of SAARC to form SAFTA, a higher level of regionalism than the current SAPTA, moves the integration process in the region one step forward. In Central Asia, the ADB-initiated CAREC programme can serve as a stimulus for building an economic bloc in Central Asia similar to SAARC or ASEAN.

Several initiatives can provide bridges between sub-regional economic blocs in Asia. BIMSTEC, which includes five South Asian countries and two Southeast Asian countries, will soon be implementing a Regional Trade Agreement (RTA), while India is currently negotiating an RTA with ASEAN.

Will Asia's regionalism give rise to a "fortress Asia" mentality? This is unlikely to happen because the formation of RTAs in the region has been led by some of the more open economies in Asia. The integration process that occurred in the region was mainly market-driven, and the formation of RTAs is a means to formalise and accelerate the integration process.

At present, intra-regional trade among SAARC countries constitutes only 5 per cent of the total trade of the region. Trade between European Union members, on the other hand, is estimated at 60 per cent of their total trade. The Association of Southeast Asian Nations (ASEAN) is on the verge of forming the biggest common market in association with China and Japan. These are all incentives for SAARC to start accelerating its efforts to set up a free trade zone. Bilateral trade between India and China is booming after a free trade agreement was signed. India offers its two-year-old agreement with Sri Lanka as an illustration of a successful free trade agreement. Bilateral trade has expanded considerably between the two countries. The Sri Lankan President mentioned this in her speech in the 13th SAARC Summit. On the other hand the Indian Prime Minister expected that the formation of South Asian Free Trade Area (SAFTA) would represent only a modest beginning of the goal of a regional economic union.

1.7 CHALLENGES OF THE SECOND GENERATION REFORMS

1.7.1 Cost of Doing Business

Increasing investment rates will require improving the investment climate and reducing the cost of doing business. Figure 1.1[2] shows comparison of investment climate in South Asia with East Asia and Central Europe. Access to infrastructure has been cited as the

[2] Based on Investment Climate Survey by the World Bank on Bangladesh, India, Pakistan and Sri Lanka, that used cross country data on the cost of doing business and firm level survey.

number one problem faced by the firms in South Asia (SA). The key issue for most of the firms is access to reliable electricity (concurrently more attention is given later on how South Asian countries can harness electricity through regional cooperation and some Bangladesh initiatives have been cited). Corruption is the second biggest problems facing SA firms. When Officials have discretion to decision; it creates an opportunity to make unofficial payment to influence the outcome. The cost of bribe and uncertainty of standards imposed differently among firms can reduce the incentive to invest or to expand. Across SA the share of bribes is about 2.5% of sales. In a comparison of cost of doing business in SA, EA and OECD countries (Figures 1.2 & 1.3), despite substantial regulations, regulatory burden (tax, customs and labour regulations) remains substantially higher in SA. While access to finance has improved, credit information and secure lending systems lag in contrast to the other regions. Time to enforce a contract is higher in SA, which coupled with the institutional influence climate and cost of doing business complicates the process severely.

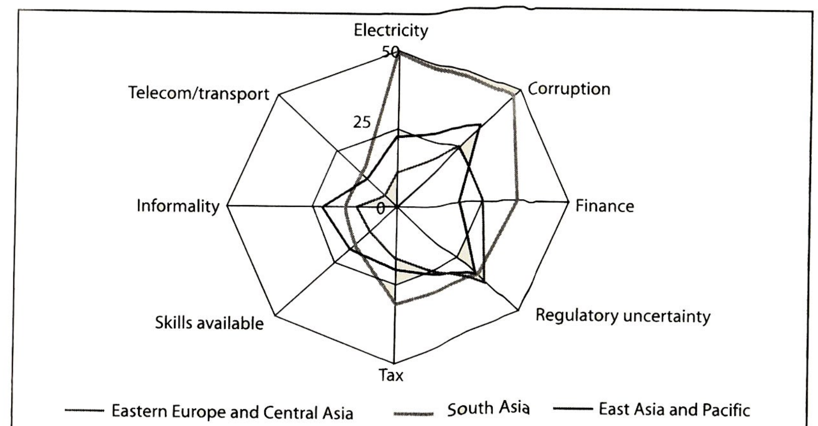


Figure 1.2: Share of South Asian Firms Reporting the Issues as a 'Major' or 'Severe' Constraint on the Operation of their Business

1.7.2 Institutions

It is increasingly recognized that weak institutions deter growth and development (World Bank, 2001). The cost of poor institutions and governance is borne by the poor (World Bank, 2006). The relationship between institutions and growth, how institutions are measured and how SA institutions compare to the world are some of the critical questions on quality of institutions. It is difficult to measure institutions and the link between institution and growth is complex. Several researches have suggested that there is strong positive correlation between measures of institutional quality and log-levels of per capita income (Figure 1.4). The rule of law measure captures the perceptions of individuals, firms, commercial risk taking agencies etc. The Figure shows strong negative correlation between the broad institutional measure and levels of development. Prevalence of corruption is taken as proxy for absence of well functioning institutions that prevent the arbitrary or abusive exercise of authority. There is great diversity of SA institutions, Bangladesh, Sri Lanka and Pakistan have better contracting institutions but India has better property right institutions. It is found that property right institutions are more critical to the growth of SA.

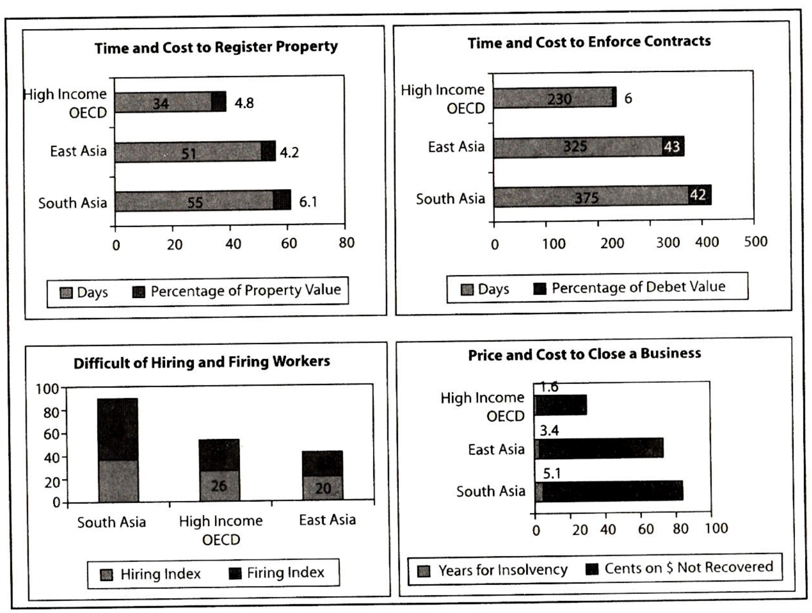
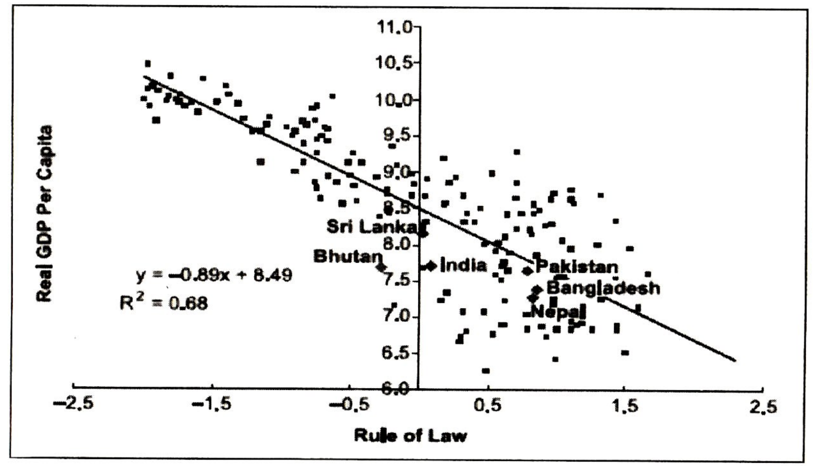


Figure 1.3: Cost of Doing Business is High in South Asia

Poor performance on corruption by Bangladesh indicates that reforms in such area can have substantial impact. There is tremendous variability of institutions within countries. India has some of the best and worst among institutional performance in SA. Overall there remains a major question of how SA sustained high growth despite weak institutions. One answer is that SA has implemented major policy reforms that are good for growth. In the first generation reforms, although the role of state had been curtailed, the effectiveness of state was not improved. The delivery of basic services did not improve as needed in SA. Concordantly, second generation reforms need to focus on improving the effectiveness of the state, which is in itself a broad subject.



Source: World Bank, 2006.

Figure 1.4: Rule of Law and Per Capita Incomes

1.7.3 Knowledge Based Economy

Generation and use of new technology, knowledge, ideas and innovation is widely acknowledged to be a crucial driver of growth and competitiveness. In Porter's diamond, this item is recognized in all the 4 attributes. Given the higher speed of creation and dissemination of new knowledge globally, low capital and labour cost are no longer only competitive edge to a firm. The new drivers of contemporary competitiveness are the ability to rapidly deploy resources to capture new opportunities, ensure quality, skills and flexibility of labour force and management, keeping up with rapidly changing technological and organizational advances to higher value parts of value chain, make effective use of information, technology to reduce transaction costs and improvements in capacity to respond to changing opportunities and threats. The key indicators of knowledge economy are:

- Education
- Innovation
- Information infrastructure
- Institutional regime governing knowledge

As per Figure 1.5, SA does poorly on knowledge economy compared to other developing regions, except Africa. While India performed the best among South Asian countries, its performance has not improved with time. This is due to high index on innovation, given large number of scientists, R&D and publications. Sri Lanka is second best, which showed the biggest improvement in the economic incentive and institutional regime. Furthermore, it made significant improvement in ICT and small improvement in innovation. However, Pakistan, Bangladesh and Nepal lose ground in the aggregate knowledge economy index (KEI). Bangladesh lost most ground in the innovation index and in economic incentive regime but makes some gains in ICT and smaller gain in education.

Education is becoming important because of the increase in speed of the creation and dissemination of new knowledge. Development of knowledge economy demands flexible education system. SA countries are relatively weak in education and skills. India is ranked higher in terms of quality of science and math education, staff training and management education. A strong ICT service is yet to be developed in the smaller SA countries because of their smaller scale and lesser prevalence of English. Given the greater mobility of factors, products, services and knowledge, innovation is another important element. It consists of network institutions, rules, and procedures that affect how a country acquires, creates, disseminates and uses knowledge. As a region, SA does better on the innovation pillar than other regions

largely because of the capabilities of large countries such as India and Pakistan, and to a lesser extent Bangladesh.

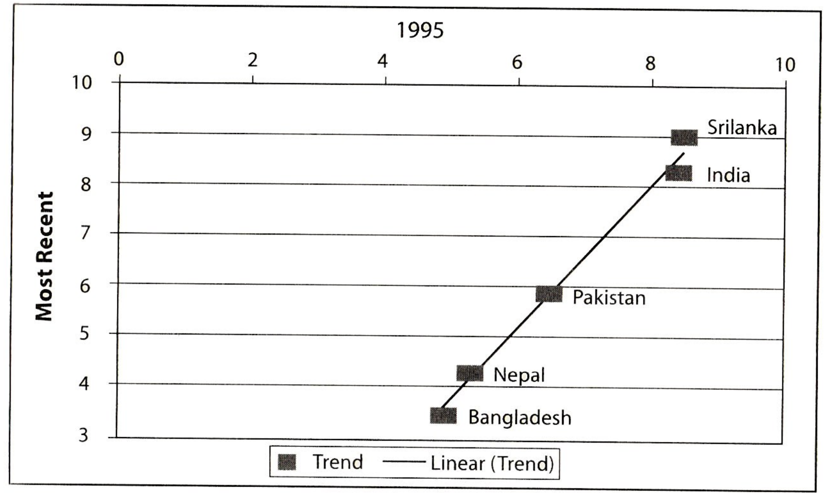


Figure 1.5: Overall Knowledge Economy Index for South Asia: 1995 vs. the Most Recent

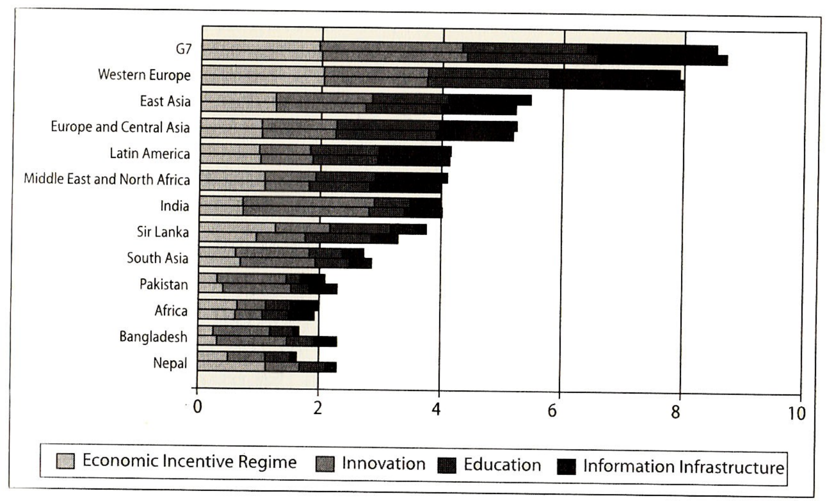


Figure 1.6: Comparison of KEI Components Parts for World Regions with South Asian Countries (most recent in top line, compared to 1995 Bottom line each group)

Another area of relative strength is the strong state cluster of development, mostly concentrated in India (IT services, pharmaceuticals, textiles, and metal engineering industries) and Pakistan (medical instruments, sporting goods, textiles and garments) and Sri Lanka (textiles and garments).

R&D as a share of the GDP for South Asia is very small, which accounts for only 0.48% of the GDP. While India fares slightly better with 0.78% of their GDP being allocated in R&D, most large researches in SA are undertaken in the public sector laboratories. On global knowledge except Sri Lanka all 5 countries are very low. Concordantly, it can be concluded that the South Asian countries are significantly behind the global frontier in context of education, innovation and ICT. While there is considerable diversity among 5 members, India is currently ahead in skills, technology, and innovation with Nepal bringing up the rear.

In general there are several generic actions to be taken to improve the knowledge economy of SA countries that include (i) all countries to find ways to extend education to the large part of their population, (ii) sharing country experiences, (iii) Transfer of knowledge, technology and skills from the advanced countries to the less advanced ones, and (iv) collaboration across countries and joint researches.

1.7.4 Infrastructure and Energy Grid

Modern infrastructure (electricity, telecoms, and roads) is the key to economic development. Studies on infrastructure productivity suggest that infrastructure has strong complementarities with other human and physical capital. Infrastructure requires a huge investment, has long implementation period and even longer recovery period. This brings goods and services to the market and raw materials, workforce and management to the manufacturing and service sectors- all at lower costs.

It had been earlier mentioned that Investment Climate Survey found that infrastructure, particularly inadequate electricity, is a major constraint to the growth in SA. The concern on lack of electricity is striking in SA. In India, manufacturers found 17 significant power failures per month versus one in Malaysia and

less than 5 in China. In Pakistan, a business typically loses 5.6% of annual revenue due to power outage. SA ranks the last among all the world regions, in terms of road density, rail lines, and mobile tele-density per capita. SA has no city with 24/7 water supply and is slightly ahead of Sub-Saharan Africa on mainline electricity coverage, improved water sources and sanitation.

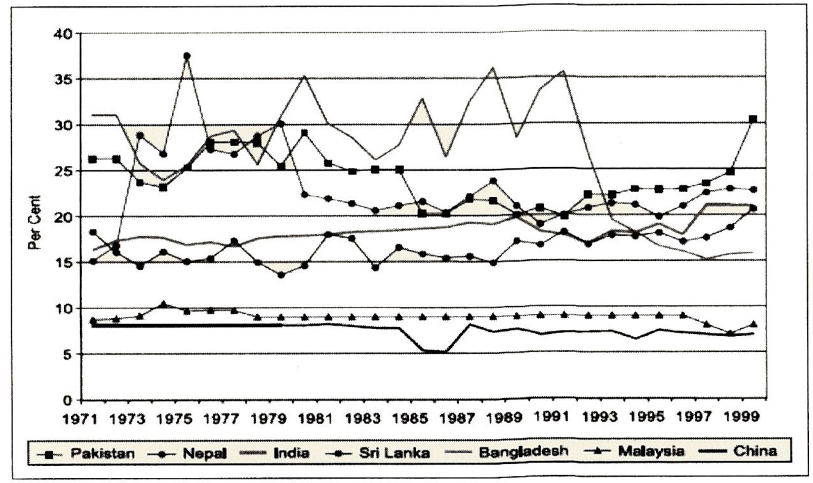


Figure 1.7: Comparative System Losses is South Asia and China

Table 1.6 Infrastructure Stocks in South Asia, East Asia and China, 2003

Sector	India	China	South Asia	EAP (2000)	Latin America and the Caribbean
Electricity generation capacity (million kilowatts)	126.3	356.1	151.9	66.5	
Paved roads (km per 1,000 km²)	267.2	171.6	227.5		
Rail routes (km per 1,000 km²)	19.2	6.3	14.6		
Mainlines (lines per 1,000 hab)	46.3	209.0	38.9 (35)	49.0 (76 in 2003)	192.0
Mobile (lines per 1,000 hab)	24.7	215.0	22.6 (37)	48.0 (96 in 2003)	249.0
Access to improved water (per cent of population)	88 (86)	77.0	86 (72)	75.0	90.0
Access to improved water (per cent of population)	34 (30)	44.0	39 (48)	60.0	77.0

Source: EAP Infrastructure Flagship, World Development Indicators and SASEI Database.

The challenge facing the infrastructure deficit and in particular the shortcomings in policies and service delivery that has led to the deficit, is enormous. The politicization of tariff setting of services has led to prices well below costs with government subsidies but those services are not well targeted to the poor. The gap of infrastructure provision with East Asia is shown in Table 1.6.