Welfare Effects of South Asian Free Trade Area (SAFTA)

***Regional Trading Arrangements (RTAs) in South Asia: Implications for the Bangladesh Economy*[1]**

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I. Introduction

Recently, there has been increased interest in regional economic integration in the South Asia region. And with the collapse of the WTO negotiations in late July 2006, it is expected that interest in regional trading arrangements will increase. A first step in this direction came in 1995 when the SAARC Preferential Trading Arrangement (SAPTA) was signed. In early 2004, the South Asia Free Trade Agreement (SAFTA) was signed. The SAFTA is a parallel initiative to the multilateral trade liberalization commitments of SAARC member countries. SAFTA has come into force from 1 July 2006, with the aim of reducing tariffs for intraregional trade among the 7 SAARC members. It has been agreed that for the South Asian countries Pakistan and India will eliminated all tariffs by 2012, Sri Lanka by 2013 and Bangladesh, Bhutan, Maldives and Nepal by 2015. Also, there have been other initiatives for regional integration or bilateral preferential trading arrangements involving the South Asian countries, especially Bangladesh. Examples are BIMSTEC, the Generalized System of Trade Preferences (GSTP) negotiations, Bangladesh's bilateral trade agreements with the countries within the region (e.g. India, Pakistan) or country outside the region (USA).

There have been some strong arguments for the regional economic integration in South Asia, as this integration is thought to generate significant intraregional trade and welfare gains for the South Asian countries. However, critics have pointed out that the potential benefits from the SAFTA and other regional trading arrangements in South Asia are little because there are limited complementarities in the region; major trading partners of the individual South Asian countries are located in the West, etc. It is also alleged that an RTA in South Asia will lead to substantial trade diversion than trade creation and it may work as a stumbling bloc to multilateral trade liberalization. Given these aforementioned arguments and counter-arguments it is therefore imperative to examine the impacts of the SAFTA and some other proposed RTA for the South Asian countries.

The structure of this paper is as follows: in Sections II, III, IV and V the issues involving SAFTA, BIMSTEC, GSTP, and FTAs with India, and Pakistan and the USA are analysed. In Section VI some stylized facts about the inter-regional trade in South Asia are presented. Section VII analyses the theoretical propositions on the welfare effects of regional trading arrangements (RTA). In Section VIII the GTAP model is used to examine the trade creation and trade diversion effects of SAFTA. Finally Section IX concludes.

II. The South Asian Free Trade Area (SAFTA)

South Asian Association for Regional Cooperation (SAARC) was although, formally setup in 1985 following a proposal by the government of Bangladesh in 1980, the issues of economic cooperation were deliberately kept outside it purview. Initially SAARC's activities was confined to nine ``non-controversial'' areas of regional cooperation in transport, communication, science and technology, education, culture, health, population, sports and arts. In early 90's there was a surge in regional arrangements. Out of 109 Agreements notified to GATT from 1947 to the end of 1994 33 were notified between 1990 and 1994. The experience of the growth and consolidation of various regional block brought to fore the realization that core economic areas need to be brought within the scope of SAARC activities if the objective of bringing about accelerated social and economic development in the region through mutual cooperation was to materialize. Based on the recommendation of SAARC study on Trade, Manufactures and services the Committee on Economic Cooperation was set up and the Sixth Summit of Heads of the states or Governments declared their commitment to initiate cooperation in economic areas initially in trade and agreed to formulate an agreement on an institutional framework for trade liberalization among themselves. Thus a framework agreement on South Asian Preferential Trading Arrangement was finalized and signed in 1993 in Seventh Summit held in Dhaka in 1993. The SAPTA Agreement came into force in December 1995 after conclusion of First Round of negotiations in April 1995. Since then three other rounds were concluded and tariff concessions were exchanged on around 5000 products. However, there no was substantial trade under SAPTA.

Idea of creating a free trade area in South Asia was mooted in 19th session of SAARC Ministerial Council held in December 1995 after SAPTA coming into force and a group of expert was formed to develop a wok programme for moving SAPTA to SAFTA. However, the Group could not come with any tangible outscore. Later during 10th SARRC summit the Head of the SAARC states/Governments had decided to enter into a free trade area in the SAARC region. Accordingly the summit directed to establish a Committee of Exports and directed the Committee to draft a comprehensive treaty ob South Asian Free Trade Area by the 2001. The Committee of Experts first met in August 1999 but it took four years to reach an agreement on South Asian Free Trade Area. The Agreement was signed on 6 January 2004 during 12th SAARC Summit.

The Agreement on SAFTA was signed without any agreement on the sensitive lists, rules of origin, mechanism for compensation of revenue losses for least Developed countries and areas for technical assistance for LDCs. However, the Summit directed to continue the work of the Committee of Experts to conclude negotiation on these issues in order to operationalise SAFTA from 1 January 2006. The Committee of Experts concluded negotiations in December 2005 and SAFTA came into force on 1 January 2006. However, there was a delay in commencement of trade liberalization programme due procedural requirement for ratification of the Agreement. It was therefore agreed that tariff reduction programme would commence on 1 July 2006. At the same time it was agreed that time frame for reduction of tariff would remain unchanged.

The purpose of this paper is to explore the welfare impacts of SAFTA on the member countries using a global general equilibrium model, namely the GTAP model.

2.1. Salient features of the Agreement on SAFTA

The Agreement on SAFTA has seven core elements:

- Trade liberalization Programme
- Rules of Origin
- Institutional Arrangements
- Revenue Compensation Mechanism
- Technical Assistance for LDCs
- Safeguard Measures
- Consultations and Dispute Settlement Procedures

2.1.1. Trade Liberalization Programme

As per Article 7 of the Agreement tariffs on all products except the products under sensitive lists would be reduced to 0-5% within time frames agreed for LDCs and Non- LDCs. The Agreement stipulates that SAFTA Committee of Experts would review non-tariff barriers in its regular meeting with a view to eliminating them or making them non-restrictive.

The Agreement provides different timeframe for tariff reduction by LDCs and Non-LDCs. Morover, Non-LDCs are required to reduce their tariffs for the products of LDCs within shorter period. Non-LDCs are required to reduce their tariffs applied on 1 January 2006 to 0-5% among themselves within seven years (with one extra year for Sri Lanka) (Table 1).

Table 1: Tariff Reduction Programme

Tariff Lines	1 July 2006	31 December 2006	31 December 2006	31st December 2008 to 31st December 2012*
Lines >20%	(t-20)/4	(t-20)/4	(t-20)/2	0-5% in 5 equal installment
Lines<20%	5% MoP	10% MoP	10% MoP	

* for Sri Lanka the period is 31st December 2008 to 31st December 2013 and number of installment is 6.
t= tariff applicable on 1 January 2006
MoP= Margin of preference to be applied on tariff of 1 January 2006

Non-LDCs are required to reduce tariffs on the products other than products under Sensitive Lists for LDCs to 0-5% within 31 December 2008 as per following schedule.

Table 2: Schedule of Tariff Reduction for Non-LDCs

Date	Pace of Reduction
1st July 2006	10% MoP
31st December 2006	30 % MoP
31st December 2007	30 % MoP
31st December 2008	25 – 30% MoP

However, India is reducing its tariff for LDCs at an accelerated pace. Time table for tariff reduction by India is as follows:

Table 3: Schedule of Tariff Reduction by India

Date	Pace of Reduction
1st July 2006	33.33% MoP
1st July 2007	33.33% MoP
1st July 2008	0-5% (end duty)

LDCs are required to reduce tariffs on the products other than the products under sensitive lists to 0-05% within 31 December 2015 as per following schedule:

Table 6.4: Schedule of Tariff Reduction for LDCs

Tariff Lines	1 July 2006	31 December 2006	31 December 2007	31st Dec. 2008 to 31st Dec. 2015
Lines >30%	(t-30)/4	(t-30)/4	(t-30)/2	0-5% in 8 equal installment
Lines<30%	2 ½ % MoP	2 ½ % MoP	5% MoP	

2.1.2. Sensitive Lists

The Agreement provides scope for maintaining of sensitive lists, which are not subject to tariff reduction programme. Although the Agreement maintains that sensitive list shall be different for LDCs and non-LDCs, only three countries namely Bangladesh, India and Nepal maintain different sensitive lists for LDCs and Non-LDCs. Besides, the LDCs maintain longer sensitive lists than the Non-LDCs.

Table 5: Sensitive Lists Among the SAFTA Members

Country	Total number of Sensitive List		Coverage of Sensitive List as % of Total HS Lines	
	For Non-LDCs	For LDCs	For Non-LDCs	For LDCs
Bangladesh	1,254	1,249	24.0	23.9
Bhutan	157	157	3.0	3.0
India	865	744	16.6	14.2
Maldives	671	671	12.8	12.8
Nepal	1,335	1,299	25.6	24.9
Pakistan	1,191	1,191	22.8	22.8
Sri Lanka	1,079	1,079	20.7	20.7

2.1.3. Non-Tariff and Para-Tariff barriers

The Agreement requires that all quantitative restrictions, if not permitted under GATT 1994 shall be eliminated. With respect to other non-tariff measures and para-tariff measures the Agreement requires that the countries notify the measures to SAARC Secretariat on an annual basis and SAFTA Committee of Experts review the non-tariff and para-tariff barriers in its regular meeting with a view to making recommendation for their elimination or making them non-restrictive. The Agreement also requires "The initial notification shall be made within three months from the date of coming into force of the Agreement and the COE shall review the notifications in its first meeting and take appropriate decisions". In order to implement commitment of this provisions a sub-group on non-tariff measures has already been established, which is engaged in addressing the non-tariff barriers.

2.1.4. Rules of Origin

Rules of origin are one of most important aspects of any free trade area. The Rules of Origin agreed under SAFTA are general in nature (i.e. one criterion for all products) barring 1991 products for which product specific rules are applied. Thus, SAFTA Rules of Origin requires that in order to enjoy the preference under SAFTA a product must undergo sufficient processing for changing the tariff heading from the non-originating inputs and for having value at least 40% value addition measures as percentage of fob value. However, value addition requirement is lower for Sri Lanka and LDCs, which is 35% and 30% respectively. In order to avoid fraudulent practices detailed operational certification procedures have been adopted.

2.1.5. Institutional Arrangement

In order to monitor the implementation of SAFTA Agreement two bodies namely SAFTA Ministerial Council and Committee of Experts have been established. SAFTA Ministerial Council (SMC) Comprising Commerce/Trade Minister of Member countries is the highest decision making body of SAFTA. The Council shall meet once in a year or more often. SMC will be supported by the SAFTA Committee of Experts comprising senior trade officials of member countries, which will meet once in every six months.

2.1.6. Mechanism for Compensation of Revenue loss

A mechanism has been established to compensate the revenue loss to be incurred by the LDCs due to reduction of tariffs. The Compensation will be in cash and partial: maximum 5% of the Customs duty collected from SAARC import in 2005. Compensation will be available for 4 years only (for Maldives compensation will be available for six years).

2.1.7. Technical Assistance for LDCs

There are provisions for technical assistance for LDCs at their request. Areas of Technical Assistance as agreed upon are as follows:

- Capacity building (Trade related)
- Development and improvement of tax policy and instruments
- Customs procedures related measures
- Legislative and policy related measures, assistance for improvement of national capacity
- Studies on trade related physical infrastructure development, improvement of banking sector, development of export financing

2.1.8. Safeguard Measures

In order to protect domestic industry from possible injury due to increased preferential import, the Agreement provided scope for partial or full withdrawal of preference granted under SAFTA for a period of maximum 3 years. Safeguard measures cannot be applied against the product of LDCs if share of import from an LDC of the product concerned in total import of importing country is less than 5%.

2.1.9. Consultations and Dispute Settlement Procedures

There is specific article on dispute settlement mechanism with specific time table. Bilateral consultation shall be held within 30 days upon a request made by any member. If dispute cannot be settled through bilateral consultation, the matter will be referred to the COE for its recommendation within 60 days. The COE may consult witth a panel of experts for peer review. Any decision of the COE can be appealed to SMC for its decision within 60 days. The decision of the SMC will be final.

III. Bay of Bengal Initiatives on Multi-Sectoral Technical and Economic Cooperation (BIMSTEC)

The idea of establishing Bangladesh- India-Thailand-Sri Lanka Economic Cooperation was first initiated by Thailand in 1994 to explore economic cooperation on a sub regional basis involving contiguous countries of South and South East Asia surrounding the Bay of Bengal. It was formally launched as BIST-EC (Bangladesh India Sri Lanka Thailand Economic Cooperation) on 6 June 1997 in Bangkok with the adoption of the Bangkok declaration. . In a Special Ministerial Meeting held in Bangkok on 22 December 1997 Myanmar was accorded full membership of the group and following Myanmar's entry it was renamed as BIMST-EC (Bangladesh India Myanmar Sri Lanka Thailand Economic Cooperation). At the Ministerial meeting held in February 2004, Bhutan and Nepal were welcomed as new members. Subsequently, the Grouping was renamed as "Bay of Bengal Initiatives on Multi-Sectoral Technical and Economic Cooperation (BIMSTEC).

Unlike SAARC BIMSTEC was established to promote economic cooperation in the region. Accordingly, during the second Ministerial meeting held in December, member countries identified six areas of cooperation namely trade and investment, technology, transport and communication, fisheries, energy and tourism. Idea of identifying these sectors was to enhance cooperation in these sectors through identification and implementation of specific cooperation projects. From beginning of the initiation of BIMSTEC stress was given to active participation of private sector and accordingly private sector representatives also participate actively in the sectoral committees.

Despite the fact that BIMSTEC was primarily established for promoting economic cooperation in the region, Member countries adopted a step-by-step towards to establish a free trade area in the region. Trade/Economic Ministers at their second meeting held in April 2000 in New Delhi established an Inter-Governmental Group with a mandate to prepare a concept paper on possible approaches towards a free trade area. As per recommendation of the Inter-Government Group, Third Trade/Economic Ministers meeting established a Group of Experts, which recommended to adopt a negative list approach for moving towards a free trade area in the Region. Later, the 4th BIMSTEC Trade/Economic Ministers held in Colombo on 7th March 2003 decided to establish a Group of Experts led by Sri Lanka to draft the Framework Agreement of the BIMSTEC FTA.

The GOE met four times and finalized a draft framework Agreement on BIMSTEC FTA in December 2003, which was subsequently adopted by the Senior Trade/Economic official meeting and signed by all member countries except Bangladesh during First BIMSTEC Summit, held in February 2004. Bangladesh signed the Agreement on 25 June 2004. The Agreement came into force on 30 June 2004.

3.1. Core Elements of the Framework Agreement

Unlike SAFTA, the Framework Agreement on BIMSTEC FTA covers trade in service and investment in addition to trade in goods. However, the framework only fixes the timeframe for tariff liberalization in trade in goods and requires member countries to enter into negotiations on various issues of trade in goods; trade in services and investment through a positive list approach; and other areas of economic cooperation. For this purpose it requires establishment of Trade negotiating Committee. Thus, the Framework Agreement is only a "Mother Agreement" which sets the road map for a building block approach to a Free Trade Area.

3.1.1. Trade in goods

With regard to trade in goods, the Agreement provides for two-track approaches tariff reduction/elimination. The schedules tariff reductions/elimination under fast track and normal track are as follows:

Table 6: Schedule for Fast Track products

Countries	For Developing Country Parties	For LDC Parties
India, Sri Lanka & Thailand (developing Countries)	1 July 2006 to 30 June 2009	1 July 2006 to 30 June 2007
Bangladesh, Bhutan, Nepal & Myanmar (LDCs)	1 July 2006 to 30 June 2011	1 July 2006 to 30 June 2009

Table 7: Schedule for Normal Track products

Countries	For Developing Country Parties	For LDC Parties
India, Sri Lanka & Thailand (developing Countries)	1 July 2007 to 30 June 2012	1 July 2007 to 30 June 2010
Bangladesh, Bhutan, Nepal & Myanmar (LDCs)	1 July 2007 to 30 June 2017	1 July 2007 to 30 June 2015

The Agreement envisages that the products to be covered under fast and normal tracks are to be selected by the member countries on their own accords. However, it provides for a maximum ceiling for the products under negative list, which will not be subject to tariff reduction. It also provides scope for providing derogation to LDCs for the products of their export interest in respect of the negative list. These are elements, which have been agreed in the Framework Agreement. Thus, the Agreement stipulates that further negotiations are to be conducted for implementing the tariff reduction programme agreed in the Framework Agreement. The areas of negotiations are:

a. The agreement on Trade in goods
b. Detailed modalities governing the tariff reduction or elimination programmes;
c. Rules of Origin;
d. Non-tariff measures/ barriers imposed on any product covered under this Agreement;
e. Products to be covered under the Fast Track

f. Products to be covered under the Normal Track
g. Products coverage under the Negative Lists;
h. Detailed procedures for safeguards based on GATT principles;

The Agreement envisaged that negotiations on the aforesaid areas were to be conducted during the period between July 2004 and December 2005 so that tariff reduction/elimination programme could commence on 1 July 2006.

3.1.2. Trade in Services and Investment

The Framework Agreement provides for entering into negotiations to progressively liberalize trade in services with substantial sectoral coverage through a Positive List approach with a view to progressively eliminating substantially all discrimination between or among the parties and/or prohibition of new or more discriminatory measures. Besides, The Agreement also provides for arrangements to promote and protect investments, progressively liberalize investment regimes and strengthen cooperation for facilitating investment in tandem with liberalization of trade in goods and services. The Framework Agreement envisages that negotiations on trade in services and investment would commence in 2005 and would be concluded by 2007. However, the identification of the sectors of services and investments and the pace of liberalization shall be finalized for implementation subsequently in accordance with the timeframes to be mutually agreed upon; (a) taking into account the sensitive sectors of the parties; and (b) with special and differential treatment and flexibility for the LDC parties

3.1.3. Dispute Settlement Mechanism

The Agreement provides for detailed dispute settlement procures and mechanism to be negotiated and concluded by December 2005.

3.1.4. Institutional Arrangement

The agreement establishes the institutional arrangement for conducting negotiations to make the Agreement operational. For this purpose, it establishes Trade Negotiating Committee for conducting negotiations, which reports to the BIMSTEC Trade/ Economic Ministers through the Senior Trade and Economic Officials Meeting on the progress and outcome of its negotiations.

3.2. Current Sate of Negotiations on BIMSTEC

As per the Framework Agreement Trade Negotiating Committee (TNC) has been established under the chairmanship of Thailand. The TNC had its first meeting in September 2004. As of June 2006 the TNC met 11 times. However, the TNC could not reach agreements on issues required to be settled for commencing the tariff reduction programme from 1 July 2006. As a result, it is obvious that tariff reduction programme could commence on agreed date. As of June 2006, the TNC agreed on draft text of the Agreement on Trade in Goods. It was also agreed that tariffs on the products under the fast track approach will be eliminated, while the tariffs under the normal track will be reduced to 0-5%. Although the member countries are free to select the products for reducing the tariffs within the range of 0 and 5%, they are required to specify the tariffs to be applied at the end of the implementation period in the schedules of concessions. The member are yet to reach consensus on Rules of origin, size of the negative list, minimum number of products to be covered under the fast track approach, safeguard mechanism etc.

The TNC has already initiated negotiations on Trade in Services and Investment, which are still in preliminary stage. It seems that full fledged negotiations on these issues would commence after concluding the negotiations on trade in goods

IV. Generalized System of Trade Preference (GSTP)

At the UNCTAD XI conference, a group of developing countries have announced the launch of a round of South-South trade liberalisation negotiations under the framework of the Agreement on the Global System of Trade Preferences among the developing countries (GSTP). The GSTP Agreement, which dates from 1989, provides a framework for mutual trade and economic cooperation among developing countries, through the exchange of market access concessions. In contrast to the WTO, GSTP participants are not required to extend the benefits they give one another to the industrialised countries. It is not entirely clear if benefits negotiated by some of the GSTP signatories must be extended to all signatories – this issue is under discussion. GSTP does, however, allow for non-reciprocal concessions to LDC members. GSTP is consistent with GATT rules (Enabling clause).

The GSTP was originally an initiative of the Group of 77. It entered into force in 1989, ratified by 41 countries, but never became an effective forum for South-South trade liberalisation. The members, who now number 44, wish to revive the GSTP by launching a new round of negotiations and by extending the membership to other countries in the G77 and to China. Existing members include most of the larger developing economies (with the exception of China and South Africa) and half a dozen LDCs. Participation in the GSTP is also open to regional groupings; Mercosur is a member. Trade among the 44 members totals nearly two trillion dollars – or about 55% of South-South trade.

GSTP is not part of the WTO system and is serviced by a secretariat in UNCTAD. Participants finance operations through voluntary contributions. In 1986, the first Round of GSTP Negotiations was launched, with the GSTP Agreement as a provisional legal framework. This concluded in 1988. The second round (1991-1998) concluded with 28 countries exchanging tariff concessions. However, these have not yet been implemented due to lack of ratification by participants. In 2000, the GSTP Committee of Participants launched initiatives to improve the operation and administration of the Agreement.

GSTP-negotiated market access agreements to date are not economically significant. The reduction of tariff barriers in developing countries has happened through unilateral action (often under pressure from the IMF and World Bank,) and through multilateral and regional agreements. GSTP negotiations have suffered from the unwillingness of some members to make concessions in the hope that they could gain benefits for free. The effectiveness of the GSTP in future depends on the political will of the members, and its capacity to recruit more participants.

In chapter 4 of this volume, using the GTAP model, a simulation is performed (simulation DFQF2) which considers DFQF market access of LDCs in the developed as well as in the advanced developing countries' markets. The simulation results suggest significant welfare gains for Bangladesh and other LDCs. It can, therefore, be argued that Bangladesh and other LDCs should try to gain DFQF access in the developing countries' markets through the Generalized System of Trade Preference (GSTP).

V. Bangladesh's Negotiations on FTAs with India, Pakistan and the USA

The indicator of bilateral trade between Bangladesh and India has been showing deficit position of Bangladesh for over the years. There is also considerable incidence of informal trade between India and Bangladesh as a consequence of trade restrictions on the free flow of goods. The volume of unofficial exports to Bangladesh is reportedly in the range of $350 million to $500 million every year.

At the meetings of the business people of India and Bangladesh as well as at the joint meetings of the policy makers of these two countries, with a view to strengthen the intra-regional economic cooperation and the development of national economics, the need to establish and promote free trade arrangements between India and Bangladesh is been highlighted in the recent years. The expected benefits of such a proposed FTA between India and Bangladesh include the duty free entry for all goods except those included in a short negotiated negative list, as well as the elimination of all non-tariff barriers in a time-bound framework. From the Bangladesh perspective, it is argued that an assured access to the large Indian market within a long-term contractual framework will enable Bangladesh to create export capacity for even those products in which it has potential competitive advantage, but which currently do not figure in the export basket. It is also hoped that such assured access would result in an enlarged flow of foreign private capital for investment towards building export capacity in Bangladesh. It is also expected that such an FTA can provide for measures for deeper integration, such as freeing of trade in services, free flow of investments, trade facilitation, harmonisation and mutual recognition of standard and coordination of macro-economic policies. Besides these, such an FTA is likely to improve the over-all competitiveness of the Bangladesh economy through access to the marketing network, skill and technology of Indian manufacturers and trading partners.

It is, however, important to note that no significant progress has been made with respect to the FTA between Bangladesh and India. Non-tariff barrier appears to one of the major impediments to cut the trade deficit with India. There is a need for regular dialogue on standoff issues existing between the two countries to boost bilateral trade.

There is also an ongoing negotiation between Bangladesh and Pakistan to establish an FTA between these two countries in order to foster bilateral trade and economic cooperation. The FTA is expected to spur business and trade between these two countries. Pakistan has proposed to open bilateral shipping services to promote bilateral trade. In the trade negotiations the need of raising of trade to US$ 1b between the two countries has been highlighted. It is also stressed in the negotiations that the trade between the two countries was being hampered due to absence of direct shipping line between Chittagong and Karachi. Pakistan has also proposed to invest in Bangladesh in vertical integration of the country's textile sector.

Bangladesh and the USA is also in the process of signing a Trade and Investment Framework Agreement (TIFA). The agreement is about to establish a "US-Bangladesh Council" on trade and investment issues. This council will establish different working groups and will identify and work toward the removal of impediments to trade and investment flows. It also aims for adequate and effective protection and enforcement of Intellectual Property Rights and adequate and effective protection and enforcement of labour laws and improving the observance internationally recognized core labour standards. However, there have been several criticisms on TIFA. Though the interests of these two countries are different in WTO trade negotiations, the short-term objective of this agreement is about "strengthening cooperative efforts to complete successfully the Doha Development Agenda". It is feared that this binding will undermine the LDC initiatives in the WTO multilateral negotiations.

VI. Inter-Regional Trade in South Asia: Some Stylized Facts

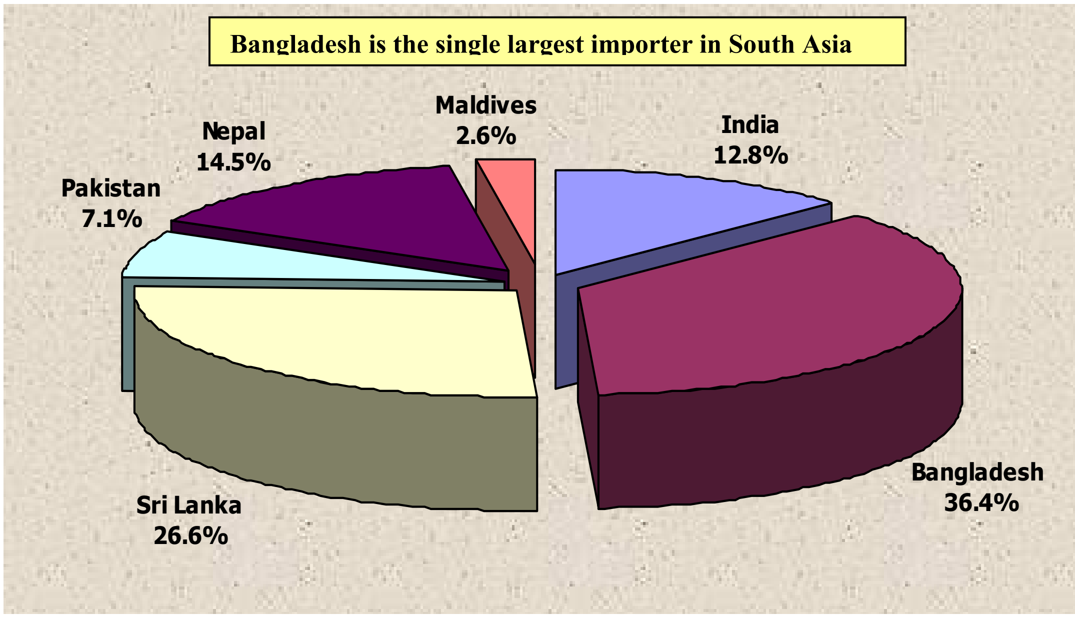
Table 8 suggests that intra-regional imports among the South Asian countries as a share of world imports is very low, only 4.45 percent. However, there are differences among individual countries in South Asia. For example, India's figure of total imports from other South Asian countries is only 0.86 percent of her total imports from all over the world. Nepal's share in this regard is the highest in South Asia, as Nepal is heavily dependent on India for her imports. Bangladesh's share is 20.3 percent which is primarily imports from India. Figure 1 shows that Bangladesh is the largest importer in South Asia as far as regional imports share is concerned.

Table 8: Intra-Regional Imports of South Asian Countries (million US$) in 2003

	Reporting Country									Intra-regional Imports as Share(%) of SAARC Countries in World Imports
Partner Country	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	Total (SAARC)	World	
Bangladesh	.	2.73	1349.45	0.95	5.52	68.40	7.95	1435.01	7069.51	20.30
Bhutan**	NA	.	NA	NA	NA	NA	NA	NA	NA	NA
India	76.69	51.74	.	0.37	282.59	56.95	192.37	660.71	77201.33	0.86
Maldives	0.00	0.00	47.65	.	0.00	1.73	64.59	113.97	470.77	24.21
Nepal**	4.85	0.57	954.91	NA	.	3.30	1.99	965.62	1801.62	53.60
Pakistan	45.79	0.16	381.07	0.18	3.42	.	48.25	478.88	15549.41	3.08
Sri Lanka	5.63	0.00	1076.44	22.64	0.01	70.97	.	1175.68	6514.26	18.05
Total								4829.87	108606.90	4.45

Source: COMTRADE, UN

Figure 1: Country-wise Share (%) in Intra-SAARC Imports in 2003



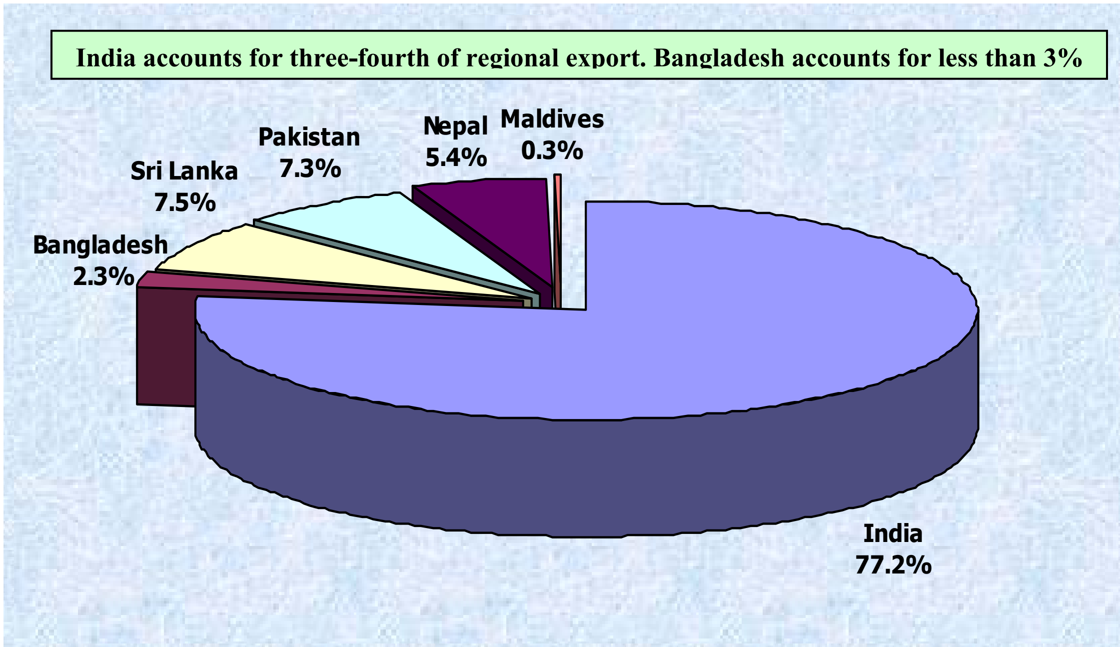
According to table 9, the intra-regional exports as share of South Asian countries in world exports is only 6.14 percent, which implies that South Asia is not any important export destination for almost all the South Asian countries. For example, the corresponding figure for Bangladesh is only 1.84 percent. Figure 2 shows that, apart from Maldives, Bangladesh is the lowest exporter in South Asia as far as regional exports share is concerned.

Table 9: Intra-Regional Exports of South Asian Countries (million US$) in 2003

	Reporting Country									
Partner Country	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	Total (SAARC)	World	Intra-regional Export as Share (%) of SAARC Countries in World Exports
Bangladesh	.	1.57	47.15	0.01	3.28	32.69	3.29	87.99	4787.83	1.84
Bhutan	NA	.	NA	NA	NA	NA	NA	NA	NA	NA
India	1719.17	88.38	.	41.76	660.99	283.38	1302.83	4096.51	63028.79	6.50
Maldives	0.00	0.00	0.35	.	0.00	0.00	15.34	15.69	112.96	13.89
Nepal	6.11	1.37	341.80	NA	.	0.99	1.19	351.46	652.69	53.85
Pakistan	194.41	0.38	95.86	1.91	4.60	.	97.62	394.78	12695.14	3.11
Sri Lanka	10.40	0.00	241.14	54.26	1.66	36.13	.	343.58	4867.83	7.06
Total								5290.01	86145.24	6.14

Source: COMTRADE, UN

Figure 2: Country-wise Share (%) in Intra-SAARC Exports in 2003



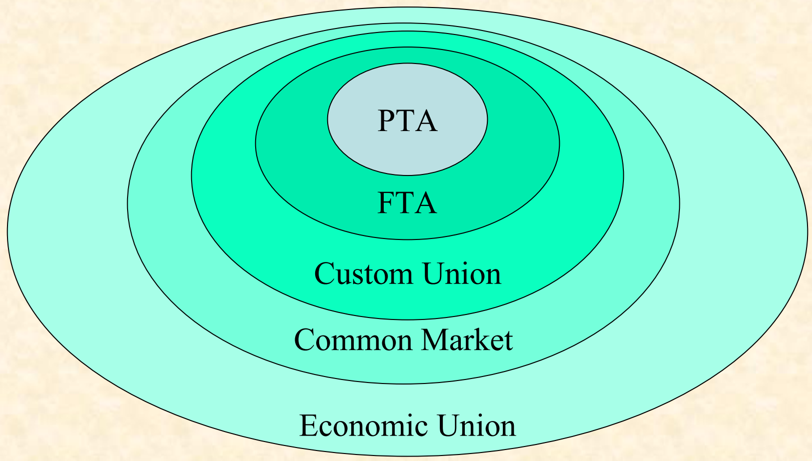
VII. Welfare Effects of Regional Trading Arrangements (RTA)

Trade theory and evidences suggest that there are several forms of RTA:

- Preferential Trade Area (PTA): Tariffs are lowered among the members but maintained against the outside world
- Free Trade Areas (FTA): Tariffs are removed among members but maintained against the outside world
- Customs Union: All tariffs amongst the members are eliminated, while external tariffs are adjusted to a common level
- Common Market: Customs Union + free movement of factors of production
- Economic Union: Customs Union + Common economic laws

Box 1 presents the boundaries of the scopes of these various RTAs.

Box 1: Forms of RTAs



In trade literature the welfare effects of any RTA are analysed using two concepts: trade creation and trade diversion (box 2 explains these two concepts). The overall welfare effects of economic integration are ambiguous and require case-by-case judgment. The reason is that integration is both a policy of protection and a move toward free trade. The effect of the protectionist element of integration is called trade diversion, and the effect of the trade liberalization element is called trade creation. The free-trade area's overall effect on welfare is determined by comparing the trade-creation and trade-diversion effects. If trade creation dominates, the formation of a free-trade area will enhance welfare. Note that if member countries are the low-cost producers of the traded good, there will be no trade diversion effect and integration will unambiguously increase welfare.

Box 2: Trade Creation and Trade Diversion

	Country A	Country B	Country C
Supply price	50	40	30

Case – Alpha: If A imposes a tariff of 100% on both B and C, only A's own producers will be in the A's domestic market.

Case – Beta: If A imposes a tariff of 50% on both B and C, only C will be the supplying country in A's market.

Case – Gamma: If A forms customs union with B, but retains the 50% duty on C => B will be the supplying country in A.

If Alpha was the initial condition, moving to Gamma will be considered as trade creation, welfare enhancing for A.

If Beta was the initial condition, moving to Gamma is an example of trade diversion with adverse consequences on welfare of A.

The fundamental arguments for regionalism rest on the evidences which suggest RTAs to be predominantly trade-creating. It is also argued that through RTAs countries can 'lock-in' reform, which is often politically not feasible under multilateralism. Also, failure of multilateral trade talks means trade liberalisation can only take place through RTAs. It is also highlighted that countries can build on the progress of regionalism and can ultimately move toward a freer trade regime on the whole.

There are, however, some critical arguments against formation of any RTA. It is alleged that through RTA the spirit of multilateralism is undermined. Also, the 'spaghetti bowl' effect can emerge because of many complicated simultaneous RTA negotiations. There is also the possibility of the discrimination against the excluded countries, and as a result, this may lead to terms of trade shock for them. Even LDCs could be seriously discriminated against. It is also argued that the world might be divided into a few protectionist blocs. Also, protectionists might accept RTAs to oppose further multilateral liberalisation. It is further put forward that resources in trade ministries are limited. Therefore, too much involvement in RTA negotiations may distract attention from multilateral liberalisation.

In general, there are some agreements among the economists about the pre-conditions for home-country welfare expansion. For example - (i) the higher the level of the home country's tariffs prior to the agreement; (ii) the higher the tariff level of the contemplated partner; (iii) the higher the economic size of the partner; (iv) the higher the share of the partner in providing the home country's imports – compatibility; (v) the lower the ratio of imports from the rest of the world to the home country's aggregate economic activity; (vi) the closer the relative prices in the partner's economy are to those of the rest of the world; and (vii) the more similar the partner to the rest of the world in the structure of its economic activity – the higher the welfare of the home country.

VII. Trade Creation and Trade Diversion Effects under SAFTA: Estimates using the GTAP Model

Studies based on the partial equilibrium *gravity model* to estimate the welfare gains from regional trading arrangements (RTAs) are methodologically flawed. The left hand side of the *Gravity equation* is the bilateral trade not the welfare. Also, the impact of the RTA is captured by introducing the dummy variables in the equation which is a very weak methodology. Furthermore, *Gravity models* are partial equilibrium analysis, not a general equilibrium analysis. Therefore, they fail to take into consideration the inter-sectoral and inter-regional linkage effects. Therefore, gravity models can not actually estimate the *trade creation* and *trade diversion* impacts of RTAs.

We, therefore, argue that a global general equilibrium model like the GTAP model is the best method in explaining the welfare effects of any regional trading arrangements. Box 3 presents the commodity and regional aggregation of the GTAP model under consideration.

Box 3: Aggregated Commodities and Regions in the GTAP Model

Constructed broad sectors	Aggregated regions
Paddy Rice	Bangladesh
Milled Rice	Other LDCs
Wheat	India
Other Cereal	Sri Lanka
Commercial crop	Rest of South Asia (Pakistan, Nepal, Bhutan, Maldives)
Milk and Dairy	Thailand
Other food	China
Live Stock	Brazil
Other Agriculture	Other Developing Countries
Mineral	Australia
Textile	Japan
Wearing Apparel	Korea
Leather	USA
Chemicals	Canada
Machinery	EU
Petroleum	Rest of the World
Other Manufacturing	
Services	

8.1. GTAP Simulation Design for Different SAFTA Scenarios

With the aim of estimating the welfare effects of the SAFTA on different member countries of the world two different scenarios in the GTAP model are simulated. Table 10 presents the simulation scenarios. In the scenario SAFTA1 all member countries eliminate their intra-regional tariffs and keep their tariffs with the rest of the world unaffected. In the scenario SAFTA2, in addition to SAFTA1, Bangladesh eliminates her tariffs for the rest of the world by 50 percent.

Table 10: SAFTA Scenarios

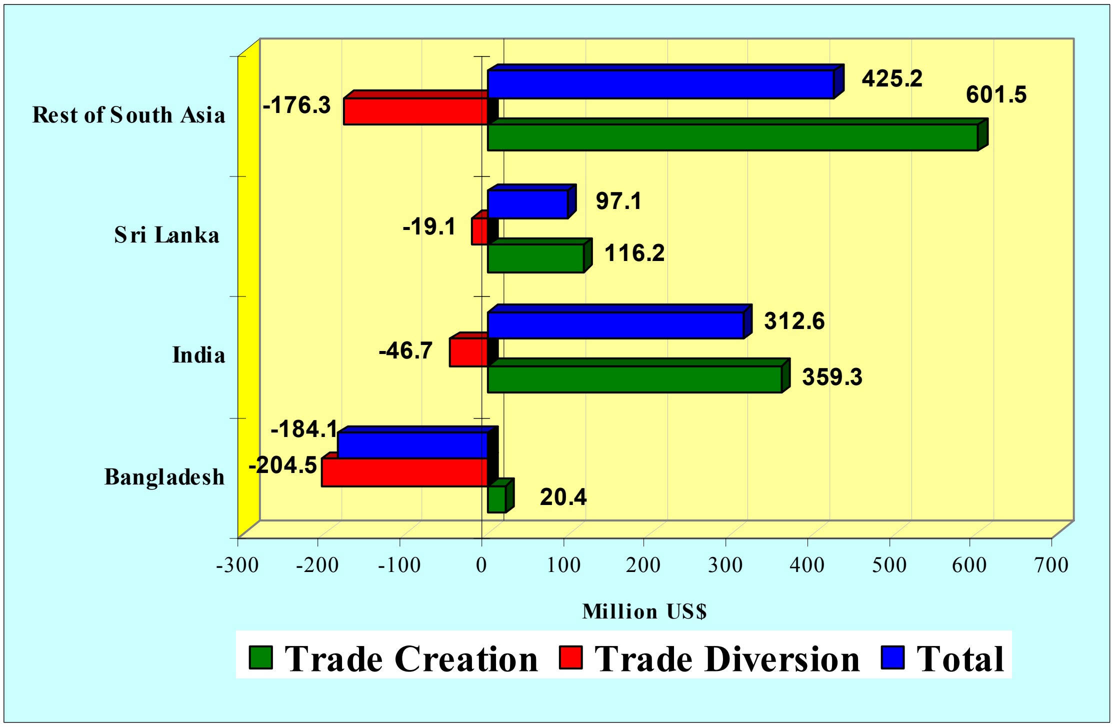
Name	Explanation	Bangladesh	India	Sri Lanka	Rest of South Asia
SAFTA1	Full Implementation of SAFTA. 100% Tariff cut for the SAFTA Countries	100%	100%	100%	100%
SAFTA2	Full Implementation of SAFTA. 100% Tariff cut for the SAFTA countries and Bangladesh reduces her MFN tariffs by 50%	100% for SAFTA+ 50% for MFN Tariff	100%	100%	100%

8.2. Decomposition of the Welfare Effects into Trade Creation and Trade Diversion

It should, however, be noted that the original GTAP framework does not provide any estimates of trade creation and trade diversion aspects of the total welfare effects. In order to estimate these two effects we have made some adjustments in the GTAP model. The GTAP model provides a net welfare estimate of the SAFTA simulation which is a sum of trade creation and trade diversion. With a view to separate the trade creation effect from the total welfare effect a separate simulation is run where we make necessary adjustments in the GTAP closure so that the imports to all the South Asian countries from all over the world (except from the South Asian countries) are held fixed. The welfare effects from this scenario are nothing but the trade creation effects for individual South Asian countries. This trade creation effect is then deducted from the welfare effect in the original simulation to get the estimate of the trade diversion effect.

Figure 3 provides the results of this exercise. It appears that Bangladesh incurs a net welfare loss from the SAFTA1 scenario. Though, for Bangladesh there is a positive trade creation effect the negative trade diversion effect is large enough to offset the positive gain. However, all other South Asian countries stand to gain from SAFTA1. The gain for India is the largest as far as any individual country is concerned.

Figure 3: Trade Creation and Trade Diversion Effects of SAFTA1 Scenario



Source: GTAP simulation Results

The high negative trade diversion effect for Bangladesh under SAFTA1 can be explained by the fact that imports from India (a relatively high cost import source) increases substantially and imports from all over the world (relatively low cost import source) also declines significantly (table 11).

Table 11: Changes in Imports to Bangladesh from different Countries under SAFTA1 (Million US$)

	India	Sri Lanka	Rest of South Asia	China	Japan	Korea	USA	EU	Rest of the World
Agricultural Products	426.3	14.9	5.7	-12.1	-3.6	-1.7	-16.6	-17.1	-243.3
Textile	279.9	3.7	291.2	-96.5	-5.2	-38.8	-2.9	-4.3	-111.6
Wearing Apparels	13.8	1.7	8.7	-0.8	-0.8	-0.8	-1.4	-3.6	-6.3
Leather	5.0	0.0	1.4	-0.2	0.0	-2.0	0.0	-0.3	-0.9
Chemicals	133.0	3.4	11.0	-11.6	-4.3	-12.9	-8.0	-19.4	-48.5
Machineries	114.4	2.2	6.0	-17.6	-16.6	-6.9	-6.6	-32.1	-31.8
Other Manufacturing	517.1	8.5	22.6	-28.8	-60.8	-59.5	-16.0	-53.1	-162.9
Service	-0.1	-0.1	-0.2	-0.1	-0.1	-0.1	-1.2	-1.8	-2.1
Total	1489.4	34.3	346.3	-167.8	-91.4	-122.7	-52.8	-131.6	-607.2

Source: GTAP simulation Results

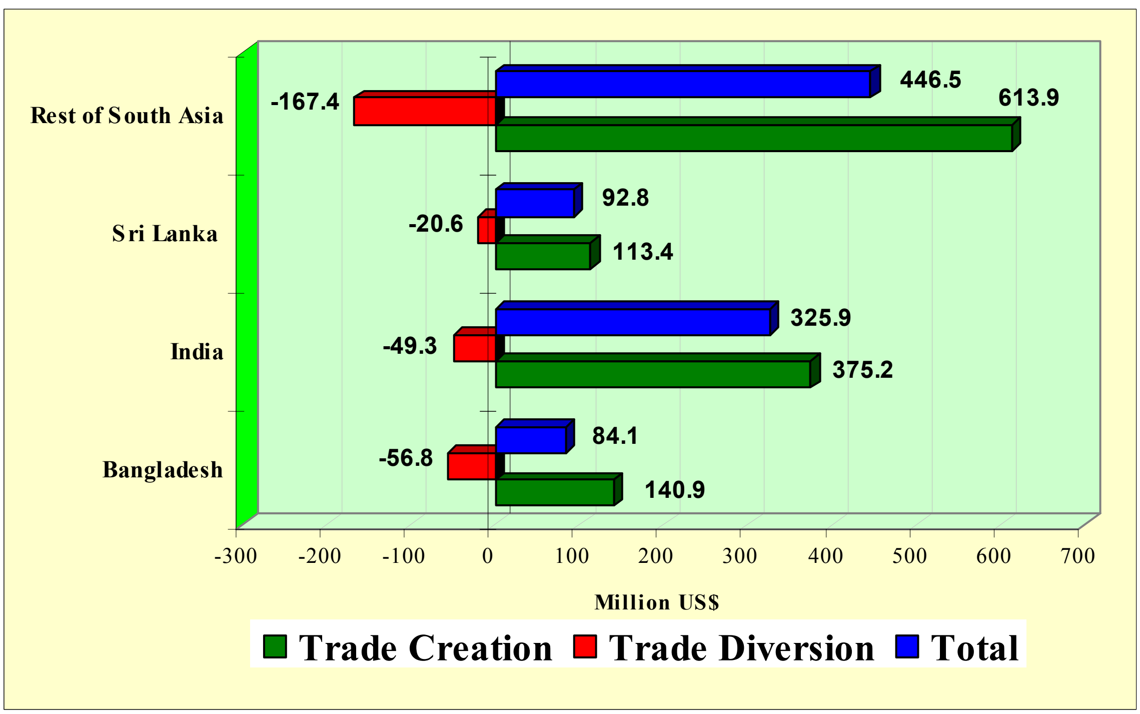
Table 12 reports the estimates of the changes in exports from Bangladesh to other South Asian countries. Comparing the figures of table 6.10 with those of 6.9 it appears that Bangladesh trade balances with India will deteriorate under SAFTA1. According to table 6.12 Bangladesh's exports to India increases by only 134 million US$, whereas India's exports to Bangladesh increases by 1489 million US$ (table 11). In fact, Bangladesh's exports to other South Asian countries increase less than the increases in the exports of other South Asian countries to Bangladesh.

Table 12: Rise in Exports from Bangladesh to other South Asian Countries under SAFTA1 (Million US$)

	India		Sri Lanka		Rest of South Asia	
Export Items	Base year exports	Exports under SAFTA1	Base year exports	Exports under SAFTA1	Base year exports	Exports under SAFTA1
Agricultural Products	40.1	144.85	0.43	2.08	49.77	102.55
Textile	4.56	12.38	1.96	2.6	0.46	1.71
Wearing Apparels	1.06	3.18	0.08	0.14	0.96	4.28
Leather	1.8	7.42	0.02	0.02	0.17	0.69
Chemicals, rubber etc.	11.83	17.32	0.68	0.7	3.36	10.23
Machinery and equipments	1.11	4.8	0.33	0.83	0.9	2.87
Other Manufacturing products	3.5	7.85	1.05	1.74	0.51	2.22
Service	6.44	6.56	0.45	0.47	3.99	4.17
Total	70.4	204.36	5.0	8.59	60.12	128.72

Source: GTAP simulation Results

Figure 4: Trade Creation and Trade Diversion Effects of SAFTA2 Scenario



Source: GTAP simulation Results

Figure 4 presents the welfare effects of SAFTA2 scenario. In contrast to SAFTA1 under SAFTA2 Bangladesh undertakes some unilateral trade liberalisation measure. The results suggests that the negative trade diversion effect of SAFTA1 is eliminated to large extent under SAFTA2 and the trade creation effect is large enough to offset the trade diversion effect, which leads to a net welfare gain. The welfare statuses of other South Asian countries are largely unaffected.

IX. Conclusion

This paper has examined the features and prospects of different regional integration and bilateral FTAs in South Asia involving Bangladesh. It appears that among the RTA initiatives only the SAFTA has become operationalised. With respect to different bilateral FTAs no significant progress has been achieved so far.

This paper has also estimated the trade creation and trade diversion aspects of the total welfare effects of SAFTA scenarios. It appears 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 liberalisation 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. Technical assistance to Bangladesh and other South Asian LDCs to diversify their export basket can be a vital agenda. It should also be noted that the Special and Different Treatments for the LDCs under SAFTA are not sufficient, especially maintaining the sensitive list for some of the critical products by India will not help the South Asian LDCs to increase their export share. Also, South Asian LDCs should reduce tariff on the import of (at least) raw materials from India, which will have positive impact on LDCs welfare.