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REGIONAL COOPERATION IN SOUTH ASIA: FUTURE OF SAFTA

Abstract

The creation of South Asian Free Trade Area (SAFTA) is a widely discussed policy issue in this region. Recently, there has been an increased interest in regional economic integration in the South Asia region. The SAFTA is a parallel initiative to the multilateral trade liberalisation commitments of SAARC member countries. There have been some strong arguments for regional economic integration in South Asia, as this integration is thought to generate significant intra-regional 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 modest because of limited complementarities in the region and location of major trading partners of the individual South Asian countries outside the region. Mindless politics over people's concerns, mistrust and hegemonic attitude of the bigger towards the smaller countries would also prohibit deriving full benefits out of an excellent free trade agreement. Given this backdrop, the paper is intended to examine mainly the features, prospects and challenges of SAFTA.

Key Words: SAFTA, FTA, GTAP Model, Regional Cooperation, Trade Liberalisation.

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1. Introduction

In recent years, one important policy concern regarding trade relations among South Asian countries is whether the creation of South Asian Free Trade Area (SAFTA) would ensure gains for its member countries or not. In December 1985, seven countries of South Asia, *i.e.*, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka formed the South Asian Association for Regional Cooperation (SAARC) to promote economic, social and cultural cooperation. In 1993, the South Asian Preferential Trade Agreement (SAPTA) was initiated by SAARC to promote greater regional economic cooperation, which came into effect from December 1995. Subsequently, the member countries of SAARC transformed SAPTA into SAFTA, which is expected to be in place (in a complete form) by 2016. The key motivation behind the creation of SAFTA is to enhance intra-regional trade among SAARC members through the removal of tariff and non-tariff barriers and thereby to enjoy the gains of regional integration and at the same time to become more competitive in the global market.

The literature on South Asian regional grouping has expressed divergent views about the possible impact of SAFTA on its members. While some have expressed optimism about the impact, others remained skeptical. There have been some strong arguments for the regional economic integration in South Asia towards generating significant intraregional trade and welfare gains for the regional countries. However, critics have pointed out that the potential benefits from 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.¹

Given this backdrop, the main objective of this paper is to assess the prospects of SAFTA. To reach a conclusion regarding the prospect of SAFTA and its impacts on member countries, a quantitative assessment is needed. In doing this, we used a popular applied general equilibrium (AGE) model called Global Trade

¹ Selim Raihan and M. A. Razzaque, "Welfare Effects of South Asian Free Trade Area (SAFTA), Regional Trading Arrangements (RTAs) in South Asia: Implications for Bangladesh Economy", Paper Presented in a Conference on *Trade Liberalization and SAFTA: Opportunities, Concerns and Challenges*, Rawalpindi, Pakistan, January 2007, p.2.

Analysis Project (GTAP) model. The paper is organised as follows. Section 1 is the introduction, while Section 2 provides the salient features of SAFTA. Section 3 presents the criteria for a successful Free Trade Area (FTA). Section 4 discusses the future of SAFTA based on GTAP simulation results. Section 5 sketches a brief picture of the political environment and free trade Agreement in South Asia. Challenges of SAFTA are presented in Section 6, while Section 7 provides the conclusion.

2. Salient Features of SAFTA

The origin of SAFTA could be traced back to the Malé Summit of SAARC held in 1997. During the Summit, the SAARC countries initiated the regional approach of FTA in South Asia. They intended to establish SAFTA by 2001. But the political instability in South Asian region delayed SAFTA's enforcement within the stipulated time frame. However, to draw up a comprehensive treaty regime for creating a free trade area in South Asia, a 'committee of experts' was set up at the Colombo Summit in 1998. The framework of the proposed SAFTA was prepared by this committee and the member nations agreed in principle to it. During the Islamabad Summit held in 2004, the Foreign Ministers signed the framework agreement to launch SAFTA in order to attain better economic cooperation among the South Asian nations. Following the SAFTA Agreement, the member countries agreed to reduce tariff according to the following schedule:

Table 1: Schedule of Tariff Reduction under SAFTA

<i>Countries</i>	<i>Existing Tariff Rates</i>	<i>Tariff Rates Under SAFTA Agreement</i>	<i>Time Schedule</i>
SAFTA First Phase			
India, Pakistan and Sri Lanka	More than 20%	Reduce to 20%	2 Years
	Less than 20%	Annual reduction of 10%	2 Years
Bangladesh, Bhutan, Maldives and Nepal	More than 30%	Reduce to 30%	2 Years
	Less than 30%	Annual reduction of 5%	2 Years
SAFTA Second Phase			
Pakistan and India	20% or below	0-5%	5 Years
Sri Lanka	20% or below	0-5%	6 Years
Bangladesh, Bhutan, Maldives and Nepal	30% or below	0-5%	8 Years

Source: Hossain (2005).

It is evident from Table 1 that in the first phase, the developing countries i.e., India, Pakistan and Sri Lanka, will reduce tariff to 20 percent while the least developed countries in the region namely, Bangladesh, Bhutan, Maldives and Nepal, will reduce to 30 percent if the actual tariff rates are higher than this limit. However, there will be a 10 percent annual reduction on a Margin of Preference basis for developing countries and 5 percent for least developed countries (LDCs)² on actual tariff rates for each of the two years if the actual tariff rates are below this limit. In the second phase, it will take 5 years for the developed countries to reduce tariff to 0-5 percent whereas Sri Lanka will take an additional year to decrease tariff to 0-5 percent. The least developed countries will reduce tariff within 8 years. However, the member states are encouraged to adopt reductions in equal annual instalment, but not less than 15 percent annually.³

The Agreement on SAFTA has seven core elements:⁴

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

2.1. Trade Liberalisation Programme

2.1.1. Tariff reduction

As per Article 7 of the Agreement, tariffs on all products except the products under sensitive lists would be reduced to 0-5 percent within time frames agreed for LDCs and non-LDCs. The Agreement stipulates that SAFTA Committee of Experts would review non-

² India, Pakistan and Sri Lanka are developed countries, and the rest are LDCs in SAARC.

³ Sharif M. Hossain, "Bangladesh and the Free Trade Area: Regional and Bilateral Routes", *BISS Journal*, Vol. 26, No.3, July 2005, pp. 396-397.

⁴ Raihan and Razzaque, *op. cit.*, pp.4 -7.

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. Moreover, 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 percent among themselves within seven years, with one extra year for Sri Lanka (Table 1).

2.1.2. Sensitive lists

SAFTA sets up a sensitive list where products are exempted from the Trade Liberalisation Programme. This list is negotiated by the contracting states and incorporated in the Agreement as an integral part. However, the number of products in the sensitive lists is subject to maximum ceiling, which are mutually agreed among the contracting states, with flexibility to least developed contracting states to seek derogation in respect of the products of their export interest. Furthermore, the Agreement stipulates that the sensitive list shall be reviewed every four years or sooner, as may be decided by SAFTA Ministerial Council, with a view to reducing the number of items in the sensitive list.⁵

Table 2: Sensitive Lists Among the SAFTA Members

Country	Total Number of Sensitive List		Coverage of Sensitive List as % of Total HS Lines	
	For LDCs	For Non-LDCs	For Non-LDCs	For LDCs
Bangladesh	1254	1249	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	1335	1299	25.6	24.9
Pakistan	1191	1191	22.8	22.8
Sri Lanka	1079	1079	20.7	20.7

Source: Raihan and Razzaque (2007).

⁵ Ahmed Sheikh, "SAFTA: An Evaluation of Framework Agreement", Paper Presented at the Commonwealth Business Council SAFTA Roundtable, India, 2004, p. 6.

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 and para-tariff measures, the Agreement requires that the countries notify the measures to SAARC Secretariat on an annual basis. The SAFTA Committee of Experts will then 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 that “The initial notification shall be made within three months from the date of coming into force of the Agreement and the Committee of Experts shall review the notifications in its first meeting and take appropriate decisions”.⁶ In order to implement commitment to this provisions, a sub-group on non-tariff measures has already been established, which is engaged in addressing the non-tariff barriers.

2.2. Rules of Origin

Rules of origin is one of the 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 percent value addition measures as percentage of fob (free on board) value. However, value addition requirement is lower for Sri Lanka and LDCs, which is 35 percent and 30 percent respectively. In order to avoid fraudulent practices, detailed operational certification procedures have been adopted.

2.3. Institutional Arrangement

In order to monitor the implementation of SAFTA, two bodies namely SAFTA Ministerial Council and Committee of Experts have been established. SAFTA Ministerial Council comprising of

⁶ SAFTA Agreement, available at: www.saarc-sec.org/data/agenda/economic/safta/SAFTA%20AGREEMENT.pdf, accessed on 10 June 2007.

Commerce/Trade Minister of member countries is the highest decision making body of SAFTA. The Council shall meet once a year or more often. It will be supported by the SAFTA Committee of Experts comprising senior trade officials of member countries, which will meet once in every six months.

2.4. 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 percent 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).

2.5. 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:

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

2.6. Safeguard Measures

In order to protect domestic industry from potential damage 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 percent.

2.7. Consultations and Dispute Settlement Procedures

There is a 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 Committee of Experts for its recommendation within 60 days. The Committee of Experts may consult with a panel of experts for peer review. Any decision of the Committee of Experts can be appealed to SAFTA Ministerial Council for its decision within 60 days. The decision of the SAFTA Ministerial Council will be final.

3. Criteria for a Successful FTA

Theoretically, success of an FTA depends on fulfilment of some criteria. If those have been fulfilled, then the probability is higher for an economically viable FTA. In trade related theories and literatures, the economists agreed to set up some common necessary conditions. The common set of conditions is described below.

3.1. Geographical Proximity

Geographical proximity had always been a key issue for trade between the two countries. Around the world, one of the major determinants of bilateral trade is transport cost. Evidently, for reduced transport and communication cost neighbouring countries could get advantage while countries far away get disadvantaged. Regional trading arrangements should be undertaken on the basis that it is natural for neighbours to indulge in trade with each other. Goods from neighbouring countries may also be more compatible with local factors of production than those from farther away. While regional trading arrangements follow this pattern, bilateral trading arrangements may take place between distant partners. Although these FTAs do not benefit from transport cost savings, they benefit on other counts, as they would have traded in any case. In case of SAFTA, all the member countries enjoy lower transport cost compared to other trading partners.

3.2. High Pre-FTA Tariff Rates

High pre-FTA tariff rates increase the probability of trade creation among members, rather than diverted from non-members to

members. South Asian countries have long maintained high tariff rates and other protection measures despite their recent efforts to liberalise trade.⁷ The average tariff rate in South Asia is still higher compared to other regions in the world. It shows that high pre-FTA tariffs as a precondition for forming an FTA does indeed exist in South Asia.

3.3. Intra-regional Trade

High degree of intra-regional trade is an encouraging sign for establishing an FTA. Benefits from regional FTA would be higher among the countries having high degree of intra-regional trade while trade agreement with little prior trade would be unsuccessful. Intra-regional trade may depend more on the existence of product complementarities and comparative advantage and other characteristics such as the degree of concentration and diversification of trade profiles amongst the regional partners. The share of intra-regional trade in South Asia is very low compared to other trading blocs. Tables 3 and 4 show the share of bilateral and regional export and import as percentage of world exports and imports. The bilateral export and import shares of all SAFTA members are below 1 percent except India in most of the cases. India's trade share is relatively higher within SAFTA bloc.

⁷ Jayatilleke S Bandara and Wusheng Yu, "How Desirable is the South Asian Free Trade Area? A Quantitative Assessment", available at: <http://www.foi.life.ku.dk/upload/foi/docs/publikationer/working%20papers/2001/16.pdf>, accessed on 14 July, 2007, p. 9.

Table 3: Share of Bilateral/Regional Export as a Percentage of World Export in 2005

	<i>Bangla desh</i>	<i>Bhutan</i>	<i>India</i>	<i>Maldi ves</i>	<i>Nepal</i>	<i>Pakista n</i>	<i>Sri Lanka</i>	<i>SAARC</i>
Banglade sh		0.00	1.25	0.00	0.00	0.67	0.09	2.00
Bhutan	0.00		75.31	0.00	0.00	0.48	0.00	75.79
India	1.62	0.10		0.07	0.83	0.67	1.97	5.39
Maldives	0.00	0.00	0.72		0.00	0.00	12.24	12.96
Nepal	0.00	0.00	56.34	0.00		0.53	0.02	56.88
Pakistan	1.46	0.00	2.10	0.02	0.02		0.96	11.19
Sri Lanka	0.25	0.00	9.07	0.40	0.00	0.70		10.46
SAARC	1.40	0.07	1.13	0.07	0.63	0.63	1.62	

Source: Based on Trade Map Data, International Trade Centre, available at <http://www.trademap.org/>, accessed on 26 April 2007.

Table 4: Share of Bilateral/Regional Import as a Percentage of World Import in 2005

	<i>Bangla desh</i>	<i>Bhut an</i>	<i>India</i>	<i>Maldiv es</i>	<i>Nep al</i>	<i>Pakist an</i>	<i>Sri Lanka</i>	<i>SAAR C</i>
Banglad esh		0.00	15.24	0.00	0.00	2.14	0.14	17.52
Bhutan	0.00		69.08	0.00	0.00	0.17	0.01	69.26
India	0.09	0.06		0.00	0.25	0.12	0.39	0.95
Maldives	0.00	0.00	11.26		0.00	0.39	5.72	17.36
Nepal	0.00	0.00	64.39	0.00		0.27	0.02	64.68
Pakistan	0.27	0.00	2.30	0.01	0.01		0.24	3.05
Sri Lanka	0.11	0.00	17.33	0.25	0.00	1.39		19.08
SAARC	0.10	0.04	2.45	0.01	0.19	0.80	0.35	

Source: Based on Trade Map Data, International Trade Centre, available at <http://www.trademap.org/>, accessed on 26 April 2007.

3.4. Trade Complementarities

FTAs are likely to succeed in strengthening bilateral trade if the trade structures of member countries exhibit strong complementarities. When the commodities of one country have a considerable demand to another, the potential benefits of trade are higher. If the commodities of FTA member countries are same in nature, member countries would not be able to touch the envisaged levels of trade due to low level of trade complementarities. Trade complementarity between a pair of countries is traditionally measured by the Trade Complementarity Index (TCI). It can provide useful information on prospects for intraregional trade in that it shows how well the structures of a country's imports and exports match. The index is a measure of similarities between the export basket of one country and the import basket of another. TCI is defined as follows:⁸

$$TCI_{ij} = 100 - \sum_k \frac{|M_{jk} - X_{ik}|}{2}$$

where X_{ik} is country i 's total exports of product k , and M_{jk} is country j 's total imports of product k . The index ranges from zero to 100. The index is zero when none of the goods exported by one country is imported by the other and 100 when the export-import shares perfectly correspond. According to a World Bank study, SAFTA would not be able to touch the envisaged levels of trade due to a very low level of TCI of 1.3, as compared to 56.3 for NAFTA, 53.4 for the European Union, and 28.6 for Mercosur (Table 5).

⁸ International Monetary Fund, "Central American Economics and Monetary Community: Selected Issues", *IMF Country Report No. 06/309*, August 2006, p. 9.

Table 5: Trade Complementarity Index of Major Trading Blocs

<i>Trading Blocs</i>	<i>Trade Complementarity Index (TCI)</i>
South Asian Free Trade Area (SAFTA)	1.3
North American Free Trade Area (NAFTA)	56.3
European Union (EU)	53.4
Andean Pact	7.4
Mercosur	28.6
Canada - USA FTA	64.3
Latin American Free Trade Area (LAFTA)	22.3

Source: Pitigala (2005).

3.5. Comparative Advantage

The central characteristics of international trade based on efficiency are governed by the concept of comparative advantage and specialisation.⁹ Countries having different specialisation among different commodity groups would be able to establish a successful FTA. Prospects of trade expansion are likely to be weak for countries that have comparative advantage in similar products. To analyse the specialisation, policymakers frequently used the International Revealed Comparative Advantage (IRCA) index. IRCA index is a ratio of the share of a given product in a country's exports to its share in world exports. IRCA is defined as follows:¹⁰

$$IRCA_{ij} = \frac{X_{ij}/X_{wj}}{\sum X_{ij}/\sum X_{wj}}$$

where $IRCA_{ij}$ is the index of revealed comparative advantage of country i in commodity j ; X_{ij} is country i 's export of commodity j ; X_{wj} is world exports of commodity j ; $\sum X_i$ is total exports of country i ; and $\sum X_w$ is total world exports. A country is said to have a revealed comparative advantage in product if the index exceeds unity. According to IRCA index, the South Asian countries enjoy comparative advantage in a relatively narrow range of products with

⁹ Nihal Pitigala, "What Does Regional Trade in South Asia Reveal about Future Trade Integration? Some Empirical Evidence", *World Bank Policy Research Working Paper 3497*, February 2005, p. 28.

¹⁰ *Ibid.*

the exception of India and Sri Lanka.¹¹ Bangladesh, Nepal and Pakistan out of 71 commodity groups have revealed comparative advantage in only 7, 5 and 12 commodity groups while India and Sri Lanka have comparative advantage in 26 and 21 product categories; and none of the countries has comparative advantage in capital intensive and high value-added products.

3.6. Insignificant Political Tensions

Political tensions have also undermined efforts to foster trading arrangements. Political conflicts hamper the negotiation and implementation of any trading arrangement. As long as political tension is insignificant, it does not create much hindrance towards a friendly environment among the member countries to reach the final decision smoothly. But political tensions existing between Pakistan and India, and to some extent between Bangladesh and India are always a problem for creating a congenial environment for cooperation.

It is thus clear that member countries of SAFTA do not meet all the preconditions which are required to create a successful free trade area in this region. But it is not mandatory to satisfy all the criteria in all the cases. Because following the formation of an FTA the demand of products would change and the member countries may be able to diversify their products. The same situation could be expected in case of comparative advantage. With increased demand of goods and large scale of production, countries might not have identical comparative advantages. However, obtaining such trade complementarity is not easy for nations of South Asia, which is still far away from making an economic breakthrough to achieve a sustainable cycle of rapid growth¹². Thus, the South Asian countries need to move up in their respective growth trajectories.

¹¹ A. R. Kemal, "SAFTA and Economic Cooperation", Paper Presented at SAFMA Regional Conference, 20-21 August 2004, Dhaka, available at: http://www.southasianmedia.net/conference/Regional_Cooperation/safta.htm, accessed on 12 July 2005.

¹² Moudud Ahmed, *South Asia, Crisis of Development: The Case of Bangladesh*, The University Press Limited, Dhaka, 2002, p. 229.

4. Future of SAFTA: A GTAP Analysis

The present study has used the data and the modelling framework given under GTAP which captures various aspects of world economic activity. Currently, the GTAP model has become a useful tool for analysing the effects of Preferential Trading Arrangements (PTAs).¹³ Since the main objective of this paper is to assess the impact of SAFTA on its member countries, a multi-regional AGE model is an appropriate analytical tool.

The GTAP database covers all the bilateral trade, transport and protection data that link 87 country/regional economic databases. The latest version (Version 6) of the GTAP database represents the world economy in 2001.¹⁴ This version has 87 regions, 57 commodities and 5 factors of production. Each member of SAFTA has been separated as much as possible such as – Bangladesh, India, Pakistan and Sri Lanka.¹⁵ In case of commodity aggregation, 57 commodities are aggregated as 8 commodities. There are 5 factors of production – land, unskilled labour, skilled labour, capital and natural resources. There is also a change in the closure in the present study. In the default setting of the GTAP modelling framework, labour is assumed to be employed fully. However, in reality, large scale unemployment of unskilled labour is a major feature in the SAARC region. Therefore, this study has assumed that supply of unskilled labour for the SAARC member countries is perfectly elastic. Thus, in this case the wage is fixed for the unskilled labour of the SAARC region. With the aim of estimating the various effects of SAFTA, all tariff and non-tariff barriers have been eliminated among

¹³ For details about the GTAP modelling framework and the sources and characteristics of the data, see Thomas W. Hertel, *Global Trade Analysis: Modeling and Applications*, Cambridge University Press, USA, 1997.

¹⁴ The regional data bases have been derived from individual country domestic data bases or input-output tables. The individual country input-output tables then have been reconstructed in a form of sectoral disaggregation.

¹⁵ The version 6 of GTAP database did not separate Pakistan, Nepal and Maldives. They are considered jointly as rest of South Asia. In the rest of South Asia group, Pakistan is dominating and in this study rest of South Asia is considered as Pakistan.

the member countries in the GTAP simulation. But they keep their tariff with the rest of the world unaffected.

4.1. GTAP Simulation Results

In this section, the results of the SAFTA simulations are presented and analysed. The welfare results of different countries are shown as Equivalent Variation (EV) and presented in Table 6. To get an immediate picture of the outcome of any policy option, it is plausible to look at the welfare impact of such policy. In GTAP, welfare effects are determined mainly by three factors, *i.e.*, changes in allocative efficiency, changes in country's terms of trade (ToT) and changes in endowment. allocative efficiency refers to the efficient sector-wise allocation of scarce resources to produce the optimal combination of output. In the open economy context, it also refers to efficiency in resource use in purchasing imported products. ToT effect refers to relative movement in prices of countries exports and imports. It increases with relative increase in the price of exports as compared to imports. Endowment effect is a measure of how much the countries gain due to increase in employment of factors of production such as land, labour or capital. The table shows that all the member countries experience a sufficient welfare gain from SAFTA.

Table 6: Decomposition of Equivalent Variation (\$ US million)

	<i>Allocative Efficiency</i>	<i>Endowment Effect</i>	<i>ToT Effect</i>	<i>I-S Effect</i>	<i>Total</i>
Bangladesh	-18.1	217.7	-135.2	-17.7	46.6
India	134.2	521.7	250.7	-3.6	902.9
Pakistan	110.5	183	374.3	11.7	679.5
Sri Lanka	38.3	128.3	52.3	0.8	219.6

Source: GTAP simulation result.

From the welfare impacts, we observe that India is the biggest gainer from SAFTA and experiences a welfare gain of US\$ 902.9 million.¹⁶ Pakistan and Sri Lanka also experience a sufficient welfare gain of US\$ 679.5 million and US\$ 219 million respectively. In case

¹⁶ In GTAP, welfare is measured by equivalent variations (EV) using base year price and consumption for each type of household.

of Bangladesh, SAFTA generates only a small welfare gain. However, this is not an efficient solution as it leads to losses in allocative efficiency and terms of trade loss despite some marginal gain in the endowment effect due to a slight expansion in the export industries.

Table 7: Commodity Decomposition of Allocative Efficiency (\$US million)

	<i>Bangladesh</i>	<i>India</i>	<i>Pakistan</i>	<i>Sri Lanka</i>
Rice	0.1	1.3	1.8	5.8
Other Agri.	7.1	-6.2	34.5	7.6
Textile	-48	-4.3	-44.6	0.9
Garments	7.4	-11.4	-16.3	-0.6
Leather	0.4	-1.2	-0.1	-0.5
Chemical	-4.8	-15.8	52.9	4
Other Mfg.	-33.5	145.4	65.5	13.3
Services	-0.5	9	4.8	4

Source: GTAP simulation result.

Table 7 represents the commodity decomposition of allocative efficiency. The gain from the resource reallocation in agricultural sector is positive for all the countries except India. It loses slightly in some agricultural products. India's gain from manufacturing sector is the biggest, which is near US\$ 145 million. Pakistan experiences positive gain in chemical and other manufacturing sectors and loses in textile and garments sectors. In Bangladesh, among the manufacturing sectors only garments sector has efficiently reallocated the scarce resources. Sri Lanka experiences positive gain in most of the products with the highest gain in the manufacturing sector.

Table 8: Effects on GDP, Trade and Employment

	<i>Value of GDP (%)</i>	<i>Balance of Trade (US\$ million)</i>	<i>Volume of Export (%)</i>	<i>Volume of Import (%)</i>	<i>Employment (%)</i>
Bangladesh	-0.64	-161.8	11.81	9.28	1.54
India	0.63	-394.57	2.57	3.65	0.35
Pakistan	3.5	-415.62	5.95	11.03	0.66
Sri Lanka	1.87	-132.92	1.95	4.67	2.27

Source: GTAP simulation result.

Table 8 shows the effects on GDP, trade and employment. After arranging SAFTA, all the member countries experience sufficient increase in volume of export and import. But net increase of import is higher than net increase of export which results in a deterioration of balance of trade. With the higher demand of exportable commodities, industry output and economic activities are increased and generates additional employment as shown in Table 8.

It is important to note that the benefits of SAFTA cannot be fully captured by a perfectly competitive static model. The GTAP model assumes constant returns to scale and perfect competition in all sectors. The GTAP model also cannot capture dynamic effects of trade liberalisation. Any trade liberalisation under such models will always be welfare increasing. In that sense the result depicting welfare increase is not surprising. What is important, however, is the source of the gain. As South Asia is in general a labour-surplus region with high unemployment, the conventional model has been modified to reflect this ground reality. Much of the welfare gain occurs due to increased employment of labour. While the changes in output are not substantial, the total unemployment pool is so large that even a small increase in labour employment may have resulted in large aggregate welfare gains.

5. Political Environment and Free Trade Agreement in South Asia

It is the historical relationship among the South Asian nations and the complexities evolved during the process of their independence which still dictate inter-state relations in this region. Regional cooperation is heavily influenced by such political relationship. The most important reason for least effective regional integration in South Asia has been the intense hostility between Pakistan and India over Kashmir since 1947 when the two countries gained independence from colonial rule.¹⁷ The Kashmir issue usually rules any Indo-Pak talk. Therefore, the Indo-Pak relationship has become one of the most crucial issues for regional cooperation in South Asia. Rivalry between these two South Asian giants has even

¹⁷ Shahid Javed Burki, "Potential of the South Asian Free Trade Area", in *South Asian Free Trade Area: Opportunities and Challenges*, Nathan Associates Inc, USA, October 2005, p.11.

hindered the progress of SAARC. As a result, this regional organisation, since its inception, has remained mostly ineffective and has achieved very little in tangible terms. Also, some other political tensions among its member states have led to the underachievement of SAARC. There are a number of severe problems that the organisation faces. Other than the issue of Kashmir, the conflicting issues, which have plagued the region for years are water distribution in the east, and internal power sharing in the north (Nepal) and south (Sri Lanka).¹⁸ For Bangladesh, the lifeline for the country is water that flows through India. However, the latter's unilateral diversion of water in the upstream during the dry season has created great problem in the former. And this adversely affects the cooperation between the two countries. In addition, the northern and southern parts of both Nepal and Sri Lanka have been bogged down for years by their infighting over internal power sharing, which is having a serious impact on their attitude to and cooperation with others. All these political tensions and conflicts in South Asia have posed a question of uncertainty and challenge the implementation of SAFTA.

India, with its largest and fastest growing economy, has the upper hand for resolving the major issues that have afflicted the region. Hence, the country has a great responsibility to steer SAARC nations in the direction of economic integration. By doing so, India will expedite its own growth and ensure its stability as well. Experts suggest that India can assist most of the other South Asian states in their developmental efforts by virtue of its diversified industrial base and relatively skilled manpower. For instance, Nepal and Bangladesh could benefit in textiles and plastic products, while Bangladesh and Pakistan could substantially improve iron and steel production with cooperation from India.¹⁹ India as a leading power in the region has an enormous obligation to lead by setting a good example for other member states. Another important missing ingredient is a shared perception of common benefits. All the members must feel they are sharing the costs and benefits of the cooperation equitably. The recent developments in relations between Pakistan and India have

¹⁸ Mahfuz R. Chowdhury, "Free Trade", *The Daily Star*, 7 August 2007.

¹⁹ CUTS-CITEE, "Economic Cooperation in South Asia: Current States and Prospects", *Briefing Paper No. 2/2005*, CUTS Centre for International Trade, Economics and Environment, India, 2005, p.4.

enkindled hopes for acceleration of such regional cooperation. Trade between two nations accrues gains to both while the loss of existing trade ties, resulting from political conflict between them, implies a loss of economic benefits for both. Two countries trading with each other, therefore, should make an effort to avoid conflicts in order not to suffer such a loss.²⁰

6. Challenges to Successful Implementation

Political instability, high transportation cost, low level of intra-regional trade among members, similar pattern of comparative advantage, and absence of trade complementarities pose threat to inception of any FTA. Apart from these, there are some other factors that challenge successful implementation of SAFTA. On the economic front, the main inhibiting factor has been the competitive rather than complementary nature of products.²¹ There are several areas where South Asian countries compete for the same market, thereby making it harder to cooperate among themselves. Due to competing nature of the product, there is mutual distrust among the member states that one country might outmanoeuvre the other.²² Another impediment is the tendency of SAFTA member countries to enter into free trade agreements with other member countries or to become associated with other parallel economic bloc like Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC). In such a case, SAFTA might become marginal to trade interests of its members.²³ Though there is nothing

²⁰ Saroj Bishoyi, "India-Pakistan Relations and SAFTA", Article No. 2102, August 2007, available at: http://ipcs.org/India_Pak_articles2.jsp?action=showView&kValue=2117&country=1016&status=article&mod=a&portal=pakistan, accessed on 25 August 2007.

²¹ For details, see A. R. Kemal, *op. cit.*

²² Asadul Islam, "South Asian Free Trade Agreement: Perspectives of the Private Sector and Government of Bangladesh", *mimeograph*, Bangladesh Institute of Development Studies, (undated), p.17.

²³ Saman Kelegama, "Impediments to Regional Economic Cooperation in South Asia", FES Publication No 49, Institute of Policy Studies of Sri Lanka and Coalition for Action on South Asian Cooperation, available at: www.fessrilanka.org/pdf/pub/Impediments/i-1.pdf, accessed on 26 August, 2007.

wrong with the bilateral agreements, in the current situation it is desirable that every member country invest their time in making SAFTA successful. Lack of physical infrastructure like linkages through road, railway and waterway increases the transportation cost in this region and thus becomes another challenge to SAFTA. In a highly competitive world economy, transport cost is a significant determinant of competitiveness, which makes an integrated and efficient surface transport network an essential element of the enabling environment for economic integration at any level.²⁴ It would be essential to have adequate facilitation measures to ensure that goods and vehicles can move freely across borders and through countries. SAFTA will facilitate optimum trade flow among member countries when a forward looking approach is undertaken towards integrating the transit network in the whole region. It should also be noted that to derive gain from SAFTA, some other meaningful issues like removal of non- tariff barriers, solving the problem of illegal border trade and expanding tariff liberalisation span have to be considered. Unfortunately, while everybody agrees to removal of tariff, actual trade has often crossed much tougher non-tariff barriers which under no stretch of imagination can be touted as free trade. As long as such a situation of unfettered movement of goods and services occurs, the gain from SAFTA will not be realised.

7. Conclusion

SAFTA was launched in the poverty-ridden South Asia with the aim to liberalise trade, gain economic welfare and to pursue a higher economic growth for the people. But, the region still remains the least integrated zone in the world.²⁵ However, South Asia could be

²⁴ M. Rahmatullah, "Improving Transport Connectivity and Facilitation Measures", Paper Presented at the Fourth International Forum on Regional Economic Cooperation among Bangladesh, China, India, Myanmar, March 2003.

²⁵ Asif Maqbool, Muhammad Waqas Alam Chattha and Masood Azeem, "Challenges and Opportunities for Pakistan under SAFTA" ", Paper Presented in a Conference on Trade Liberalization and SAFTA: Opportunities, Concerns and Challenges, Rawalpindi, Pakistan, January 2007, available at: <https://www.gtap.agecon.purdue.edu/resources/download/2977.pdf>, accessed on 15 July 2007.

benefited if it implements SAFTA successfully as quantitative analysis clearly depicts a net welfare gain even for least developed countries of the region. Thus, countries like Bangladesh and Nepal can remain hopeful to accrue dividends of SAFTA. On the other hand, from realistic point of view, a number of multifaceted challenges have encircled this regional economic bloc. Low volume of intra regional trade coupled with poor infrastructure and a few other problems which are mentioned earlier have already posed a question mark to the future of SAFTA. On the political front, eternal rivalry between Pakistan and India over Kashmir has become a stumbling block to the success of SAFTA. Moreover, some other South Asian countries' disputed relations with India may not provide SAFTA the conducive environment. Nevertheless, by setting aside the disputed affairs the countries should explore the possible opportunities which arise from operating under integrated economic bloc. Interestingly, it is India which improved its trade and economic links with China despite having a soured relationship with the latter. Also, past animosity has not hampered the Japan-South Korea or China-Japan economic ties. Therefore, countries from South Asia should maintain meaningful trade links among themselves, while continue to discuss on the sticky political matters. Such policy might brighten prospects for SAFTA to contribute positively to the wellbeing of the South Asian population.