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SOUTH ASIAN FREE TRADE AREA

OPPORTUNITIES AND CHALLENGES

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Preface

Over the past year, the U.S. Agency for International Development (USAID) has supported collaborative research and analysis of opportunities for and obstacles to regional economic integration under the South Asian Free Trade Area (SAFTA) Agreement. This agreement is to be implemented in January 2006 under terms agreed on at the 12th summit of the South Asian Association for Regional Cooperation (SAARC) held in Islamabad in January 2004.

This compendium of papers on SAFTA's opportunities and obstacles was prepared by a team of regional and country experts. The team will present the papers to policymakers, business leaders, and analysts from throughout the region at a conference in New Delhi, October 24–26, 2005. Individual team members will then present their findings to, and summarize conference proceedings for, senior government officials and other stakeholders in South Asian capitals.

Led by Shahid Javed Burki, the research team consisted of Dr. James Walker, Senior Economic Advisor to USAID's Bureau of Asia and the Near East (USAID/ANE), and seven regional or country experts: James W. Robertson, Dr. Amita Batra, Dr. Mohammed Akbar, Dr. Mohammed Ali Rashid, Dr. Binod Karmarcharya, Dr. Sanath Jayanetti, and Dr. Kathleen Trask.

Erin Endean of Nathan Associates Inc. directed the activity, which was sponsored by the USAID Bureau of Economic Growth, Agriculture, and Trade under its global Trade Capacity-Building Project, with support from USAID/ANE.

Executive Summary

The papers in this compendium offer unique perspectives on the opportunities that the South Asian Free Trade Area (SAFTA) Agreement presents for South Asia's economic development, as well as perspectives on obstacles to the agreement's success. They examine the agreement in the context of the region's history, geopolitical heritage, and economic structure, including the many infrastructural and political barriers to regional integration that are outside the scope of most trade agreements. They also examine the agreement from the perspectives of individual countries that are its signatories and of countries, such as Afghanistan, that might be brought into SAFTA later.

Five common themes emerge in the papers: (1) the SAFTA agreement can be of political as well as economic benefit; (2) the success of the agreement depends on political commitment and harmony among all members and on the vigor and vision with which India, the largest economy in the region, leads by example in adopting meaningful trade reforms; (3) the agreement has serious shortcomings that can be remedied by strengthening the agreement or the implementing institutions, or both; (4) policymakers need to pursue measures external to the agreement that will support it; and (5) bureaucratic and administrative obstacles to the agreement's success must be addressed, often by individual countries.

If successful, the SAFTA agreement will accelerate growth, deepen cross-border trade and investment, and further stabilize the region. It will also bring about profound structural changes in the region's economies.

Why has intraregional trade in South Asia languished, making up only 5 percent of total trade? The short answer is: a combination of politics and protectionism.

- ***Politics.*** In the late 1940s, when most South Asian countries were part of one political entity— British India—trade among them was sizeable. In 1947, when Pakistan (Pakistan then included Bangladesh) and India became independent, more than half of Pakistan's imports came from India and nearly two-thirds of its exports went to India. But, as the two countries engaged in bitter disputes over territory, currency valuation, and water distribution, these shares declined.
- ***Protectionism.*** All countries in the region pursued economic development by adopting import substitution rather than export promotion strategies, keeping trade as a proportion of national production relatively low. The countries exported traditional products to already established markets in developed and distant countries: the United States became the most important trading partner for most economies of the region.

Both of these factors are changing for the better. Now that India and Pakistan are resolving differences through diplomacy and all countries are opening their economies to global trade, the countries of South Asia are ready to increase regional economic cooperation.

They can learn much from regional integration elsewhere. One important lesson is that benefits are greatest when countries have relatively open economies. Building regional trading arrangements behind high walls of tariffs diverts trade; it does not create significant new trading opportunities. South Asia is a more protected region than other developing regions and the countries must open their economies before attempting to structure a regional trading arrangement. India and Pakistan have both significantly reduced trade-weighted tariffs in 2005.

Specific sectors in which barriers to trade or regional economic integration have been especially steep stand to benefit the most from the dismantling of such barriers. Among these, we see significant opportunities in agriculture, energy, textiles/apparel, and tourism.

- ***Agriculture.*** The regions that now comprise Bangladesh, India, and Pakistan traded extensively in agricultural products when they were part of the British Indian Empire. Once they gained independence, they followed highly protective trade policies, with tariffs in India, Pakistan, and Bangladesh bound at prohibitively high levels (more than 100 percent), and tariffs in Sri Lanka and Nepal at lower, but still steep, levels. Nontariff measures such as state trading monopolies and subsidies or domestic supports have further distorted trade in the sector.
- ***Energy.*** South Asia has an energy deficit as a whole, but some countries have considerable untapped potential for generating power from hydro sources (Pakistan and Nepal) or from tapping gas reserves (Pakistan and Bangladesh). Just outside the region, moreover, enormous reserves of oil and gas stand ready to be piped to the region, provided there is agreement among the countries on transit trade in energy. If all countries were to adopt policies for tapping the potential of various energy sources, they could take advantage of complementarities in primary energy endowments to match supply with demand across national boundaries. Serious barriers to the development of a regional supply market for energy exist, but individual projects that cross borders (such as to supply power from Pakistan's national electricity grid to neighboring power-deficient Indian states or to supply Bangladeshi gas to the power-deficient industrial Kolkata) could pave the way for SAFTA countries to work out a broader policy framework for opening up long-term regional energy trade and investment.
- ***Textiles/Apparel.*** Countries in South Asia have complementary, rather than competing, interests in this sector as well. Global markets are in flux as a result of the elimination in January 2005 of quotas that had long constrained certain exporting countries, the consolidation of global sourcing by buyers, and the proliferation of trade agreements and trade preferences to certain exporting countries. In South Asia, India and Pakistan have a natural advantage in the production of textile yarn and fabrics; they are among the world's largest producers of cotton. At the same time, Bangladesh, Sri Lanka, and Nepal have seen sharp growth in apparel manufacturing and exporting. South Asian producers would be prudent to explore how to work together to develop an integrated industry with some division according to comparative advantage. Such integration could save the

garment factories of Bangladesh and Sri Lanka from disinvestment in the heightened competition of the post-quota era, while India and Pakistan could concentrate on capital-intensive spinning and weaving.

- ***Tourism.*** There is considerable scope for intraregional tourism. After the partition of British India and the movement of millions of people across the new border between India and Pakistan, hundreds of thousands of families were split. Opening the borders and removing constraints on travel would result in considerable travel just among families trying to reunite. In addition, religious sites in India would attract Muslims from Bangladesh and Pakistan; and holy sites in Pakistan would attract members of the Sikh community. The region also could attract more tourists from outside of South Asia were geopolitical stability to be enhanced through regional economic integration.

Economic cooperation and political harmony are mutually reinforcing. South Asia's senior leaders, taking their cue from the European Union and the Mercosur in Latin America, recognize that by opening their economies to trade, especially to trade with neighboring countries, they can lay the groundwork for bringing peace to a conflict-ridden region. A peaceful region—one characterized by the free movement of people, by open cultural exchange, even by visits by sports teams—is a sounder basis for public policy than a hostile one. Despite the inevitable problems that implementing the SAFTA agreement will give rise to, the political momentum for regional integration needs to be maintained. We worry that some of the political impetus for economic integration has weakened in 2005 and might delay preparations for the launch of the agreement.

In this regard, the papers commonly cite two variables that will determine the success of the agreement. First, though political commitment to economic integration is critical, political differences will likely continue to threaten the agreement's implementation. And second, India's trade policy, more than that of any other country, will be decisive in the success or failure of SAFTA. Most successful regional trade arrangements have had at their core a single strong economy and India's economy is much larger than others in the region.

In noting significant shortcomings in the text of the agreement, all papers recommend how the agreement or its implementing institutions might be strengthened to further regional economic integration, as follows:

- ***Accelerate the implementation schedule for tariff cuts and reduce "sensitive lists" to broaden coverage.*** The SAFTA agreement is conventional in prolonging tariff reductions and providing safeguards for likely losers. But even in tariff reduction, member countries are permitted considerable discretion in determining peak tariffs and tariff distribution. SAFTA's Committee of Experts is expected to finish preparing sensitive lists and defining rules of origin before the November summit of the South Asian Association for Regional Cooperation (SAARC). All countries have taken a very conservative stance on these issues. For example, Pakistan's sensitive list initially covered 45 percent of all tariff lines. India covered only one-sixth, but excluded entire chapters that have great significance for exports from Pakistan. India believes that Pakistan's list is intended to keep exports of automobiles, auto-parts, and textile machinery from the Pakistani market. India is also unhappy that Pakistan has not granted it most favored nation status although India treats Pakistan as an MFN country. Bureaucratic inertia is driving this cautious

approach to design of the free trade area; business communities are prepared to adopt a much more aggressive stance toward regional integration. Overcoming mid-level bureaucratic inertia will require intervention by senior political leaders in each key country.

- ***Define rules of origin that will facilitate regional integration without constraining the region's growth opportunities.*** The SAFTA signatories are also at odds over how to define rules of origin, with the region's smaller countries generally favoring more liberal rules that will allow them to boost exports of processed goods made from imported raw material and intermediates, while developed economies want to encourage sourcing of such inputs within the region to boost their own exports of raw materials and intermediate goods.
- ***Broaden liberalization commitments to encompass nontariff barriers.*** Other barriers that drive up transaction costs and impede trade expansion become more evident when tariffs are significantly reduced. The agreement does not specify a timeframe for identifying and eliminating such barriers; the provision about withdrawing parataiffs and nontariff barriers is a "best endeavor" clause. As the experience of South America shows, however, explicit and implicit nontariff barriers can nullify the benefit of tariff reduction. If trade promotion is a goal and if political leaders are committed to it, the issue of nontariff barriers must be addressed. Negotiating parties should identify these barriers—explicit and hidden—to realize the full impact of free trade in the region.
- ***Incorporate services and investment.*** In contrast to successful regional trading arrangements, the SAFTA agreement is less ambitious in scope and has two glaring omissions. It does not cover services, the most rapidly growing sector in international trade, nor does it promote intraregional investment. Should it be changed to include these features or should inclusion be postponed? SAFTA must also address cross-border investment and movement of people across international borders. And, India, because it has the capital and corporate experience to invest in other SAARC countries, must take the lead in these areas. India could also meet shortages of sophisticated skills in other South Asian countries. A regional framework would encourage such efforts. Opportunities for regional collaboration are significant in information technology services, some social services (e.g., education and health), and banking.
- ***Develop mechanisms for compensating for revenue losses and providing assistance.*** Agreement is still lacking on compensating least developed countries for possible revenue losses once SAFTA goes into effect, and providing technical assistance to these countries during the period of transition. The more developed economies—India, Pakistan, and Sri Lanka—are not willing to compensate the less developed for possible initial revenue losses. Some multilateral donors may be willing to provide short-term support. If agreement cannot be reached, the date for commencing implementation of the accord might slip. These issues must be addressed before or during the November SAARC summit.
- ***Strengthen the SAARC Secretariat.*** Beholden to member countries, the SAARC Secretariat has no capacity to do research and analysis or to advise on policy, nor can it

receive funding from multilateral or bilateral donors to investigate the promotion of regionalism. Member governments are understandably reluctant to grant autonomy to the Secretariat; doing so would diminish their hold on the process and direction of regional integration. But, as experience with evolving arrangements such as the European Union and Mercosur, the common market in South America, suggests, this approach hinders regionalism. Many issues can only be handled efficiently if the Secretariat has some independent authority. This is particularly so in reaching agreement on the standards and harmonization critical to the success of any regional trading arrangement. A stronger secretariat will also be better positioned to find and develop financing for regional infrastructure projects.

- ***Agree on parameters for geographic expansion.*** All successful agreements have provisions for expansion, but SAFTA members have not discussed expansion. They need to reach consensus on how to admit new members and how to work with other regional arrangements, such as the ASEAN. SAFTA will be considerably strengthened if it includes Afghanistan in its coverage very early on. This would require that Afghanistan first join SAARC. The regional stake in Afghanistan's political stability would be raised as well if the country were a part of SAFTA.

In addition to recommending these potential changes to the agreement, its institutions, or its membership, the papers uniformly urge policymakers to implement measures that will support the SAFTA process, even if not embodied in the agreement itself.

- ***Focus on trade facilitation.*** As indicated above, external tariffs are now much lower than when the SAFTA framework was developed, so much more trade can be created if governments focus less on tariff reductions and more on trade facilitation. Policymakers seem not to appreciate that significant reductions in transaction costs will be critical to the agreement's effectiveness. To reduce trade-related transaction costs, governments must collaborate on a trade facilitation agenda that encompasses procedures, regulations, and processes that impose costs on cross-border commercial transactions (e.g., customs, standards, movement of persons).
- ***Plan for regional transport and communications infrastructure.*** SAARC countries should together plan a regional transport network, with transport defined broadly to include the flow of various forms of energy across international borders. A well-formulated plan will link the region's road, rail, and ports systems; allow countries access to each other's airlines and airports for the movement of people and goods; and link the electricity, gas, and oil grids. We believe such a plan would be of interest to development institutions, such as the World Bank and the Asian Development Bank, to the private sector, and to large global private equity funds.
- ***Negotiate transit rights.*** Of the seven SAARC countries, two are landlocked, one (India) shares borders with four others, and two are island economies. If SAFTA expands north, bringing in Afghanistan and the countries of Central Asia, or east, bringing in Myanmar, Thailand, and other countries of East Asia, transit rights will become even more important. Exporters in Bangladesh and Nepal are already demanding that India provide transit facilities for trade with Pakistan while exporters in India are demanding transit

from Pakistan for trade with Afghanistan and Central Asia. It is unfortunate that both India and Pakistan continue to use transit rights to promote political agendas. The granting of transit rights for interstate commerce needs to be depoliticized; leaders must not permit countries' narrow interests to trump the benefits of freely flowing commerce for the region. The countries of the Mercosur agreement, the common market involving several South American countries, overcame mutual suspicions to allow transit rights for member countries. Several arrangements in sub-Saharan Africa also permit transit rights. Intraregional commerce has flourished in these groups.

Finally, the papers note that obstacles to the agreement's success, while not insurmountable, are significant and must be addressed, often by individual countries rather than in any formal collective action or agreement:

- ***Proliferation of other regional or subregional trade agreements.*** Some South Asian governments have entered into bilateral and multilateral arrangements while contemplating a SAFTA-type accord. The proliferation of these agreements, sometimes with countries outside of the region, will complicate implementation of the SAFTA agreement. For example, if the pace of tariff cutting is not accelerated, SAFTA may become irrelevant in light of other agreements.
- ***Bureaucratic inertia.*** Inertia could hamper implementation of the SAFTA agreement, especially in India, Pakistan, and Bangladesh, where entrenched pre-World War II bureaucracies use administrative controls to reach social goals. A free trade regime of the type envisaged in the SAFTA agreement will require fundamental change in bureaucratic culture and practices. Such change can happen only when senior political leaders at the federal or central level make a firm commitment to regional integration and free trade.
- ***Decentralization of political and economic authority.*** Decentralization of state and provincial authority could also undermine implementation. In India and Pakistan, states and provinces are increasingly autonomous in exercising economic authority. They sometimes do not accept the priorities of central authorities if they conflict with local perceived economic interests. This is why, for example, Nepalese and Bangladeshi exporters face difficulties in getting goods across the border into India. Conversely, when subnational governments perceive mutual interests they promote trade beyond the designs of central authorities. This seems to be happening in the rapidly developing economic relations between the Indian state of Punjab and the Pakistani province of Punjab.

Region-wide perspectives on the potential of SAFTA to enable prosperity and ease political tensions among member states, and the critical importance of trade facilitation measures to the success of the SAFTA agreement, are presented in Part 1. The agreement's potential and shortcomings when viewed from the perspectives of individual countries are presented in Part 2.

Introduction

During a summit in Islamabad in January 2004, the heads of state and government of the seven members of the South Asian Association for Regional Cooperation (SAARC) decided to establish a free trade area in South Asia. The "Islamabad Declaration" aims to launch the South Asian Free Trade Area (SAFTA) on January 1, 2006. This decision could usher in profound economic and political changes in the region. Successful implementation of the Islamabad Declaration could lift the burden of history which the countries of the region have borne since the time of their independence in the late 1940s.

SAFTA'S GEOPOLITICAL CONTEXT

Many economists subscribe to the "gravity" model of international trade, in which distance heavily influences the destination of trade. Indeed, most international trade occurs within a radius of 3,000 km. But most exports from South Asia go to the world's rich countries—in particular the United States. South Asia deviates from the model not because it is structurally different from other parts of the world, but because of intense hostility between India and Pakistan, the region's largest economies. That hostility, which began with the dispute over accession of the state of Kashmir in 1948, and with a trade war that same year, has persisted for more than a half century. The easing of tensions between these two countries started with the offer of the "hand of friendship" by Atal Bihari Vajpayee, then Prime Minister of India, in a speech in Srinagar, Kashmir, in April 2003. That speech set the stage for reversing this pattern and for the signing of the Islamabad Declaration.

Trade has also had a relatively low share in the region's gross domestic product because South Asian governments have followed an import-substitution strategy of development for 40 years. This strategy was abandoned in the early 1990s, first by Sri Lanka and then others, in favor of openness. Consequently, the region's trade-to-GDP ratio has increased in recent years but intraregional trade still accounts for less than 5 percent of the total. A properly designed SAFTA should help increase intraregional trade and improve living standards. Regional trading arrangements tend to be most successful when participating countries have already opened their economies to the world. The various rounds of South Asia Preferential Trading Arrangement (SAPTA)—a predecessor of SAFTA—did not produce meaningful consequences partly because of the highly protective trade regimes most countries had in place.

SAPTA implementation was also made difficult by the abiding hostility between India and Pakistan. The fourth round of tariff reductions under SAPTA, for example, had to be deferred because of the return of military rule in Pakistan and mounting tensions between the two

countries in 2001 and 2002. These tensions have dissipated somewhat in recent months, and SAFTA is being launched in a more supportive economic and political environment.

Just as the region's geopolitical heritage has and will continue to significantly influence the region's economic structure and interchanges, cross-border commerce could exert a beneficial influence on geopolitical relationships. Successful regional trade arrangements (RTAs) do more than integrate economies; they often help ease political tensions. Such an outcome would be of great significance for strife-torn South Asia. The central question for the region then is: Will the countries not only have the technical capacity but also the political will to implement SAFTA as proposed in the Islamabad Declaration?

OVERVIEW OF THE SAFTA AGREEMENT

The SAFTA agreement's stated objective is to "strengthen intra-SAARC economic cooperation to maximize the realization of the region's potential for trade and the development of their people." The agreement calls for eliminating barriers to trade and facilitating the cross-border movement of goods between contracting states; promoting conditions for fair competition; and establishing a framework for further regional cooperation. Governed by the principles of the World Trade Organization (WTO), reciprocity, and an awareness of the needs of least-developed SAFTA countries (Bangladesh, Nepal, Bhutan, Maldives), the agreement targets the elimination of tariffs, parataiffs, and nontariff barriers.[1]

The agreement provides for the creation of two institutions to oversee implementation. The SAFTA Ministerial Council will be the highest decision-making body and will consist of the ministers of commerce or trade of member states. The council will meet at least once each year, with the chair of the council changing annually. The Committee of Experts, consisting of a senior economic official from each member state, will support the council, report on implementation status semiannually, and serve as the dispute settlement body. The Committee of Experts will meet at least once every six months, with the chair of the committee changing annually.

Tariffs

SAFTA member states have committed to a ten-year phase out of tariffs beginning in January 2006. Reductions will proceed in two stages but at a different pace for least developed members (LDM) and non-least developed members (NLDM). In the first two years

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

[1] Parataiffs are border charges levied exclusively on imports and which do not correspond to specific services. Such charges violate WTO provisions.

In the second phase of implementation

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

Qualifying for SAFTA preferences has some additional requirements for rules of origin, sensitive lists, balance of payments, and safeguard measures. Rules of origin determine eligibility for tariff preferences by specifying how a good is classified as being produced in a member state—usually as a percentage of value added. Negotiations of rules of origin may determine the benefits of the agreement. If the rules are too restrictive they will eliminate trade expansion possibilities.

Certain categories of products may be excluded permanently or temporarily from preferences. The agreement contains provisions restricting trade in the interests of national security, public morals, health (human, animal, and plant), or historic value. It also provides for exemptions of sensitive list products. The agreement does not restrict the size or scope of sensitive lists, stating simply that these will be decided through negotiation. The agreement does require that lists be reviewed every four years "with a view to reducing the number of items" but entails no commitment to shortening the lists. The WTO, however, requires that preferential trading agreements free "substantially all trade" between member states where "substantially all" is interpreted as 85 percent. This would seem to place a maximum limit on the size a country's sensitive list (i.e., no more than 15 percent of intra-SAFTA trade).

Countries facing serious balance of payments issues can temporarily suspend the concessions of the agreement. The Committee of Experts will monitor such situations and require that the suspension be phased out once the balance of payments situation has improved. Member states may also temporarily suspend concessions for specific goods when the quantity of imports "causes or threatens to cause serious injury to producers of like or directly competitive products." The suspension can be extended for a maximum of three years.

Nontariff Barriers

Trade liberalization provisions also address nontariff barriers. The most definite requirement is that quantitative restrictions not consistent with WTO provisions be eliminated for products not on sensitive lists. No timeframe or mechanism, however, is specified. In addition, all nontariff barriers and parataiffs must be notified to the SAARC Secretariat annually. The Committee of Experts will review measures for WTO compliance and can recommend their elimination or amendment. The agreement makes no positive statement about compliance or systematic elimination of nontariff barriers.

Special and Differential Treatment

The agreement has several provisions for differential treatment of LDMs, including a longer implementation period, faster tariff reductions for NLDMs, and "favorable" consideration for applying antidumping and/or countervailing measures and for continuing quantitative restrictions

or direct trade measures. Most significantly, the agreement provides for a ***revenue compensation mechanism*** for LDMs by which member states agree "to establish an appropriate mechanism to compensate the Least Developed Contracting States for their loss of customs revenue." It also requires that this mechanism be established before tariff reductions begin in January 2006. It seems unlikely that a financial compensation mechanism will be implemented. More likely to be negotiated is some other form of compensation, such as technical assistance.

Other Issues and Provisions

A stated principle of the agreement is the adoption of trade facilitation initiatives. Such initiatives would provide significant benefits for Afghanistan as it re-establishes its trade regime. No mechanism or timeframe is specified, however. The agreement also highlights areas that might be considered in future negotiations: the harmonization of standards, customs clearance procedures, customs classifications, and import licensing and registration; customs cooperation; transit facilitation; removal of investment barriers within SAARC; macroeconomic consultation; rules for fair competition; communication and transportation infrastructure; and the elimination of exchange restrictions.

ORGANIZATION OF THIS BOOK

Part 1 of this compendium presents regional perspectives on the potential of SAFTA to enable prosperity and ease political tensions among member states, and on the critical importance of trade facilitation measures to the success of the SAFTA agreement. Part 2 presents the agreement's potential as well as shortcomings when viewed from an individual country-level perspective for signatories India, Bangladesh, Nepal, Sri Lanka, Maldives, and Pakistan. It also presents a perspective for one non-signatory, Afghanistan, which might be brought into agreement at a later date. The appendix summarizes in table form other trade agreements and arrangements now functioning or being negotiated in the region.

Part 1. Regional Perspectives

1. Potential of the South Asian Free Trade Area

Shahid Javed Burki

Economic historians have identified “catch-up periods” in world history during which some lagging economies caught up with—and in some cases overtook—the leading economy. The first of these periods occurred in the quarter century before the beginning of the First World War when the United States overtook Great Britain as the leading world economy in size and in income per head of population. The second lasted from about 1950 to 1975 when Japan caught up with the United States and Western Europe in per capita income. Because of its smaller population, Japan’s GDP remained much smaller in size than that of United States, the world’s leading economy.

The third catch-period began in the early 1970s and lasted until the closing years of the 20th century. During this period a number of small East Asian economies caught up with the United States, Europe, and Japan not in economic size and not even in per capita income. This time the catching up was in technology. Several East Asian “miracle economies” are now leading players in several important industrial technologies, especially those relating to telecommunications, automobiles, and computer hardware and software. These technologies will have a profound effect on the development of the global economy in the next few decades.

There is emerging consensus among economic historians that the fourth catch-up period may have begun in the early years of the 21st century with the remarkable economic expansion in China. In purchasing power parity, China’s economy is likely to overtake the United States in size by 2025. By then, its GDP in today’s prices will be about $25 trillion or one-quarter the global total of $100 trillion. The United States might drop to second place with an estimated GDP of $23 trillion.

Increased participation in global trade was an important determinant of economic growth of the catch-up economies. This is one reason why South Asia has lagged and has not been a catch-up economy. Is this about to change? Could the decision at the 2004 summit of the countries of the South Asian Association for Regional Corporation (SAARC) to launch a free trade area change South Asia’s economic structure and its prospects? Could South Asia become a major player in the global economic and trading system?

On January 6, 2004, SAARC leaders signed the "Islamabad Declaration" pledging to create the South Asian Free Trade Area (SAFTA) by January 1, 2006. That these leaders had even agreed to meet in Islamabad, the capital of Pakistan, was itself a development of some consequence. In the preceding two years the armed forces of India and Pakistan had glared at each other across their long border; and at one point the intense rivalry between the two countries threatened to result in the use of nuclear weapons. The move to create SAFTA, therefore, represents a major development in the region. Properly implemented, SAFTA could bring both economic development and peace to the region.

The purpose of this paper is to analyze the prospects of SAFTA by raising and answering several important questions. Will the South Asian nations succeed in creating the free trade area they agreed to establish at the Islamabad summit? Is a regional trading arrangement (RTA) the right approach for these countries to increase their economic growth rates and alleviate poverty? Or should they concentrate on integrating their economies into the global economic and trading system by participating in the Doha round of multilateral trade negotiations? Given the experience with RTAs around the world, is the SAFTA proposal as presented in the Islamabad Declaration the right way to proceed? If not, what options do these countries have for increasing intraregional trade?

The first part of the paper presents basic data and information pertinent to a discussion of regional integration in South Asia, as well as some historical context for understanding regional integration in South Asia. We then summarize the literature on regional integration as a backdrop to the discussion on integration within South Asia. The final part examines attempts at South Asian regional economic integration, including SAFTA, and poses some questions to guide further work on regional integration and development.

Other papers in this compendium analyze in greater detail, and from a narrower perspective, how SAFTA will affect the region. Many of these studies assess the amount of intraregional trade that will be generated once the free trade area is in place and how much of this will fall into the categories of "trade diversion" and "trade creation." They also cover

- The likely impact of SAFTA on foreign direct investment.
- The structural changes that might result once SAFTA is in place.
- How SAFTA might affect corporate structures and development in South Asia.
- How much investment in physical infrastructure, regulatory systems, and trade facilitating measures will be needed to ensure the success of SAFTA.
- The kind of technical and financial assistance that could be provided by international donors, multilateral and bilateral, to help launch and develop SAFTA.
- Whether the initial design of SAFTA should incorporate the prospect of expanding into other nearby countries, in particular Afghanistan.
- Whether the design of SAFTA is also a factor in the possibility of association with other RTAs, in particular ASEAN.

SOUTH ASIA IN CONTEXT

Economic Development: Trends and Comparative Statistics

For the purpose of this study, the South Asian region includes all countries represented in SAARC: Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. In 2002, the region's estimated population was 1.4 billion and its combined gross domestic product was $640 billion, measured at market exchange rates, or $3.4 trillion in terms of purchasing power parity (PPP). This is a relatively poor region with average per capita income of only $467 in conventional terms and of $3,560 in PPP terms (Table 1-1).

Table 1-1

Macroeconomic Data for SAFTA Countries, 2002

		GDP		Per capita Income		Trade	
	Population (thousands)	PPP (current int'l $m)	Current US$ M	PPP	Current US$	Total (US$ m)	Percent of GDP
Bangladesh	135,684	229,995	47,563	1,695	351	15,849	33
Bhutan	851	..	591	..	695	358	61
India	1,048,641	2,810,987	510,177	2,681	487	157,242	31
Maldives	287	..	641	..	2232	970	151
Nepal	24,125	33,344	5,494	1,382	228	2,462	45
Pakistan	144,902	281,270	59,235	1,941	409	22,347	38
Sri Lanka	19,007	67,668	16,567	3,560	872	13,093	79
South Asia	1,373,497	3,423,264[a]	640,268	11,259[a]	467	212,321	33
Low income	2,269,705	4,697,081	197,781	2,070	418	416,358	46

[a] *Excludes Bhutan and Nepal.*

SOURCE: *World Development Indicators 2004, The World Bank Group.*

By way of comparison, China in 2002 had a population of 1.280 billion, while its GDP in both conventional and PPP terms was considerably higher—$1.234 trillion and $5.792 trillion, respectively. Its GDP per capita, estimated at $960 at market exchange rates, was more than twice as high as that of South Asia. In PPP terms China's income per capita ($5,792) was three times greater than that of South Asia.

China scholars increasingly believe that the open trading system adopted by the country since it began to reform its economy in the late 1970s has helped it achieve and maintain high rates of economic growth. As measured by trade as a proportion of GDP, the South Asia region was considerably less open than China. In 2002, China had a trade-to-GDP ratio of 75 percent; South Asia's was only 33 percent.

In the last four decades, developing countries have carved out a prominent place in the evolving global production system and in world trade. The two developments are closely linked. The global production system is based on the activities of some 60,000 transnational corporations (TNCs). That system now encompasses a number of East Asian countries other than those in the

developed world. TNCs' choice of location is sometimes dictated by fiscal environment but usually by factor endowments. Even the simplest operations, such as the production of garments, are now split into several steps.

Splitting the final product into several intermediate products and components allows TNCs to maximize returns on investments. They are able to play on various kinds of arbitrages—wage, skill, and knowledge being the most important—in locating the manufacture of parts and components in countries that have a comparative advantage in producing them. Parts are then sent for assembly into final products and shipment to customers all over the globe. East Asian countries have become major suppliers of parts and components that make up final products produced in this dispersed system. This is why China runs a sizeable trade deficit with the countries of East Asia and has a large trade surplus with the United States. The East Asians have specialized in the production of parts of components while the United States is the largest consumer of final products. China has emerged as the major assembler of parts and components and shipper of the final product to various parts of the world, especially the United States.

Under this system of production, much international trade takes place within firms. The direction of trade is also profoundly influenced by this system—which partly explains why the developing world's share of world trade increased from about one-fifth in 1960 to about one-third in 2004. During this time, international trade as a whole was increasing at unprecedented rates. Growth in exports outpaced growth in output in every region. Among developing countries, the East Asian region outperformed the rest. Latin American exports also grew as a share of the world market in the 1990s but not as sharply as in East Asia. South Asia, in contrast, did less well. Although the region's GDP growth in 1980–2000 and the share of exports in output increased—particularly in the latter part of this period of two decades—South Asia has the lowest share of trade in the aggregate GDP of any region, barring the Middle East and North Africa. Non-oil export shares of the East Asia and Pacific region increased from 18 percent in 1980, to 25 percent in 1990, to 34 percent in 2000. The corresponding shares for the South Asia region were 8, 8.5, and 14 percent, respectively.

Could formal regional integration reverse this trend? The Islamabad Declaration of 2004 has set into motion a process that might culminate in the creation of a free trade area. Would this improve the region's economic performance and its integration into the global economic system? Should the success of the proposed SAFTA be measured only in economic terms?

Even at this stage of analysis of the possible outcome of SAFTA and its impact on the economies of the region, it is important to underscore that success will depend on non-economic outcomes. As Robin Cook, former Foreign Minister of Britain, said of the signing of the European Constitution, "pause for a while to contemplate the remarkable transformation of European politics which made this event possible. Most of the countries sitting together in the same council chamber have been at war with each other in living memory and in the century that preceded it." But progress toward increasing economic and political association among the countries of Europe was not always easy: "[T]heir appeal to past millennium betrays what drives their resistance to European integration—a misplaced nostalgia for the outdated world of free standing nations. It is an era that has vanished. We are all interdependent now"(Cook 26).

Could a regional trading arrangement such as the one envisaged under the framework of the SAFTA set in motion the same kind of dynamism that has brought Europe to its present situation? The following overview of economic development in the South Asian region underscores Robin Cook's point: a great deal of historical baggage has to be cast off before countries in the region can begin to work together.

Historical Context for Regional Integration

The most important reason for poor regional integration in South Asia has been intense hostility between India and Pakistan dating from when the two countries gained independence from colonial rule in 1947. Only now, following the SAARC summit of 2004 and the meeting between Pakistan's President Pervez Musharraf and India's former Prime Minister Atal Bihari Vajpayee on the summit's sidelines, have relations begun to thaw. Much, however, must still occur before history's legacy can be overcome. Even 30 months half after Vajpayee extended the hand of friendship to Pakistan at a public meeting in Srinagar, the capital of the disputed state of Kashmir, Delhi and Islamabad have made little progress in resolving their differences. President Musharraf met with Prime Minister Manmohan Singh, India's new leader in New York in September 2004 and pledged to work toward creating a South Asian region in which peace would prevail. In November, Prime Minister Singh traveled to Srinagar and reiterated his wish to work with Pakistan to improve the economic well being of the more than billion people of South Asia. In April 2005 Musharraf and Vajpayee met again, this time in Delhi when the Pakistani president accepted an invitation to watch the final match of the India–Pakistan cricket series. In that meeting, trade was explicitly mentioned as an area where the two countries needed to be more open to one another. The two leaders have continued to contact each other, most recently at the UN summit in New York. Singh is scheduled to visit Islamabad soon after the 13th SAARC summit in Dhaka to be held in November.

All these discussions have not produced much movement. Some tangible progress in trade could create an environment in which the two rivals could learn to work together. Successful implementation of SAFTA could help improve relations between South Asia's two long-time antagonists.

Successful implementation of SAFTA would also help restore health to the South Asian economy by removing some of the distortions that resulted from the partition of British India into the independent states of India and Pakistan and the subsequent emergence of Bangladesh. Under colonial rule, most of the region was one country with much of the physical infrastructure built to allow easy flow of goods and commodities among the provinces of British India. In fact, the British administration in India invested heavily in developing the irrigation systems in the provinces of Punjab and Sindh to feed the food-deficient parts of the empire. In the latter part of the nineteenth century and the earlier part of the twentieth century, India was repeatedly ravaged by famines that took a heavy toll on the British domain in South Asia. According to historian Niall Ferguson, "Another famine [after the one in 1780] in 1783 killed more than a fifth of the population of the Indian plains; this was followed by severe scarcities in 1791, 1801, and 1805"(Ferguson 53). The enormous loss of life caused by the famines created great anxiety in the India Office in London. Blue-ribbon Royal Famine Commissions were established to devise a

long-term solution to persistent food scarcities. Eventually, a strategy for increasing the domestic supply of food grain in India was adopted.

British planners saw that the vast tracts of virgin land in Punjab and Sindh could be cultivated by irrigating them with water from the Indus river system. The strategy worked and within a few decades, Punjab and Sindh were producing surplus food grains. But this surplus had to be transported to the northeast, especially the heavily populated province of Bengal. To do this, the British invested heavily in transport infrastructure, in particular farm-to-market roads, a system of roads linked with the fabled Grand Trunk Road that linked Kabul with Kolkata, railways, and the port of Karachi. These investments formed the basis for close economic integration of the British Indian Empire and are now parts of the independent states of Bangladesh, India, and Pakistan. If SAFTA succeeds in its aims, the economic and trading system that existed before British India was divided into independent countries could very well be restored—and quickly. But it was *politics* that severed these links; it will take *politics* to restore them.

Politics intervened most dramatically in the way the waters of the Indus were divided between the successor states of India and Pakistan. The water dispute surfaced in the early 1950s and almost brought India and Pakistan to war. Intense international diplomacy and the involvement of a consortium led by the World Bank salvaged the situation. The Indus Water Treaty of 1960 led to the assignment of three western rivers of the system to Pakistan and three eastern rivers to India.[1]

This was not the only dispute between India and Pakistan that had profound economic consequences for the region. For example, the 1947 partition of British India into India and Pakistan need not have resulted in the sharp decline in trade between these new political entities. Trade declined mostly for political reasons. In 1949, Pakistan refused to follow other countries of the "Sterling Area"[2] in devaluing its currency with respect to the U.S. dollar; India, in return, refused to recognize the new exchange rate of 144 of its rupees to 100 Pakistani rupees and halted all trade with its neighbor. Pakistan, starved of most manufactured goods of daily consumption launched a program of industrialization to achieve a measure of self-sufficiency. Had this trade war not occurred, Pakistan would not have industrialized as rapidly as it did and would not have forsaken its comparative advantage in agriculture.[3] Again, successful implementation of SAFTA could reverse some of these developments to the benefit of South Asia's economies.

The growing political problems between India and Pakistan were not the only reason for weak intraregional trade. All countries in the region pursued import-substitution approaches to economic development for nearly 40 years, from independence in the late 1940s to the adoption of greater openness in trade beginning in the mid-1980s. Consequently, after independence from British rule, trade among the countries fell from about 19 percent of total trade in 1948, to about 4

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[1] For a detailed account of the development of the dispute and its ultimate resolution see Aloys Mitchell, *The Indus River*, Yale University Press (1969).

[2] The Sterling Area was made up of the countries of British colonies that had linked their currencies to the "sterling" or the British pound. The Sterling Area is roughly equivalent today's Commonwealth.

[3] For an elaboration of this view see Shahid Javed Burki, *Pakistan: A Nation in the Making*, Westview Press (1980).

percent by the end of the 1950s, and to 2 percent by 1967 (World Bank 2004d). The share of intraregional trade in total trade began to increase only after the countries abandoned import substitution in favor of general trade liberalization. In recent years, the share of intraregional trade has increased to 5 percent (Table 1-2). Still, this increase is insignificant compared to trade among countries in other regions. Intraregional trade accounted for 67 percent of the total for the European Union; 62 percent for Canada, Mexico, and the United States, the members of the North America Free Trade Agreement (NAFTA); and 26 percent for members of the Association of Southeast Asian Nations (ASEAN). Despite current low levels of trade among South Asian countries (Table 1-3), can SAFTA provide the impetus for expanding intraregional trade in South Asia to the extent achieved by other regions?

Table 1-2

Officially Recorded Intraregional Trade as a Share of Total Trade, 1981, 1990, 1994, and 1998

Country	Intraregional Imports				Intraregional Exports				Total Intraregional Trade			
	1981	1990	1995	1998	1981	1990	1995	1998	1981	1990	1995	1998
India	1.3	0.4	0.6	1.1	2.9	2.7	5.1	5.6	1.8	1.4	2.7	3.2
Pakistan	1.9	1.6	1.5	2.4	5.5	4.0	3.2	4.9	3.1	2.7	2.2	3.6
Bangladesh	4.7	7.0	17.7	17.5	7.9	3.1	2.3	2.7	5.4	5.8	12.7	12.4
Sri Lanka	5.2	7.0	11.4	12.9	8.8	3.7	2.7	2.4	6.5	5.6	7.5	8.2
Nepal	-	13.4	17.5	31.7	63.8	7.7	9.2	36.2	47.4	11.9	15.0	32.8
Maldives	6.0	7.4	4.5	7.7	22.3	13.8	22.5	16.6	9.4	9.2	6.7	9.4
Bhutan	N/A	10.9	57.5	59.9	N/A	9.6	87.9	81.9	N/A	9.7	73.5	71.8
South Asia	2.4	2.0	3.8	4.3	4.8	3.1	4.3	7.5	3.2	2.4	4.1	4.9

Note: Shares for Bhutan are based on partner data (mirror statistics). There are discrepancies between FOB and CIF values in mirror statistics. The large decline in Nepal's regional trade in the early 1990s was due to the "trade and transit" crisis with India, during which India closed a number of key trade and transit points with Nepal.

SOURCE: Estimated from IMF Direction of Trade Statistics and reproduced from World Bank Report #29949, Trade Policies in South Asia: An Overview, 2004

The dirigiste economic policies adopted by all countries in the region is another legacy. Jawaharlal Nehru, India's first prime minister, taking the advice of senior Indian economists and following his own instincts, brought socialist economic management to his country. As a result of the support it had provided to Britain in fighting the Second World War, India had a highly developed bureaucratic system that could quickly establish controls over the economy. During the war, India's bureaucrats were responsible for setting up public sector enterprises for producing goods for the war effort that could not be obtained readily from the market. They were also responsible for procuring supplies for the fighting men while ensuring that domestic shortages did not occur. To prevent price gouging, they ran an elaborate system of rationing and price controls. This bureaucracy and its elaborate systems were at hand when Nehru launched the "license raj."

Developed over three decades, the tentacles of this system left no corner of the Indian economy—old and established or new and modern—untouched.[4]

Table 1-3

Intraregional Trade, 2003 (US$ millions)

Destination	Origin						
	Bangladesh[a]	Bhutan	India	Maldives	Nepal[a]	Pakistan[a]	Sri Lanka
Sri Lanka	4	0	917	14	.188	NR	.
Pakistan	NR	NR	205	0	NR	.	29
Nepal	NR	NR	349	0	.	NR	1
Maldives	0	0	31	.	.016	2	45
India	62	32	.	.118	280	45	169
Bhutan	NR	.	39	0	NR	NR	0
Bangladesh	.	NR	1,170	0	NR	NR	9

[a] *Non-reporting country*

NR = neither country reports

SOURCE: COMTRADE Statistics 2004, USITC.

For a decade and half, Pakistan followed a different route, encouraging the private sector to help meet the enormous shortages of consumer goods created by the 1948 trade war with India. While encouraging private entrepreneurship, the state was generous in building a high wall of protection around it. It also established state-owned financial institutions to provide the private sector cheap and long-term capital. And, for a time, Pakistan operated a dual exchange rate system that gave rich incentives to those who set up import-substituting industries while punishing those who wanted to sell their products in the international market.

In the two-year period between 1972 and 1974 Zulfikar Ali Bhutto, an avowed socialist, took Pakistan in a sharply different direction. He undertook a program of extensive nationalization of private assets soon after assuming office. His administration took control of 31 large-scale industries, virtually all financial institutions, all large-scale trading companies and eventually even small agro-production enterprises. By the middle of the 1970s, the grip of the Pakistani state on the economy was as tight as the hold of the state in India. Mujibur Rahman, the first President of Bangladesh, finding no reason to experiment with a system of economic governance different from those followed by his neighbors, also brought bureaucratic socialism to his country. Thus, by about the mid-1970s, South Asia had closed itself off to the outside world.

At this point, several small countries of East Asia began to open their economies to foreign trade and to external capital flows. These two entirely different approaches to economic management profoundly influenced the economic fortunes of East and South Asia.

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[4] An excellent description of the license raj and the damage it did to the Indian economy is in Gurcharan Das, *India Unbound*. New Delhi: Penguin (2003).

The relatively poor performance of South Asia in carving out a greater role for itself in international trade has been due in part to protectionist trade policies pursued until recently by all countries in the region. It is also the consequence of the failure of the region to develop an industrial structure that is well integrated into the international production system. The region's stilted growth patterns were reinforced by the 40-year pursuit of protectionist trade policies. Fortunately, this has begun to change. Larger countries in the region are now reasonably open to international trade. In 2000, Sri Lanka was the most open, with trade-to-GDP ratio of 77 percent. The corresponding ratio for Nepal was 44 percent; for Bangladesh and Pakistan, 33 percent; and for India 19 percent. The relatively lower figure for India is typical for most large countries, except China. Still, trade among the countries of the region is scant.

Will South Asia's reforms of the mid-1980s allow it to close the yawning gap between its economic situation and that of East Asia? How could SAFTA help rescue the region from relative economic backwardness?

From Autarky to Relative Openness

First Sri Lanka in the 1970s and then India, Bangladesh, and Pakistan in the early 1990s abandoned trade protectionism in favor of openness as the strategy for development and poverty alleviation. India's greater openness was prompted by the foreign exchange crisis in 1991 and the prodding of the IMF, which had developed a new approach subsumed by most commentators under the term "the Washington Consensus." Fiscal austerity, privatization, and market liberalization were the three pillars of this program of economic adjustment. According to Joseph Stiglitz, "the Washington Consensus policies were designed to respond to the very real problems in Latin America, and made considerable sense…When trade liberalization—the lowering of tariffs and elimination of other protectionist measures—is done the right way and at the right pace, so that new jobs are created as inefficient jobs are destroyed, there can be significant efficiency gains" (Stiglitz 2003, 145). Unlike some Latin America countries, South Asian countries did not rush to implement these policies. In fact, the pace adopted by South Asian governments was perhaps too measured.

Dealing with economic crisis was not the only reason for adopting greater openness to promote growth. The South Asian governments also responded to the way development institutions such as the World Bank interpreted the performance of the "miracle economies" of East Asia (World Bank 1993). The export-oriented growth policies adopted by these countries were widely credited for their phenomenal economic growth in the quarter century before the Asian financial crisis of 1997:

> Some analysts have, with hindsight, attributed these achievements to unique cultural and geographical circumstances. But there was little evidence at the outset that East Asian economies would achieve spectacular results. In the 1950s even trade optimists were export pessimists and did not anticipate that Korea's exports would grow four times as fast as world trade during the next thirty years (WB 1993).[5]

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[5] Among this group of analysts was the Oxford economist Ian Little; see his *Economic Development*, New York, Basic Books, 1982.

In 1970, Korea's trade-to-GDP ratio was 0.32; it increased to 0.66 in 1988. For Malaysia, another miracle economy, the ratio in the same period increased from 0.89 to 1.09 (WB 1993, 39). The East Asian economic miracle had a profound impact on the thinking of policymakers in South Asia. They were also prepared to accept openness in place of the discredited import-substitution policies.

From the mid-1980s to about the mid-1990s most major economies of the South Asia region undertook reforms to achieve greater openness. But the effort stalled, particularly in India, after 2000. Unfortunately, old habits die hard and strong vested interests that had survived the demise of the license raj brought to bear political pressure to slow the reform process. Reformists, however, persisted. Liberalizing momentum resumed with large cuts in industrial tariffs by India between 2002 and February 2004. According to a recent World Bank study, "other developments—Pakistan's comprehensive liberalization of its trade policies since 1996/97 (including its agricultural trade policies), and Sri Lanka's potential to resume long-deferred reforms as prospects improve of ending its civil war—contribute to a regional picture of very mixed achievement but widely shared responsibility"(World Bank 2004b, 1). As a result of these measures, Pakistan and Sri Lanka are now the least protected markets in the region with a top customs duty rate of 25 percent and average customs duty, including other protective rates, of 18.8 percent for Pakistan. Bangladesh is the region's most protected economy with a total protection rate of 26.5 percent. India, the region's largest economy also has a relatively high rate of protection (see Table 1-4).

While regional governments were reducing protection, some also took steps to encourage intraregional trade. The SAARC was stalled because of continuing hostility between India and Pakistan, so India concluded bilateral agreements with its smaller neighbors to increase trade. As a consequence, the total value of regional trade increased rapidly in the late 1980s and most of 1990s but not the share of regional trade in total trade. This was principally because of unilateral trade liberalization by countries on India's borders and large appreciations of the exchange rates of the peripheral countries relative to the Indian rupee. Most of the increased trade was one way, with large increases in exports from India, especially to Bangladesh and Sri Lanka. This growth in regional trade had little to do with the granting of regional trade preferences under the SAPTA which, as explained below, did little to increase intraregional trade. For the major economies, trade was directed at countries far removed from the region. The United States was the major importer of South Asian goods and commodities; it accounted for 36 percent of Bangladesh's total exports, 29 percent of Pakistan's, and 21 percent of India's. There was a different pattern for the points of origin for South Asian imports. For both Bangladesh and Pakistan, the single most important source of imports is China. For India, the United States is the largest single supplier. Tables 1-5 and 1-6 provide a detailed breakdown of the destination and origin of exports and imports. It would appear from the structure of South Asian trade that the "gravity model" has not worked for the region.

Table 1-4

Summary of Tariff Structures in South Asia

	India March 04	Pakistan 2002/03	Bangladesh 2004/05[a]	Sri Lanka Feb 04	Nepal Aug 03
Top MFN customs duty rate	30[b]	25	25.0	27.5	25
Other general protective taxes	0	-	4.0	3.75	4.5
General maximum (customs duty + other)	30	25	29.0	31.25	29.5
Average MFN customs duty rate[b]	22.2	17.3	16.3	11.3	13.7
Average of other general protective taxes	0	1.5	3.9	2.1	4.3
Average of other selective protective taxes	0	0	6.3	0	
Sum (average customs duty + other protective taxes)	22.2	18.8	26.5	13.4	18.0
% of products with total protection rates>general maximum protection rate[c]	2.8	1.1	15.8	0.9	5.8
Number of MFN customs duty bands	7	4	4	6	5
Number of customs duty bands>MFN Average	17	10	None: uses para-tariffs & VAT exemption for extra protection	2	3
Range of customs duty bands>MFN average duty rate	40-210%	40-250%		75&100%	40, 80, 130%
% of ad valorem tariff lines>MFN average duty rate	2	0.1		0.2	5.2
% of tariff lines with specific duties	5.3	0.9		1.2	0.6

[a] *Tariff data on Bangladesh as of June, 2004. These figures reflect tariff changes announced in the FY05 budget on June 10, 2004, which indicated significant move towards reduction of protection via reduction of the top rate to 25, move to three non-zero tariff bands, and rationalization of supplementary duties.*

[b] *The "general maximum" Customs Duty rate is defined as a rate which includes at least 5% of total tariff lines, and above which there are no more than 10% of total tariff lines. The "general maximum" is 30% in India because of the large number of agricultural Customs duties clustered at this rate. The Indian general maximum Customs Duty rate for industrial tariffs is 20%.*

[c] *Percent of tariff lines with total protection rates (inclusive of selective para-tariffs) in excess of MFN ceiling Customs Duty plus generally used para-tariffs.*

SOURCE: Reproduced from World Bank Report #29949, Trade Policies in South Asia: An Overview, 2004.

Table 1-5

Direction of Exports from SAFTA Countries (percent of total)

Destination	Origin						
	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
United States	36	3	21	38	29	29	38
United Kingdom	11	3	5	10	2	9	13
Germany	12	<1	4	3	8	6	4
China	1	<1	4	-	-	7	-
France	7	2	2	0	1	4	2
India	1	91	.	<1	49	0.5	4

SOURCE: COMTRADE Statistics 2004, USITC.

Table 1-6
Sources of Imports into SAFTA Countries (percent of total)

Source	Destination						
	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
United States	4	2	7	1	3	9	4
United Kingdom	2	3	5	2	1	5	4
Germany	2	4	4	1	4	7	2
China	17	1	5	1	14	16	4
Singapore	12	2	2	26	9	5	7
Japan	7	16	3	2	2	9	6
Republic of Korea	8	2	2	-	2	5	5
India	19	62	-	11	47	>1	14

SOURCE: COMTRADE Statistics 2004, USITC.

PROS AND CONS OF REGIONAL TRADE ARRANGEMENTS

Among the three approaches to increasing trade among countries, purists prefer unilateral action not contingent on the granting of reciprocity by trading partners.[6] The second-best approach is to conduct negotiations on removing barriers to cross-border trade in the context of such "international rounds" as the Tokyo and the Uruguay Round multilateral discussions and the ongoing Doha parlays. According to this line of thinking, the least satisfactory approach is to start with regional integration as the first step in easing constraints on global trade.

Notwithstanding the disdain with which purists regard regional integration, such agreements have proliferated as has the literature analyzing their contribution to promoting international trade. The number of regional trading arrangements, or RTAs, has more than quadrupled since 1990, rising to about 230 by 2004 (World Bank 2004b). Trade between RTA partners now makes up nearly 40 percent of the world total.

Trade Facilitation

As countries reduce tariffs across the board, however, the value of preferences declines while that of trade facilitation rises. Three aspects of trade facilitation are worthy of attention: customs clearance, transport, and standards and their conformity assessment. Costs of trade, which include custom procedures, bottlenecks, and adoptions of standards, can be equivalent to an additional 30 to 105 percent tax on trade Lowering these costs can be much more beneficial than simply reducing tariffs.

Unlike several factors that increase the cost of trade, there is general agreement about what constitutes good customs procedures. Signatories of the Kyoto Convention, for example, commit to implementing the best practices of The World Customs Organization for policies and

[6] The economist Jagdish Bhagwati is one of the most articulate exponents of this view. For his approach to international trade see his recent, *In Defense of Globalization*, New York: Oxford, 2004.

procedures. A review of regional initiatives to modernize customs suggests what changes are viewed as productive: (1) aligning customs codes and international standards; (2) simplifying and harmonizing procedures; (3) bringing tariff structures into accord with the international harmonized tariff classification; (4) striving for transparency; (5) adopting and implementing the WTO Customs Valuation Agreement; and (6) establishing joint border posts.

The second broad area of facilitation is transport improvement. Transport inefficiencies can be costly. In the Andean Community, for instance, trucks spend more than half of their journey time at border crossings (Prado 2001). It is estimated that each day lost to transport delays is equivalent to a tax of about 0.5 percent on the value of trade. The situation in the developing world is much worse (Hummels 2000). In recent years a number of transport and trade facilitation (TTF) agreements have been negotiated to ease the movement of goods and services across borders. Most of these agreements were concluded as part of, or in parallel with, an RTA.

The most efficient way to introduce efficiency in the transport sector is to encourage compensation among partners in a regional arrangement. This requires regional legal frameworks and effective enforcement mechanisms, both of which will take a fair amount of time to achieve. For instance, the European Union only fully implemented such agreements in 1985, 28 years after the signing of the Treaty of Rome. The possibility of taking legal action under regional treaties can aid implementation of transport facilitation measures. This happened in the EU, where the European Court of Justice has played an important role.

The third important type of facilitation measure is the formulation and implementation of systems of standards, quality assurance, accreditation, and metrology. To reduce the negative consequences of divergent standards, WTO members have agreed to discipline the use of mandatory standards by governments. The scope of this discipline is relatively modest; the governments have committed to transparent standard regimes, equal treatment of all trading partners, and the need to differ from internationally agreed norms. Until now, according to a recent World Bank study, "RTAs in the developing world have not realized their full potential for overcoming standards-related obstacles to regional or global trade, although some slow progress is evident, such as in MERCOSUR. That is likely to change as the WTO agreements on Technical Barriers to Trade (TBT) and Sanitary and Phytosanitary Measures (SPS) come into full practical application, and as the importance of reforming standards systems in developing countries gains prominence. In the meantime, several principles can contribute to successful cooperation in standards and conformity assessment procedures" (World Bank 2004, 89).

Services

With tariff reductions, non-trade issues become important and RTAs become more ambitious in scope.[7] New agreements, including those between developed and developing countries—or

[7] Although some North-North agreements, such as the recent expansion of the European Union, have incorporated labor movements, most North-South and South-South agreements are confined to intra-firm movements of professionals, and neither substantially increase access for temporary workers, skilled or unskilled.

North-South agreements—are addressing issues that go beyond trade (e.g., investment, labor and environmental laws, and, in some cases, political openness). Most South-South agreements, however, focus on merchandise trade, and tend to treat services, investment, and intellectual property rights unevenly or ignore such subjects altogether. Agreements such as ASEAN and Mercosur have not provided specifically for liberalization of services beyond what is already available as a result of unilateral actions by the member states or are included in multilateral accords such as the General Agreement on Trade in Services (GATS) in the context of the WTO.

Modern services should be included in RTAs because services play a large role in the economies of developing countries and attract foreign investment. According to a recent study on economic integration in Latin America, controlling for other factors, countries with fully liberalized financial and telecommunications sectors grew annually on average about 1.5 percentage points faster than other countries (Mattoo *et al*, 2004). This is because preferential treatment of services allows more suppliers to compete in the regional market, lowering prices and increasing efficiency. Including services in trading agreements does not erode government revenues because, in contrast to goods, the movement of services across international borders is normally not taxed.

Investment

Do RTAs attract more investment? That they should encourage domestic investment is obvious but their impact on foreign direct investment (FDI) inflows is less so. The World Bank recently investigated the effects of 238 RTAs and other variables on FDI flows for 152 countries over a period of 22 years, from 1980 to 2002. In general the Bank found that the countries that were open (measured as the ratio of trade to GDP), grew more rapidly, are more stable (measured by rates of inflation), and attracted greater amounts of FDI. On average, a 10 percent increase in market size associated with an RTA produces a 5 percent increase in FDI. However, the study underscored that an RTA cannot substitute for an adequate investment climate (World Bank 2004a, 5-12).

Proximity

Analysts who support RTAs as stepping stones to free international trade maintain that geographic proximity is a good reason to encourage them. In supporting the "natural bloc" concept, some trade experts have used "gravity models"[8] to argue that geography is a good determinant of the quantum of trade (Frankel *et al*, 1997). It is natural for neighboring countries to trade extensively among themselves. But proximity has not worked in South Asia; intraregional trade is an insignificant component of total trade. This "inverse" regionalism is not necessarily the result of political problems between India and Pakistan (Lahiri 1998). Proximity, it is argued, is not a good enough reason to expend political and bureaucratic energy on regional integration in South Asia. We disagree. Given the long history of intraregional trade when the

[8] These models draw their name from Newtonian physics in that trade flows between two countries increase in proportion to their economic mass (as measured by their respective GDPs) and are constrained by the friction between them (proxied by the distance between them) due to the transaction and other costs.

independent states were part of the British Indian Empire, some of the old patterns of exchanges of goods and commodities could be established once the right environment for them is created.

THE SOUTH ASIA FREE TRADE AREA

Regional Economic Integration Attempts

Over past 15 years, South Asian countries have tried to improve regional trade. Formal agreements have been less effective than changes in macroeconomic policies, such as the adoption of market exchange rates. In 1985, the seven members of the SAARC agreed to a charter with the following objectives:

> (a) to promote the welfare of the peoples of South Asia and to improve their quality of life; (b) 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 realize their full potentials; (c) to promote and strengthen collective self reliance among the countries of South Asia; (d) to contribute to mutual trust, understanding and appreciation of one another's problems; (e) to promote active and mutual assistance in the economic, social, cultural, technical and scientific fields; (f) to strengthen cooperation with other developing countries; (g) to strengthen cooperation among themselves in international forums on matters of common interests; and (to) to cooperate with international and regional organizations with similar aims and purposes.[9]

The Secretariat was set up in 1986 in Katmandu and headed by a Secretary General and one director from each member country. The Secretariat did not work on economic cooperation and integration until the Council of Ministers signed an agreement to form the South Asian Preferential Trading Arrangement (SAPTA) in April 1993. The agreement became operational in December 1995.

Following SAPTA's establishment, three rounds of preferential tariff reductions were implemented. Concluded in 1995, SAPTA-1 covered only 6 percent of traded goods (about 226 products at the 6-digit level of the Harmonized System of Tariffs). The important issue of nontariff barriers was deferred. SAPTA-2, concluded in 1997, was more ambitious; it covered 1,800 6-digit HS items and incorporated provisions about easing some nontariff barriers. SAPTA-3, signed in 1998, was the most ambitious, covering 2,700 items. Work on SAPTA-4 was initiated in 1999 but was put on hold after the military takeover in Pakistan on October 12, 1999. Politics once again halted the advance of regional integration.

Islamabad Summit Declaration, 2004

At their summit in Islamabad, the seven heads of state of the SAARC nations took a major step toward regional economic integration. They agreed to launch the South Asian Free Trade Area (SAFTA) by January 1, 2006. This step should have been taken earlier. In 1997, SAARC leaders had agreed to launch the SAFTA by 2001. The five-year delay was caused by deteriorating

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[9] http:/www.saarc-sec.org

relations between India and Pakistan after nuclear tests by the two countries in May 1998, the military takeover in Pakistan in October 1999, and the near-war in 2001 and 2002 when more than a million soldiers massed along the India–Pakistan border. Tensions began eased in April 2004 when Atal Bihari Vajpayee, then prime minister of India, pledged to work toward creating a peaceful South Asian region.

The SAFTA agreement is a traditional trade agreement in that it does not include some of the non-trade issues incorporated in RTAs elsewhere. In that sense, South Asia is playing catch-up with other developing regions. The framers of SAFTA—mostly government officials representing the Ministries of Foreign Affairs and Commerce in the SAARC countries—could learn from the experience of other RTAs.

The SAFTA agreement covers tariff reductions, rules of origin, safeguards, institutional structures, and dispute settlement. It also calls for the adoption of various trade facilitation measures such as harmonization of standards and mutual recognition of test results, harmonization of customs procedures, and cooperation in improving transport infrastructure. These measures, as discussed above, can help significantly reduce the cost of international trade, especially regional trade.

The SAFTA tariff reduction program stipulates average weighted tariffs of no more than 20 percent by the region's more developed economies—India, Pakistan, and Sri Lanka—within two years of the entry into force of the agreement. Within five years after the completion of the first phase, India and Pakistan will adjust their tariffs to the 0 to 5 percent range. The region's least developed countries—Bangladesh, Bhutan, Maldives, and Nepal—are required to have average weighted tariffs of no more than 30 percent within two years, but would be allowed longer periods for the second downward adjustment: Sri Lanka in six years and Bangladesh, Bhutan, Maldives and Nepal in eight years. India, Pakistan, and Sri Lanka will reduce their tariffs to the agreed low levels on imports from other countries no later than January 1, 2009. The agreement also calls for eliminating quantitative restrictions for products on the tariff liberalization list. While member states have been allowed to develop lists of sensitive items that would not be subjected fully to the stipulated tariff cuts, the number of products to be included in the country lists would be subject to review every four years (Table 1-7).

The Islamabad Declaration established some institutional devices to oversee the implementation of SAFTA. A Ministerial Council will be the highest decision-making authority while a Committee of Experts (COE) will monitor implementation of the agreement and resolve disputes. The COE will report to the ministers every six months on the progress of the agreement. The agreement is to be fully implemented by 2015.[10]

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[10] Details are from the SAARC Ministerial Declaration, January 2004.

Table 1-7
Planned Phased Tariff Cuts on Intra-SAFTA Trade

SAARC Countries	First Phase (Two Years)[a] 1/1/2006–1/1/2008	Second Phase[a] 1/1/2008–1/1/2013	1/1/2008–1/1/2016
LDCs—Bangladesh, Nepal, Bhutan, Maldives	Reduce maximum tariff to 30%		Reduce tariffs to the 0-5% range in 8 years (equal annual reductions recommended, but not less than 10%).
Non-LDCs--India, Pakistan, Sri Lanka	Reduce maximum tariff rate to 20%	Reduce tariffs to the 0-5% range in 5 years (Sri Lanka: in 6 years) NOTE: It is recommended that reductions be done in equal installments- at least 15 percent reduction per year Reduce tariffs to 0-5% for products of the LDCs within a timeframe of 3 years	

[a] *These phased tariff cuts for intra-SAFTA trade may not apply to items on each country's 'Sensitive Lists'*

SOURCE: *Reproduced from World Bank Report #29949, Trade Policies in South Asia: An Overview, 2000.*

After the Islamabad summit, member countries made significant progress toward agreement on rules of origin and negative lists, but not on compensating countries that fear loss of revenue once SAFTA is in place, or on technical assistance for dealing with the period of transition. Much of the progress is attributable to the COE appointed by the Islamabad summiteers. The COE has met several times since the 2004 summit but had not concluded its discussion of these issues as of October 2005. There was great expectation that heads of government would make progress during the 13th Summit of the SAARC, scheduled for January 2005, to further prepare the region for the launch of SAFTA on January 1, 2006. Unfortunately, both nature and politics intervened. The summit was postponed to early February to allow the governments of some countries to deal with consequences of the tsunami of December 26, 2004. Later, the King of Nepal's attempt to remove his country's prime minister and to assume the role of the chief executive elicited a very negative response from the Indian prime minister. He announced that he would not attend the summit at which the King would be present as the head of government. The Indians also pointed to skirmishes between the government and opposition parties in Bangladesh as having created a security problem, and demanded that the meeting in Dhaka be rescheduled.

The scheduling of the summit, therefore, became a political issue. In early February, Chandrika Kumaratunga, the Sri Lankan president, visited Islamabad to sign agreements and protocols with Pakistan, including a free trade agreement. At the banquet for the visiting head of state, President Musharraf declared that "Pakistan believes that we need to inject more seriousness into SAARC, which is for the benefit of all South Asian countries and postponement of the summit does not augur well for the effectiveness of this organization"(*Dawn* 2005).

SAFTA's Evolution: Emphasis on Sectors

In addition to moving immediately toward a broadly defined free trade area, it might be pragmatic to focus on some sectors in which intraregional trade could develop rapidly and bring economic benefits to most countries. For illustrative purposes we will discuss regional cooperation in several sectors—agriculture, energy, and textiles/apparel—that could be the focus of the free trade area.

Agriculture

The areas that now make up Bangladesh, India, and Pakistan traded extensively in agricultural products when they were part of the British Indian Empire. Once the countries gained independence, they followed highly protective trade policies. Although most international tradable agricultural products are subject to the WTO Agreement on Agriculture (AoA), India, Pakistan, and Bangladesh bound nearly all their agricultural tariffs at prohibitive levels (100, 200, and 300 percent, respectively). This was tantamount to a ban on agricultural imports. Only Sri Lanka (all AoA tariffs bound at 50 percent) and Nepal (average AoA binding at 42.3 percent negotiated as a part of Nepal's WTO accession commitments) face significant WTO constraints on increasing their tariffs above current applied levels. These were not the only constraints imposed on trade in agricultural products. South Asian countries have used a variety of nontariff measures to constrain import competition and thereby shelter domestic agricultural producers. These measures include the following:

- ***State trading and export monopolies (STEs).*** These are allowed by the WTO—a provision India has used to control imports of principal food grains and some other agricultural commodities. However, it has removed corresponding STE monopolies of exports. In other countries—most recently in Pakistan—all STE export and import monopolies of agricultural monopolies have been abolished.
- ***Subsidies and domestic supports.*** By using a variety of subsidies, countries in South Asia have developed production systems based on the crops in which they do not necessarily have comparative advantage. This is particularly so in Pakistan, where an extensive irrigation system could produce high-value crops rather than those for which large disposable surpluses already exist (e.g., rice, wheat). In addition, while South Asian countries have traditionally constrained export of agricultural products to keep consumer prices for basic food items low, this situation has begun to change. India, in particular, has become a major exporter of wheat and rice, using its large stocks to sell at below international prices. A continuation of this practice could invoke an adverse response from other grain exporters, especially since India has taken the lead in pressing developed countries to reform their agricultural systems by curtailing farm subsidies.

Energy

South Asia has an energy deficit. Economic growth and expanding access are boosting demand, while theft—sometimes more than 40 percent of supply—subjects electricity grids, as well as gas pipelines, to heavy commercial losses. Most theft is due to poor management by public sector utilities that dominate generation, transmission, and distribution of electric power. Significant investment is needed to increase system efficiency and keep up with rapidly growing demand.

Energy endowments differ among the countries. Pakistan (158 TWh/year) and Nepal (158 TWh/year) have considerable untapped potential for generating power from hydro sources. Both Pakistan (26.365 trillion cubic feet) and Bangladesh (10.615 tcf) have gas reserves that could supply neighboring countries. Just outside the immediate borders of the region are enormous reserves of oil and gas that could be piped to the region, provided there is agreement among the countries on transit energy trade. These reserves are available in the Central Asian countries and Iran. Iran's oil reserves are estimated at 89.7 trillion barrels, 16 times more than the known Indian reserves of 5.4 trillion barrels. Despite these endowments, trade in energy remains low among South Asian countries. Only India, Bhutan, and Nepal trade electricity—and even that is well below the potential of this trade.

This need not be the case if all countries adopt policies for tapping the potential of various energy sources. Exploiting complementarities in primary energy endowments, resource development costs, and demand profiles could prove very beneficial. In the context of an RTA, larger markets will enhance opportunities for economies of scale and scope. Organizing fuel mix could significantly cut costs for consumers. But serious barriers to the development of a regional supply market for energy exist: trans-regional energy infrastructure is lacking; the institutional and regulatory framework for regional planning, investment financing, investment protection, contract enforcement, policy and commercial risk mitigation is weak; and serious riparian rights and water-sharing issues prevent the exploitation of hydroelectricity potential in the northern areas of India and Pakistan. Tension between India and Pakistan on some aspects of the agreement the two countries signed in 1960 to share the waters of the Indus River increased to the point that the matter was referred to the World Bank in January 2005 for arbitration.

These barriers could be reduced as a part of the implementation of the proposed SAFTA or as a step toward a fully developed RTA. Countries could begin by pursuing simpler deals first (e.g., the supply of power from Pakistan's national electricity grid, the WAPDA, to the power-deficient Indian states of Punjab and Haryana, the supply of Bangladeshi gas to the power-deficient but industrial Kolkata, and tapping Nepal's large hydroelectricity potential to supply the rapidly increasing demand in northern India). At the same time, work could commence on developing a broad policy framework for opening up long-term trading and investment potential. Such a framework would need to have several components, including for technical issues such as parallel operations of electric grids.

Textiles and Apparel

The structure of global trade in the textile and apparel sector has changed in the last 20 years, largely because of the Multifiber Arrangement (MFA) adopted by textile exporting and importing countries during the Tokyo round of trade negotiations. From 1980 to 2000, the value of textile exports increased at the annual rate of 5.3 percent, while the value of apparel exports grew by an incredible 8.1 percent. Most restructuring took place between 1985 and 1990 when textile exports increased by 15 percent and apparel by 17 percent per year. During this time, the apparel industry began to globalize, with several large buyers shopping for the cheapest sources of supply within the quotas available to them, and the apparel industry established itself in Bangladesh, Mauritius, and the Caribbean. In 2000, world trade in textile and apparel was an estimated $356 billion. Textile and apparel exports accounted for 2.5 percent of world trade and 3.4 percent of world

merchandise trade. In keeping with trends, and with the end of the MFA quota regime, it is safe to assume that trade in these products will grow at rates higher than the increase in overall trade. And, while rich countries will continue to be the major consumers of these products, several parts of the developing world will also become significant consumers. This will be the particularly so in the rapidly growing countries of East Asia.

What are the trends in the trade? Products can be divided into three broad categories: textile yarn and fibers, textile fabrics, and clothing and apparel. Textile fibers barely accounted for six percent of world imports of the sector's products; textile yarn and fabrics accounted for another 39 percent. The remaining 55 percent was made-up apparel and garments. In South Asia, Bangladesh and Sri Lanka have become major exporters of ready-made apparel. Rapid development of the industry brought social change as well as economic benefits to the country. A large proportion of the workers hired by the industry are women, mostly from rural areas. For many of these women, employment in the apparel industry was their first venture into the formal sector. Women's participation as workers also brought about significant behavioral changes and contributed to the rapid decline in the rate of fertility in the country.

The developing world, especially South Asia, has a natural advantage in the production of textile yarn and fabrics since it produces the bulk of the world's output of cotton—the most important raw material for the industry. The four largest producers of cotton are India, Pakistan, the United States, and China. The developing world also has an abundant supply of cheap labor to work in this labor-intensive industry. Yet, developing countries account for only 30 percent of the total trade of this sector. With the end of the MFA regime, the share of the developing world is bound to increase.

In the developing world, sources of supply have changed significantly as wages have increased, and as a result of the production-distorting effects of the quota regime. In 1980, the major suppliers of the textile and clothing industry—as defined by a threshold of $1 billion in exports—were concentrated in East Asia (China, Hong Kong, South Korea, Taiwan). By 1990, major suppliers included Indonesia, Malaysia, Thailand, India, and Pakistan; and by 2000, the Philippines, Vietnam, Bangladesh, and Sri Lanka. According to some estimates, more than half of production capacity in the apparel industry shifted from rich to developing countries. This shift resulted from distortions introduced by the adoption of restrictive trade practices under the MFA and from globalization which, in the textile and apparel industry, meant slicing up the production chain. Globalization provided developing countries an opportunity to specialize in the labor-intensive stages of apparel manufacturing. The remarkable success of Bangladesh and Sri Lanka as garment producers and exporters shows how the industry restructured on the basis of shifting comparative advantage.

Textile production is India's and Pakistan's oldest industry, comprising spinning, weaving, processing and finishing, knitted fabrics and clothing, woven garments, and woolen spinning and weaving and garments. Textile enterprises include vertically integrated units, large concerns dealing in exclusively knitted and woven garments, and small factories involved in finishing dyeing and knit wear exports. Textiles make up the largest component of the Pakistan's manufacturing sector. In 2000, it accounted for 40 percent of direct employment, 30 percent of

value-added by the manufacturing sector, and 60 percent of merchandise exports. It is also significant in India.

In anticipation of the end of the MFA regime, textile entrepreneurs in South Asia, especially in India and Pakistan, began modernizing their plants; only time will tell if they have invested in the right subsectors. A major shift in apparel sourcing is unlikely at this time because some countries that dominate this part of global trade will continue to benefit from lower tariffs in importing countries. The end of MFA quotas does not mean that all textile and clothing exporters will be on a level field; some supplying countries—particularly the least developed among them, including Bangladesh and a number of poor countries in Africa and the Caribbean—will continue to enjoy tariff preferences in major markets.

South Asian producers would be prudent in working together to develop a regionally integrated industry with some division according to comparative advantage. Such integration would save the garment industries of Bangladesh and Sri Lanka from disinvestment, while India and Pakistan could concentrate on capital-intensive spinning and weaving. Extreme concerns about the impact on the garment industry is one reason why least-developed countries in the SAARC region are insisting on compensation for losses anticipated from the demise of the MFA regime and the launch of SAFTA. These countries fear that a free trade area in South Asia will shift comparative advantage to India and Pakistan, the major cotton producers.

SAFTA's Future: Some Possible Outcomes

Do conditions exist in the South Asia region for the SAFTA to succeed? What are the possible outcomes of the agreement signed at Islamabad on January 6, 2004? A great deal of empirical evidence from the successes and failures of RTAs around the world can help answer these questions.

First, RTAs often follow rather than determine changes in regional trading patterns. This does not augur well for South Asia since relatively little trade exists among the countries of the region. One can argue, however, that the region's focus on developed markets resulted from political problems that marred relations between India and Pakistan. If the recent easing of tensions between the two countries gains momentum, some trading patterns may change in favor of intraregional trade. The conclusion of free trade arrangements between Sri Lanka and India and Sri Lanka and Pakistan might have created a sense of dynamism that would move the entire region towards an RTA.

Second, when implemented in highly restrictive economic and trading environment, RTAs are usually inconsequential. SAPTA did not succeed because the South Asian countries had highly protective trade regimes. This has changed; external tariffs on trade and other trade-restricting practices have been reduced considerably in all countries of the region (World Bank 2004c).

Third, agreements that minimize excluded products expand the scope for positive net benefits through competition and trade creation. The temptation to use lists of sensitive items is not as great when overall tariffs are low. According to one review of South Asia's experience with regional arrangements, the 1993 SAPTA "was stillborn, given high levels of protection, a lack of

meaningful concessions, domestic political problems, hostility between India and Pakistan, India's ban on imports of all consumer goods (from SAPTA countries until 1998 and from rest of the world until 2000) and India's control over major primary goods"(Baysan 2004).

Fourth, agreements that cover more than trade in merchandise bring more benefits to regional economies. This is particularly so if services are covered. This should certainly be the case in South Asia. India now has a highly developed information technology sector that could benefit other populous countries, such as Bangladesh and Pakistan, which also have a large number of well-educated and well-trained people. At the same time, Pakistan has made advances in commercial banking from which the regional banking industry could benefit. India, with a much larger pool of savings than other countries in the region and with a more developed capital market, could help fill the region's savings and investment gap.

Fifth, trade facilitation measures are critical for reducing the cost of trade. While the SAFTA declaration incorporates these measures, they have to be interpreted much more broadly than seems to be the inclination among trade officials working on the modalities of the arrangement.

How to Measure Economic Benefits Likely from SAFTA

Broad Perspective

A recent study concluded that "a consensus has emerged among researchers that RTAs are trade creating" (Ghosh and Yamaraik). For instance, the share of NAFTA trade among the signatories' total trade increased from less than 35 percent in the late 1980s to almost 50 percent in 1999. Over the same period, the share of trade between members of Mercosur, compared to the parties' total trade, doubled from 10 to 20 percent. In most other cases, however, RTAs resulted in increasing the share of trade in GDP with expansion in both intra- and extraregional trade. In other words, the successful expansion of trade among the members of an RTA tends to be associated with increasing extraregional imports as a share of GDP with the growth of world trade. This happens when the member countries do not have high tariffs on extraregional trade. In South Asia, if tariffs remain high on imports from outside the region, it is likely that the SAFTA would divert rather than significantly expand total trade.

FDI has played a very important role in successful RTAs. South Asia needs more resources for investment than it can mobilize domestically. Successful RTAs that create large markets and improve the climate for investment can increase foreign investment. If that also happens in South Asia, SAFTA would have contributed to increasing regional GDP growth.

The corporate sector in South Asia, in sectors other than information technology, has remained unaffected by developments in the global production system. This system is increasingly vertically integrated. According to a review of the changes in industrial processes by Alan Winters, now Director of the Development Research Group of the World Bank, production chains and finer division of the production processes across countries, including developing countries, allows producers to exploit potential gains from (1) local increasing returns to scale in the production of intermediate inputs, (2) regional differences in factor costs for different components of the production process, (3) increasing competition arising from widening market,

and (4) technology transfer from developed countries embedded in intermediate inputs and backward linkages through exports (Winters 2004). In most cases trade integration has allowed developing countries to specialize in their production systems. This is most evident in the emergence of production chains, with trade in intermediate products becoming more important. This trend was encouraged by economies of scale, specialization, and scope. In the more open regions, trade in parts and components has surged. These production chains, in which intermediate inputs are traded and transformed into intermediate inputs that are moved across borders to the next stage in production, has been a major factor in surges in intraregional trade.

Country Perspectives—Guiding Questions

How SAFTA will affect the countries in the region is best understood by examining the issues that affect individual countries. The country studies, as well as an overview of trade facilitation in the region, are presented in the chapters that follow. Together, these studies aim to answer the following questions:

- Is SAFTA likely to increase trade for the region?
- Will imports from countries outside the region decline?
- Will the source of the expected increase be intraregional or extraregional, or both?
- Will foreign direct investment increase?
- How important is implementation of the agreement as now postulated to its success?
- What kind of country-level structural changes might result?
- How much investment in physical infrastructure, regulatory systems, and trade-facilitating measures will be needed to ensure the success of SAFTA?
- Will the structure of industries in the region change significantly?
- How will corporate structures and development be affected?
- Could the agreement be designed to encourage trade in services?
- Should SAFTA incorporate the prospect of expanding into other neighboring countries, in particular Afghanistan?
- Should SAFTA also factor in association with other RTAs, in particular ASEAN?
- What kind of technical and financial assistance could international donors provide to help launch and develop SAFTA?
- Is the timetable for implementation too relaxed and could the effectiveness of the arrangement be compromised by independent progress on various FTAs as well as another regional arrangement?
- What should be the role of the SAARC Secretariat in the launching and implementation of the agreement?

- Once SAFTA is launched, should the SAARC Secretariat assume regulatory functions or should an independent regional regulatory agency or agencies be established?

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2. Facilitating Regional Trade under SAFTA

James W. Robertson

International trade can be viewed as a chain that links orders for goods, transport, customs, and payment for the purchases. Like any chain, it is only as strong as its weakest link. Trade facilitation encompasses many links in the chain of trade. As tariff rates—one such link—decline, other costs of trading goods across borders—transaction costs—become more important. These costs include the time and administrative costs required to move goods through customs, meet national product standards, and comply with cross-border transportation regulations. Initiatives designed to reduce transaction costs fall under the definition of trade facilitation.

Trade facilitation measures will help ensure that the countries of the South Asian Association for Regional Cooperation (SAARC) fully realize the economic benefits of forming the South Asian Free Trade Area (SAFTA). This purpose of this paper is to assist policymakers in understanding the nature of the challenge before them as they negotiate the SAFTA agreement and to suggest ways that trade facilitation can be included in the SAFTA negotiations in a much more substantive way.

THE CHALLENGE FOR POLICYMAKERS

The region's policymakers do not need to be well versed in the details of the many, changing procedural issues that make up trade facilitation; their challenge is not to negotiate complex procedural initiatives, but to reach agreement on a strong and flexible trade facilitation framework that countries can build on, one that focuses on substantially and progressively reducing the transaction costs of cross-border trade.

The SAFTA agreement expresses the political commitment to facilitate trade in the region. What it lacks is a creative, effective framework in which to do so. The first step in creating this framework is to recognize that the SAFTA negotiation process should focus on the *outputs* of trade facilitation measures rather than the *inputs*. For example, agreement should be reached on the maximum time allowed for completing customs and related border clearance paperwork and clearing shipments. There are often many different ways to achieve the same result—and it is the result that is important because the results will define the agreement's success in reducing trade barriers. How each country meets the standards should not be the subject of negotiations.

Measuring success by results (i.e., lower transaction costs) rather than input (i.e., procedural changes) is much more likely to produce economic benefits for the region. For this approach to succeed, however, the private sector must monitor progress and identify where changes are needed.

Furthermore, policymakers should keep in mind that trade facilitation, unlike tariff reduction, is open-ended. When tariff rates have been reduced to zero, tariff reduction is complete. In contrast, steps can always be taken to reduce the costs of commercial transactions that cross borders, and unforeseen procedural impediments to maintaining an open trade regime will always need to be addressed.

Finally, it is relatively simple to agree on ambitious trade facilitation norms; the challenge lies in enforcing them. Although the SAFTA agreement includes a dispute resolution mechanism, policymakers should recognize that the standard bureaucratic enforcement approach is unlikely to be effective for many trade facilitation measures. This is because trade facilitation covers many procedures that take place along the many steps of a cross-border commercial transaction—at the border as well as beyond the border. And unlike tariff rate reductions, which are typically administered by a single government agency, trade facilitation measures require the compliance of many departments and agencies.

TRADE FACILITATION PROVISIONS IN THE SAFTA TEXT

SAFTA is the most important regional economic initiative since the formation of SAARC in 1985. Although the South Asian Preferential Trade Agreement (SAPTA) was completed almost 10 years ago, "its implementation in terms of tariff liberalization has been lethargic, mainly because of the adoption of the product-by-product approach" (Dadwal 2004). SAFTA holds out the promise of fundamentally transforming the economies of one of the largest and most economically challenged regions in the world if it can deliver substantially increased trade.

SAFTA member countries agreed to the following principles concerning trade facilitation in Article 3 of the SAFTA agreement:

> d) SAFTA shall involve the free movement of goods, between countries through, inter alia, the elimination of tariffs, para-tariffs and non-tariff restrictions on the movement of goods, and any other equivalent measures;
>
> e) SAFTA shall entail adoption of trade facilitation and other measures, and the progressive harmonization of legislations by the Contracting States in the relevant areas;

To be useful in this context, trade facilitation must be defined operationally. In the WTO, trade facilitation can be defined as "the simplification and harmonization of international trade procedures," understood as "activities, practices and formalities involved in collecting, presenting, communicating and processing data required for the movement of goods in international trade" (WTO website homepage). In this sense it relates to a wide range of activities such as import and export procedures (e.g., procedures relating to customs, licensing, and quarantine); transport formalities; and payments, insurance, and other financial requirements. In SAFTA, trade facilitation can be taken to encompass at least the following:

- Harmonization of standards
- Simplification of customs clearance procedures
- Simplification of banking procedures for import financing
- Transit facilities for intra-SAARC trade
- Removal of barriers to intra-SAARC investments
- Development of communications systems and transport infrastructure
- Simplification of procedures for business visas.

Furthermore, although trade facilitation according to this definition does not cover the facilitation of trade in services, liberalizing transportation, financial and other services related to the movement of goods is important in reducing the cost of cross-border commercial transactions.

Trade facilitation is a central element of the SAFTA agreement. Ample experience with regional trade agreements makes it clear that the hoped-for benefits from the agreement will not be realized unless trade facilitation measures are vigorously implemented.

KEEPING THE SAFTA AGREEMENT IN CONTEXT

SAFTA, like all regional trade arrangements, is intended to improve the economic performance of its member countries:

> …[P]referential trading arrangements among SAARC Member States will act as a stimulus to the strengthening of national and SAARC economic resilience, and the development of the national economies of the Contracting States by expanding investment and production opportunities, trade, and foreign exchange earnings as well as the development of economic and technological cooperation… (Preface)

Policymakers and negotiators must not lose sight of the larger context in which such an agreement is meant to operate. For example, SAARC members have standing commitments under the WTO, and new commitments are being negotiated. Most member countries also have bilateral or other regional trade commitments, including some with other SAARC members. SAFTA should be viewed as a means to achieving the larger economic objectives of the members—as a step toward creating a sound trade environment, not an end in itself.

For SAFTA to have the greatest positive impact, the commitments that countries make in the SAFTA agreement must not conflict with their other commitments. This is true not only for broad policy parameters, including tariff reduction schedules and negative lists, but for measures aimed at facilitating trade (e.g., rules of origin and related documentation). If exporters, importers, and customs officials face myriad rules and procedures for establishing conformity with rules of origin, a preferential agreement will fall far short of its potential. Exporters may calculate that, for them, the costs of taking advantage of the agreement's preferences exceed the benefits of those preferences. This has been the case under NAFTA for some types of goods.

LESSONS FROM OTHER TRADE ARRANGEMENTS

Experience provides reasonably clear and well-developed options for negotiating mutual tariff rate reductions. Although agreement is nearly unanimous on the importance of improving trade facilitation, no generally accepted template for negotiating and maintaining an effective program

of facilitation yet exists. Policymakers must examine options and take into consideration other regional and bilateral trade agreements and how their experience can be related to South Asia.[1] But they should keep in mind that the approach to trade facilitation taken in regional trade arrangements has changed dramatically in recent years. The scope and coverage of these agreements as well as the level of development of member countries are different. The global WTO and World Customs Organization (WCO) context has changed rapidly as well. An approach adopted years ago under another agreement may not be the best approach for South Asia today.

No One-Size-Fits-All Framework

The importance of vigorously addressing trade facilitation in regional trade arrangements is widely recognized. Some older regional trade arrangements only reduce tariffs and do not address trade facilitation in any substantive way. More recent arrangements do not go beyond simplifying and harmonizing certification procedures, such as those related to technical and sanitary and phytosanitary requirements. Only the European Union has gone further, specifying measures to address import, export, and border-crossing procedures in detail.[2]

A greater appreciation of the costs to business arising from cumbersome, inefficient, repetitive, or uncertain procedures is leading to movement on these issues. For example, the Asia Pacific Economic Cooperation Forum (APEC) aims at free trade among Pacific Rim countries but is moving toward this goal in an unusual way. Member countries are not negotiating a complicated, detailed, formal agreement. Instead they seek agreement on basic principles and goals and then work together to achieve their goals. Probably no trade agreement under negotiation emphasizes trade facilitation more. APEC member countries have developed principles and standards to be implemented on a voluntary basis and in a cooperative manner with the participation of the business sector. Individual country initiatives are encouraged to reduce the costs of cross-border trade flexibly and progressively.

A rapidly growing number of “new generation” trade agreements also emphasize trade facilitation. Most are bilateral agreements. They include the Japan–Singapore Economic Partnership Agreement and U.S. free trade agreements with Singapore, Australia, Chile, and Central America with the Dominican Republic. Other new generation agreements still in the talking stage include India’s comprehensive partnership agreements with Singapore and Sri Lanka and the Free Trade Area of the Americas (FTAA).

Trade facilitation in APEC and many new generation agreements is reflected in the following steps:

- Shared risk management by customs, which facilitates the clearance of low-risk goods with little or no documentary verification or physical inspection (with risk determined

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[1] An overview of trade facilitation approaches under a number of regional trade agreements is presented in the appendix. APEC’s approach is also reviewed in the next section.

[2] See for example, Moïsé (2002).

according to indicators of the likelihood of smuggling or fraud, or of issues relating to rules of origin and sanitary and phytosanitary standards).

- Simplified and streamlined procedures for express shipments.
- Greater flexibility and cooperation in sharing data among trade officials, and cooperation with electronic data interchange systems.

A review of regional trade arrangements and ongoing negotiations suggests that most agreements focus on results or principles such as harmonization and leave how facilitation measures are implemented to the participating countries. For the most part they do not adopt common rules and procedures.

In these agreements, to the extent possible, trade facilitation measures apply to all trade, not just preferential trade under the agreement. Of course, WTO prohibits differential nontariff trade barriers for countries that are not part of a free trade area or regional trade arrangement. Less restrictive trade procedures that may be limited to partners in the free trade area or regional trade arrangement include reduced customs charges or looser product standards or origin-marking requirements. (Maintaining different procedures leads to unnecessary economic distortions that impose costs on the countries.) Using regional mechanisms to reduce trade barriers more generally benefits all traders operating in a region, not only those from countries participating in the arrangement. Box 2-1 discusses ASEAN's approach to facilitating trade for economic integration.

INTERNATIONAL TRADE FACILITATION INDICATORS

Improving trade facilitation is complex task with many dimensions. Grasping the economic benefits of improving facilitation depends first on understanding how different aspects of the trade environment affect the costs of trade. But little systematic research of the strengths and weaknesses of the trade environments of SAFTA members exists.

International comparisons of economic and commercial conditions from the World Economic Forum's *Global Competitiveness Report 2004-2005* (GCR) partially fill this gap. The GCR provides detailed figures for 104 countries, four of them SAFTA members—India, Pakistan, Bangladesh, and Sri Lanka. Although incomplete, the figures offer some insight into the nature of these countries' problems that all the countries in the region may share to some extent. The GCR's figures give not only a sense of the range of conditions among SAFTA countries, but also how these countries compare with the rest of the world. Six indicators from the GCR have a bearing on trade facilitation and are discussed here to give a general idea of the scope of the challenges SAFTA countries face, although many more factors influence trade-related transaction costs and warrant further examination.

Box 2-1

ASEAN Free Trade Agreement: Facilitating Southeast Asian Economic Integration

The ASEAN Free Trade Agreement (AFTA) was launched in 1992. AFTA members are Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore and Thailand, and Vietnam. In addition to reducing tariff-based trade barriers and liberalizing investment by opening up industries and granting national treatment, AFTA has fostered regional integration by introducing trade facilitation measures, including customs reforms, harmonizing product standards, and facilitating goods in transit.

Customs. All original AFTA member countries have implemented the WTO Valuation Agreement. Latecomers—Vietnam, Laos, Myanmar, and Cambodia—are on a slower track. Common tariff nomenclature at the Harmonized System eight-digit level has been introduced. A fast-track or special channel for AFTA trade—the Green Lane—has been expanded to cover all ASEAN products. Customs administrations in ASEAN are automating and modernizing customs procedures. Singapore has introduced a state-of-the-art computer system, Trade Net. Thailand and others have introduced more efficient electronic data interchange systems.

Standards. To eliminate technical barriers to trade, a framework agreement on mutual recognition arrangements was implemented. Mutual recognition arrangements allow countries to recognize each other's product standards or regulations and thereby facilitate trade. Initial efforts focus on mutual recognition in telecommunications equipment, pharmaceutical products, and cosmetics.

Transportation. AFTA countries also agreed on a framework agreement on the facilitation of goods in transit. This allows goods to be moved by road or rail across ASEAN countries with minimum customs inspections, vehicle specifications, or regulations for drivers. Plans have also been developed for road or highway networks and railway links.

Investment. AFTA countries are trying to bring down barriers to investment by streamlining investment application processes and making them more transparent.

Infrastructure. ASEAN has made a commitment to developing a regional infrastructure and cooperating in the development of trade-related science and technology. For example, a framework for an ASEAN power grid and transboundary gas pipelines has been developed. In addition, telecommunications networks are being integrated—greater interconnectivity, coordination of frequencies, and mutual recognition of approval procedures for certain types of equipment. This integration will enable the infrastructure for cross-border electronic commerce among AFTA member countries.

Human development and capacity building**.** ASEAN officials and members of the private sector have participated in regional workshops and training programs on expanding regional trade. This has helped build capacity and helps less-developed members integrate into various aspects of ASEAN, and AFTA in particular.

Finance and Policy Coordination. Considerable progress has been made on financial cooperation. The ASEAN surveillance process has been established and peer reviews conducted. ASEAN is using the surveillance process to develop an early warning system to track macroeconomic trends and detect adverse developments. In addition, ASEAN is taking steps to adopt and implement stronger international financial practices and standards. Capital markets, particularly the bond market, are being deepened to widen the variety of instruments with longer maturity and ample liquidity. Further collective practices have been put in place to improve governance. More accurate, reliable information is being made available to all market participants in a timely manner and on a regular basis so they can independently monitor and assess the risk associated with their transactions.

Hidden Trade Barriers

The GCR survey asked respondents to rank hidden trade barriers (i.e., other than published tariffs and quotas) on a scale of 1 to 7, with 1 important and 7 not important. The SAFTA countries' ranks are as follows:

Country	*Index*	*Rank*
Sri Lanka	4.9	35
India	4.7	42
Pakistan	3.8	75
Bangladesh	3.8	76

For comparison, the best score among 104 countries was 6.4 and the worst, 2.5; the mean was 4.5 (GCR, Table 2.11). India's and Sri Lanka's scores reflect views on the extent of hidden trade barriers that are slightly better than the global mean, while Pakistan and Bangladesh fall below the mean. This suggests that transparency and the information available on trade procedures and regulations could both be improved.

Business Impact of Customs Procedures

The survey asked respondents to assess the impact of their country's custom procedures on their business on a scale of 1 to 7, with 1 being damaging and 7, beneficial. The South Asian countries' scores are as follows:

Country	*Index*	*Rank*
Sri Lanka	3.9	54
India	3.6	68
Pakistan	2.9	92
Bangladesh	2.8	96

For comparison, the best score was 6.4 and the worst, 2.1; the mean was 4.0 (GCR, Table 2.15). The South Asian countries score below the global mean, indicating negative impacts on business from customs operations. Customs in Pakistan and Bangladesh have among the strongest negative impacts on business in the world.

Efficiency of Customs Procedures

The GCR survey asked respondents to assess the efficiency of customs activities for imports on a scale of 1 to 7, with 1 being slow and inefficient and 7 among the world's most efficient. The South Asian countries' scores are as follows:

Country	*Index*	*Rank*
Sri Lanka	3.4	54
India	3.4	55
Pakistan	2.5	88
Bangladesh	2.2	100

The highest score was 6.7 and the lowest 1.8; the mean was 3.7 (GCR, Table 2.18). Once again, Sri Lanka and India are just slightly below the global mean while Pakistan and Bangladesh are near the bottom of global rankings.

Customs is one of the most important links in the trade facilitation chain between producers in one country and consumers in another. Apart from transport logistics it could be the most significant nontariff barrier. The survey results for customs make clear that although South Asian countries' rankings vary, all the countries have considerable scope for improving customs efficiency.

Business Impact of Rules on Foreign Direct Investment

The survey asked respondents to assess the impact of their country's rules governing FDI on their business, with a score of 1 being damaging and 7 beneficial. The South Asian countries' scores are as follows:

Country	*Index*	*Rank*
India	5.1	28
Pakistan	5.0	33
Sri Lanka	5.0	36
Bangladesh	4.8	53

The highest score was 6.4 and the worst, 2.8; the mean was 4.8 (GCR, Table 2.16). All South Asian countries scored at or above the global mean in this area, reflecting the efforts of the past decade to reform the environment for foreign investment. India, Pakistan, and Sri Lanka are in the top third of all countries.

Infrastructure Quality Overall

Survey respondents were asked to assess the general infrastructure in their country on a scale of 1 to 7, with 1 being poorly developed and inefficient and 7 being among the best in the world. The South Asian countries' scores are as follows:

Country	*Index*	*Rank*
India	2.7	63
Pakistan	2.8	77
Sri Lanka	2.7	79
Bangladesh	2.4	99

The best score was 6.8 and the worst, 1.5; the mean was 4.0 (GCR, Table 5.01). In this case, all four countries score well below the global mean, reflecting the substantial shortcomings in the general quality of infrastructure throughout the region. Although poor infrastructure affects the cost of doing business in all areas, it adds greatly to the transaction costs incurred in cross-border trade.

Port Infrastructure

Survey respondents were asked to assess the port infrastructure in their country, with 1 being poorly developed and inefficient and 7 being among the best in the world. The South Asian countries had the following scores:

Country	*Index*	*Rank*
Sri Lanka	3.5	60
India	3.3	65
Bangladesh	2.5	86
Pakistan	2.4	88

The highest score was 6.8 and the worst, 1.5; the mean was 4.0 (GCR, Table 5.03). The below-average scores for port infrastructure are consistent with the negative findings for infrastructure generally. The quality of port services determines a great deal of trade transaction costs because all the countries in the region depend primarily on sea transport for foreign trade.[3]

Implications of Low Trade Facilitation Scores

What does this mean? Although this brief overview examined only six indicators, we can draw several important conclusions. First, relative to many other countries, South Asian countries generally have greater scope for reducing trade-related transaction costs. And clearly, improvements in these and related areas would help improve the competitiveness of firms throughout the region, surpassing that which could be attributed to SAFTA. Second, the nature of the challenges is not the same for all countries examined in this survey. No doubt Nepal's, Bhutan's, and the Maldives' scores would vary too, if they were included. Conditions in each country differ substantially and approaches to trade facilitation must be tailored accordingly. With some understanding of the scope for improvement, the benefits and costs of improving trade facilitation can be examined.

BENEFITS AND COSTS OF TRADE FACILITATION

Benefits

First, the trade benefits that will be gained from SAFTA will depend on the amount of additional trade that takes place.[4] If no additional trade results, there will be no benefits. Second, successful regional or bilateral trade agreements demonstrate that great benefits—substantial increases in trade flows—can be gained by taking an ambitious approach to reducing regulatory and procedural barriers to trade.

As a result of increased interest in trade facilitation, a growing body of research measures the benefits of reforms.[5] Much of this research includes estimates of potential direct and indirect reductions in transaction costs. Trade transaction costs vary depending on the efficiency and integrity of the businesses and administrations involved, the characteristics or kind of goods, and the size and type of businesses. Walkenhorst and Yasui (2003) estimate that direct and indirect trade-related transaction costs amount to 1 to 15 percent of the value of traded goods. However,

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[3] The picture is more complicated than suggested. Much trade between Bhutan, Nepal, and India is transported by road or rail. However, because Bhutan and Nepal are landlocked, they must rely on Indian ports for other international trade, including trade with other SAARC countries. Two members of SAFTA—Maldives and Sri Lanka—are islands. However, considerable potential to increase the volume of trade transported by road among Pakistan, India, and Bangladesh has been constrained, largely for political reasons. Much of Afghanistan's trade goes through Pakistan's ports.

[4] Not all additional trade that takes place under a preferential trade agreement brings positive economic benefits. *Trade diversion* arises when less-efficient production from sources in the region crowds out more efficient producers from outside the region and can lead to reduced economic welfare.

[5] See for example APEC (2002, 2003) and Walkenhorst and Yasui (2003), which includes a survey of studies on this topic.

actual transaction costs in South Asian countries are probably substantially higher. Walkenhorst and Yasui (2003) estimate that if transaction costs are reduced by 1 percent *globally*, welfare gains would amount to about US$40 billion, with all countries benefiting and non-OECD countries experiencing the biggest gains in relative terms. The benefits derived from trade facilitation initiatives by APEC countries are estimated to be large (see Box 2-2).

Box 2-2

Examples of Trade Facilitation Benefits Quantified

APEC has focused on trade facilitation more aggressively than perhaps any other regional trade arrangement. A report by the Australian Department of Foreign Affairs and Trade estimated that reducing international trade transaction costs by 5 percent would add US$154 billion (in 1997 prices), equivalent to 0.9 percent of APEC GDP per year. Australia's Centre for International Economics also estimates that even for relatively limited reforms the gains are substantial:

- US$2.3 billion for Singapore's Trade Net
- US$1.2 billion for Thailand's EDI system
- US$0.4 billion for the Philippines' Super Green Lane
- US$6.2 billion for China's reforms in foreign investment regulations with respect to insurance
- US$5.4 billion for Mexico's road transport reforms
- US$1.6 billion for Australia's reform of port services

SOURCE: APEC 2002.

Some argue that the benefits of trade facilitation accrue to foreign exporters—so why make changes? In fact, virtually all the benefits from improving trade facilitation go to the consumers in the country that introduces the reforms. Domestic firms that import raw material or intermediate goods also benefit from lower transaction costs, which make them more competitive.

Finally, policymakers should keep in mind that improving trade facilitation on a regional basis will likely have economic benefits that go beyond those derived from increased trade among SAARC members. As the agencies and procedures that handle trade are streamlined, barriers to trade with countries outside SAARC will also be reduced, and the dividends of trade facilitation will be that much greater. The fact that negotiations under the ongoing WTO Doha Development Round also address trade facilitation can be used to reinforce this regional process. The WTO talks also offer countries considerable opportunities to receive technical assistance in implementing trade facilitation improvements that will also strengthen regional efforts.

Costs

The limited empirical evidence available indicates that the costs of implementing a broad array of trade facilitation initiatives are generally low in relation to the benefits gained. The largest cost components are likely to be for training and, depending on the individual country's condition, possibly for equipment and infrastructure. Substantial institutional changes, such as required for introducing risk assessment and audit-based controls, tend to be the most costly. However, such changes also have the greatest impact on reducing transaction costs.

Policymakers and SAFTA agreement negotiators must have some idea of the costs of implementing trade facilitation measures before the measures can be agreed to. Because many agencies and activities would be involved, this estimation is not simple.[6] The cost of implementing trade facilitation measures became an important issue during the WTO Doha Development Round. During the Cancun Ministerial Conference, many developing countries maintained that fulfilling the requirements would be beyond their means. In contrast, many developed countries that proposed including trade facilitation during the Doha negotiations seemed to assume that progress in these areas would entail small incremental steps in a long process that would involve only minor additional costs. One point raised was that no systematic or reliable data were available on which to base decisions, particularly for developing countries.[7]

It is not feasible here to estimate potential costs of the measures that might be introduced under the SAFTA agreement, but the nature of the costs that may be involved can be identified.

Cost Categories

The introduction or implementation of any trade facilitation measure entails costs in at least one of the following areas:

- New regulation
- Institutional changes
- Training
- Equipment
- Infrastructure.

The costs any particular country incurs depend on the nature of the human and physical resources already available. This is certainly the case for equipment and infrastructure and training.

Regulatory. Trade facilitation measures undoubtedly will require enacting new legislation or amending existing laws. This work will require the time of staff in a number of government agencies. The resources required will vary depending on each country's legislative processes. It is reasonable to expect that except where major legal changes are required, most changes pertinent to trade facilitation can be handled at the operational level and entail little incremental cost. Some countries may require technical assistance in drafting new regulations. This is a task that many donor agencies are willing to assist.

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[6] This section draws heavily on Moïsé (2004).

[7] Much of this section is based on a preliminary analysis by a group of international agencies providing technical support to the Doha process. The agencies are analyzing implementation costs to governments. Like SAFTA members, the countries in the analysis—Chile, Latvia, Morocco, and Uganda—are diverse. They have recently introduced or are introducing trade facilitation measures. Analysis is expected to expand to include countries in Asia. The analysis was restricted to a certain definition of trade facilitation that includes measures of the sort likely to be included if the SAFTA agreement addressed these issues in a substantive manner. Many measures concern customs procedures, which are particularly important because customs is the only government agency that deals with all goods crossing the border and is also usually responsible for the application of a range of other requirements, including documentary requirements (such as licenses and certificates).

Institutional. Institutions may need to be enlarged, shrunk, or restructured. New units may be required in some countries, such as a post-clearance team, a risk management team, or a central enquiry point. Major staff changes are inevitably costly, politically and financially. However, these costs are generally more manageable when changes are implemented over time.

Training. Training typically is one of the most significant costs in introducing trade facilitation measures. Four approaches to addressing the need for training may be taken:

- Recruiting new, expert staff
- Training current staff in a training center
- Providing on-the-job training
- Bringing in trained staff from other agencies.

Each country must decide which approach or combination of approaches makes the most sense for its own circumstances.

Equipment and infrastructure. Most equipment and infrastructure costs of implementing trade facilitation measures are likely to be related to information technology and communications capabilities. Investment in these types of facilities may be expensive, but can be implemented over time. Furthermore, full incremental costs need not be borne entirely by governments. If trade facilitation measures substantially reduce commercial transaction costs, cost-sharing with the commercial entities involved would be economically justified. If the measures introduced under SAFTA are consistent with what is negotiated during the Doha Development Round, international assistance for trade facilitation may also be available.

Costs by Type of Facilitation Measure

Costs may also be examined with respect to the type of trade facilitation measure undertaken:

- ***Publication and availability of information.*** With the Internet, the costs of making information readily available are low.
- ***Consultative and feedback mechanisms; communication with traders.*** Where customs administrations already have formal consultative arrangements with stakeholders, such as importer associations, government ministries and agencies, brokers associations, and traders, additional costs arising from new trade facilitation measures are likely to be low. Costs are higher where such mechanisms do not exist or are weak.
- ***Review and appeal procedures and due process.*** All member countries have some type of review process. The goal of improving trade facilitation processes is to make the process more efficient. Additional costs are likely to be low.
- ***Advance submission and processing of data.*** The advance submission and processing of data, such as through EDI facilities, are already in place or are being pursued in most (or all) SAFTA member countries.
- ***Procedures for assessment, collection, and repayment of duties and taxes.*** Allowing deferred payment of duties and taxes can speed the clearance of goods. Deferment does not lead to additional expenses for customs. Minimum-value provisions, in which duties and taxes are not collected below a set sum, can also speed the movement of goods. The

legislative cost of introducing minimum-value provisions where they do not already exist, and the subsequent loss of revenue, is marginal.

- ***Risk assessment.*** Risk assessment systems can offer the most in improving the efficiency of trade processing, but can also be among the most costly facilitation measures. The expense is mainly due to infrastructure and training required. Nevertheless, reducing inspection rates (for example, from 100 percent to 10 percent) allows staff to be shifted to other duties, and the operational and fiscal advantages outweigh the costs.
- ***Audit-based controls.*** Audit-based controls are closely linked to risk assessment. These procedures can also improve the efficiency of the management of preferential market access provisions. Like risk assessment provisions, audit-based controls may entail costs for training and reallocating or hiring staff.
- ***Special procedures for authorized traders.*** Special procedures for authorized traders include special channels, periodic entry, self-assessment, simplified declarations, and remote examination of cargo or records at approved premises. Usually companies enter into agreements with customs for such procedures. Introducing such procedures is more straightforward when carried out in conjunction with risk assessment and audit-based controls. In this environment, the costs of implementation are low.
- ***Separation of release from clearance.*** This approach permits goods to be released as soon as possible provided that the customs administration is satisfied that all its requirements will be met in a specified period and that traders have made available the information necessary for calculating duties. Implementation costs are low.
- ***Security for duties and taxes.*** Some SAFTA countries already provide this facility. Additional costs are low.
- ***Cooperation and coordination among authorities.*** Agencies responsible for public health, sanitary inspections, bureaus of standards, drug authorities, environmental authorities, line ministries, and revenue services in all SAFTA countries cooperate and coordinate to some degree.

This analysis leads to three main conclusions: First, risk assessment and audit-based controls are among the most important trade facilitation measures, not only because they contribute directly to reducing transaction costs, but also because they enable the introduction of other measures. Second, many potentially important measures can be implemented at low cost. And third, when weighing the costs and benefits of implementing new trade facilitation measures, the entire package of initiatives should be assessed jointly.

CONCLUSIONS

The policymakers responsible for negotiating the SAFTA and fulfilling the goals set out in the SAFTA agreement must determine the best course to follow to improve trade facilitation. The preceding discussion has sought to establish the following propositions:

- Trade facilitation can best be defined by its intended outcome—the reduction of trade-related transaction costs. An agenda to improve trade facilitation ought to encompass the

full range of procedures, regulations, and processes that impose costs on cross-border commercial transactions. Such an agenda will affect many agencies and institutions.

- Trade facilitation should be an integral part of any regional trade arrangement and is likely to be a part of the multilateral Doha Development Round. Although the importance of collateral measures aimed at improving trade facilitation has not always been fully appreciated, it is now well understood.
- Reducing trade-related transaction costs substantially is likely to be at least as important as reducing tariffs in expanding intraregional trade.
- Unlike reducing tariffs, facilitating trade is an ongoing process. As some barriers are lowered, others will emerge. To be effective, any trade facilitation framework must be flexible enough to address issues as they emerge.
- South Asian countries face major challenges in reducing the costs of trade. Indicators provided by the World Economic Forum suggest that these countries have a long way to go to rank among the more competitive countries.
- The benefits of improving processes that impose costs on trade almost certainly outweigh the costs. Furthermore, the benefits are likely to be spread throughout the economies where the reforms are implemented.
- The fact that the SAFTA is being negotiated in parallel with the WTO Doha Development Round presents opportunities as well as challenges. The SAFTA process can benefit from financial and technical support to developing countries for the design and implementation of trade facilitation measures. However, policymakers and negotiators should also ensure that the SAFTA process does introduce inconsistencies with whatever global arrangement may emerge from the Doha process.

A SIX-POINT TRADE FACILITATION STRATEGY FOR SAFTA

This is an appropriate time for policymakers to review how trade facilitation is addressed under SAFTA and to explore ways to improve trade facilitation. The present course is unlikely to lead to the improvement necessary to ensure that SAFTA delivers the substantial economic benefits to the region anticipated in the agreement. A much more ambitious approach is warranted. The following six-point action plan is a good beginning.

1. ***Establish strong political support.*** At the outset it is necessary to establish strong political support to ensure the impetus needed to reach the goals of the SAFTA agreement. Little progress can be expected if governments are not committed at the highest levels to progress on issues that cross many bureaucratic boundaries. Regional leaders should commit to a strategy for improving trade facilitation to serve as a charter for the bodies responsible for overseeing the design and implementation of the strategy. It should be made clear from the outset that the scope of the process should be ambitious, aiming at reaching international best practices within a definite timeframe (i.e., three to five years), including at least the following areas:

- Transparency and due process
- Harmonization of procedures

- Simplifying procedures
- Adoption of new technologies
- Customs procedures and regulatory procedures
- Customs cooperation procedures
- Dissemination of data
- Mutual recognition agreements
- Transportation bottlenecks
- Infrastructure shortcomings.

2. ***Establish a regional trade facilitation council.*** A standing body, a trade facilitation council, should be established now. It should be led by a person with a business background and invite substantial participation by the private sector and trade experts. It should have a mandate, with the working groups described below, to carry out detailed audits of the costs associated with trade-related procedures to develop and maintain an agenda of the measures required to reach the highest international standards. The council should be given adequate technical support to fully explore international best practices. Technical assistance should be sought from the international agencies supporting reform in these areas. The council should be charged with providing an annual report to senior political leaders, perhaps at an annual summit, that presents the current agenda and describes progress. The work of the council and the council's findings should be readily available to the public (i.e., through a website). Following the APEC model in this regard makes good sense.

3. ***Establish national trade facilitation working groups.*** Recognizing that each member country faces different challenges in making changes and meeting standards, each country should establish standing national working groups for trade facilitation. These working groups should also invite substantial participation by the private sector and trade experts and have access to the technical assistance necessary to assume their responsibilities. Three members from each national working group—one government official, one business representative, and one trade expert—would represent the group on the trade facilitation council. The working groups should also make their work publicly accessible.

4. ***Establish a regional customs committee.*** A committee comprising of the heads of customs agencies in each SAFTA country should be established to work with the trade facilitation council and should be represented on the council. Reforms in customs procedures are best managed by customs officials. Substantial technical resources, including the identification and measurement of progress, can be obtained through the WCO.

5. ***Undertake a regional communications program.*** A regional communications program should be undertaken to improve public understanding of the importance of aggressively pursuing measures to reduce the costs of trade. The benefits of more efficient trade include more jobs and lower prices. Benefits should be quantified and publicized and remaining challenges identified. Improvements in international rankings, such as the GCR, should be publicized.

6. ***Establish response mechanisms.*** Public sector mechanisms should be put in place to respond rapidly to private sector reports of measurable trade transaction costs or delays. Typical bureaucratic responses to such shortcomings are not effective. The complaints lodged and the responses provided should be publicly available (e.g., through a website).

This six-point action plan is a just starting point. Much additional work will be required to achieve results. That trade facilitation is an ongoing process cannot be overemphasized. In many respects it entails establishing a new mindset, which will come about only with a greater understanding of the economic importance of making these sorts of changes and the recognition of the gains that are achieved.

Interest in lowering trade-related transaction costs has never been greater. This issue is being addressed in the WTO Doha Development Round, and is a tenet of the liberalization process pursued by APEC and other regional trade arrangements. Heightened interest has given rise to a rapidly growing body of research and made much greater technical and financial resources available for related reforms. In this regard, South Asia has an unusually potent opportunity to bring unprecedented economic gains to the region.

APPENDIX. TRADE FACILITATION UNDER OTHER REGIONAL TRADE ARRANGEMENTS

Asia Pacific Economic Cooperation Forum

Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, China, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Chinese Taipei, Thailand, United States, Vietnam

In many respects APEC is pursuing the most far reaching, innovate approach to facilitating trade. This reflects, in part, the great diversity in capacity and conditions among member countries. APEC members are expected to undertake the implementation of the principles in accordance with their level of economic and technological development, differing legal framework and development objectives, in order to allow quick progress in facilitation despite the large number and different levels of development of participating countries. As a result, the design of the principles is such that they will lead to different implementation outcomes in different APEC Members. Slightly differing national implementation practices allow at least some of the participants to go beyond the lowest common denominator, but entails at the same time a risk of "facilitation à la carte" (OECD 2002).

Transparency and due process. APEC principles call for information on laws, regulations, requirements and procedures affecting trade in goods and services to be made available to all interested parties in a timely and cost-effective manner, for instance through inquiry points and electronic homepages. Stakeholders should be given the opportunity to comment on effective and prospective rules and procedures, so as to increase the degree of confidence and heighten the likelihood of compliance. Stakeholders seeking redress with respect to the implementation of rules and procedures should have access to appropriate appeal mechanisms.

Harmonization of procedures. APEC principles reaffirm the importance of harmonization and mutual recognition for reducing administrative and compliance costs for business, including customs procedures; customs tariff classification and valuation; data requirements for import and export procedures; mutual recognition arrangements for standards and conformity assessment results; mutual recognition arrangements for professional qualification and registration.

Simplifying procedures. APEC principles aim at the streamlining of applicable rules and procedures: to minimize documentation and procedural requirements; institute one-stop services; expedite customs clearance; and to reduce the frequency of conformity assessment controls to match good compliance records.

Adoption of new technologies. APEC principles call for the regular updating of applicable rules and requirements to match changed circumstances, and for maintaining the efficiency of procedures through the introduction of modern techniques and new technology, (e.g., risk management systems, EDI, internet-based paperless trading).

North American Free Trade Agreement

Canada, Mexico, United States

NAFTA has mainly reduced nontariff barriers to trade because tariff barriers, especially between Canada and the United States, were already low. Most of the benefits from the agreement have been due to procedural reforms. NAFTA preceded APEC and did not go as far in improving trade facilitation. (Mexico, Canada, and the United States are also members of APEC.)

Customs procedures and regulatory procedures. NAFTA does not change customs administrations and procedures, with the exception of rules of origin and origin determination procedures. Trade is still subject to each country's laws, regulations, procedures, and formalities. Provisions covering origin marking, valuation methods, user fees, and appeal procedures remain subject to the legal and regulatory structures in each country. The customs administrations of the three countries established a Trilateral Heads of Customs Conference to jointly address common issues such as the compatibility of standards, conformity assessment–related measures, and the establishment of the Laboratory Working Group to address technical and scientific issues.

Transparency and due process. The agreement requires prompt publication of all laws, regulations, procedures, and administrative rulings of general application related to the agreement. Members are encouraged to publish measures in advance of their adoption and provide interested parties with the opportunity to comment. Stakeholders are provided reasonable advance notice and the opportunity to respond. Impartial and independent appeals tribunals or procedures for reviewing administrative actions are required.

Simplifying procedures. The NAFTA agreement stipulates that any measure relating to country-of-origin marking be designed to minimize the difficulties, costs, and inconvenience. Members accept any method of marking used by the other members as long as it ensures visibility and permanence, but exempts from marking requirements goods that cannot be marked without being damaged or can be marked only at a prohibitive cost. In addition, customs user fees are eliminated for originating goods.

Adoption of new technologies. New approaches to trade automation, including the North American Trade Automation Prototype (NATAP), which introduces standardized trade data and harmonized customs clearance procedures and promotes the electronic transmission of standard commercial data using UN/EDIFACT messages.

ASEAN Free Trade Agreement

Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam

Transparency and dissemination of data. ASEAN has established a customs website, including information on ASEAN countries' practices for handling complaints and appeals from the trading community.

Simplifying procedures for transportation. ASEAN countries have concluded an agreement for the recognition of commercial vehicle inspection certificates for goods vehicles used for transit transport. The ASEAN Framework Agreement on the Facilitation of Goods in Transit encourages joint customs inspection for goods in transit.

Mercado Común del Sur (Southern Common Market)

Argentina, Brazil, Paraguay, Uruguay

As one of the earlier regional trade arrangements, Mercosur originally devoted relatively less attention to trade facilitation issues. Since inception, a series of agreements have been adopted to reduce nontariff barriers.

Customs cooperation procedures. Agreements aimed at increasing cooperation between customs authorities, including a 1993 agreement to coordinate border controls, which implemented measures to permit integrated border controls; a 1997 agreement on reciprocal cooperation for preventing and combating contraband; the 1999 Asunción Program on measures for simplifying foreign trade procedures and border procedures, setting goals relating to the streamlining of administrative procedures; and in 2004, an agreement that harmonizes customs clearance procedures, including provisions on customs control, customs entry forms, unloading of goods, bonded warehouses, clearance procedures for imports and exports, and verification of payment of payment of the Common External Tariff.

European Free Trade Association

Iceland, Liechtenstein, Norway, Switzerland

The EFTA agreement does not include specific common procedures and formalities for the cross-border movement of goods. However, members do commit to cooperating to ensure effective application of customs-related provisions while reducing as much as possible the formalities imposed on trade.

Transparency. Changes in procedures must be notified to all members before implementation. New formalities should not undermine trade facilitation measures already adopted.

Mutual recognition agreements. EFTA agreement provides for mutual recognition of inspections carried out and of documents certifying compliance with the requirements of the import country or equivalent requirements of the export country.

Simplifying procedures. EFTA requires that border inspections and formalities be carried out with minimum delay and be centralized at one place to the extent possible. Parties are expected to

promote the use of simplified procedures and data processing and transmission techniques. Examples include: allowing for the authorities to delegate inspection powers to a service (preferably the customs service), which will carry out inspection on their behalf; departments are to be organized to reduce waiting time; if a border crossing disruption occurs the relevant authorities inform the authorities of the other members; plant health (SPS) inspections are to be limited to random checks and sample testing only, unless circumstances require; for transit goods frontier posts operate 24 hours a day without unloading, unless frontier inspection is necessary for health protection reasons; for goods that are not in transit minimum working hour periods per week are defined.

An EFTA Group of Experts on Efficient Trade Procedures was established. It is made up of experts in trade facilitation from member countries. The group meets regularly to coordinate trade efficiency activities in the EFTA structure and participates in international forums such as EUROPRPO and UN/CEFACT.

Free Trade Area of the Americas

Antigua and Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St Lucia, St Kitts and Nevis, St Vincent and Grenadines, Suriname, Trinidad and Tobago, Uruguay, United States, Venezuela

The FTAA, still under negotiation, is focusing on measures to improve trade facilitation. Even prior to reaching agreement, the FTAA is making available on-line information on customs procedures, laws, regulations, guidelines and administrative rulings; it is also publishing a Hemispheric Guide on Customs Procedures.

Australia–New Zealand Closer Economic Relations Trade Agreement

Australia, New Zealand

ANZCERTA is notable because it explicitly commits to “common approaches toward the world outside the area covered by the agreement” (Moïsé 2002).

Customs cooperation. An agreement under ANZCERTA, the Memorandum of Understanding Regarding Mutual assistance between Customs Agencies provides for cooperation to harmonize customs procedures and policies “to the maximum extent practicable.” This entails inter alia closer alignment of national level tariff structures involving a minimum of national subdivisions and of national legal notes relating to tariffs, formats and phraseology; consultations on interpretations; or elaborating common bases for valuation.

Adoption of new technologies. Steps have been taken to establish a paperless clearance environment by Australian and New Zealand Customs. This has included development of a common format to expedite cargo clearance, accessible either from the client’s own facilities, community data networks or from customs facilities.

Agreement on the European Economic Area

Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Liechtenstein, Luxembourg, the Netherlands, Norway, Portugal, United Kingdom, Spain, Sweden.

The EEA requires members to simplify border controls and formalities and to assist each other in customs matters. Two Protocols have been adopted on the "simplification of inspections and formalities in respect of carriage of goods" and on "mutual assistance in customs matters." EEA Protocol 10 on simplification of inspection and formalities in respect of carriage of goods does not apply to maritime or air transport, nor to inspections and formalities related to the issue of health or plant health certificates. With the exception of rules relating to plant health inspections, trade facilitation measures contained in the Protocol benefit goods crossing EFTA or EFTA-EU frontiers irrespective of the origin of the goods or the nationality of involved traders.

Japan–Singapore Economic Partnership Agreement

Under the recent JSEPA, authorities in each country aim to establish a paperless trading system allowing the electronic transfer of all trade-related information and documents (including invoices, bills of lading etc.) between importers and exporters. A Joint Committee on Paperless Trading has been working to implement these systems.

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Part 2. Country Perspectives

3. India

Amita Batra

The intertwining of national interests at the multilateral and regional levels acquired a new intensity in the 1990s. Regional and bilateral trade agreements that reduce barriers to trade between countries on a reciprocal and preferential basis proliferated. Asian countries have pursued trade liberalization mainly through the multilateral trading arrangement rather than through preferential trading agreements. SAPTA, in place for some time, emphasized broad regional cooperation, not concrete measures of trade liberalization.

This emphasis changed with the signing of the SAFTA agreement. Although India's longstanding interest in the economic integration of the subcontinent is evident from its successful bilateral arrangements in South Asia, SAFTA makes this commitment more concrete. Geographical contiguity and shared economic, social, and cultural characteristics make a regional arrangement in South Asia potentially profitable. This paper analyzes the issues arising from India's participation in SAFTA and makes suggestions for improving the SAFTA agreement.

After a brief review of India's economy, the paper analyzes the structure of India's trade with the world and with SAFTA economies, as well as potential trade possibilities within SAFTA. Next, India's trade policy is presented, and the nontariff barriers in South Asia that India faces are listed. The paper also addresses the reconciliation of existing bilateral and subregional agreements in South Asia with SAFTA. Benefits that may accrue to India through the successful implementation of SAFTA are analyzed. Suggestions are made for improving the SAFTA agreement, and the political dynamics of the region are briefly presented.

OVERVIEW OF THE ECONOMY

For three decades, from 1950 to 1980, India grew steadily, with real GDP growing at the average annual rate of 3.5 percent. In the 1980s, growth accelerated to an average of 5.6 percent per year, but at the same time macroeconomic imbalances grew and a large current account deficit developed. In 1991, India suffered an external payments crisis. In response to the crisis, in July 1991 India initiated a program of stabilization and structural adjustment encompassing trade, exchange rate management, industry, public finance, and the financial sector. As a consequence, growth accelerated to 6.1 percent annually for the reform period, 1992/93 to 2002/2003. Above average growth occurred in the services sector (8 percent annually), which contributed over half of GDP in the reform period. Real per capita income grew at 3.9 percent, compared with 3.2 percent in the pre-reform decade. The period also experienced a distinct deceleration in the

compound growth rate of population. The positive outcome of the growth process during the reform period is also reflected in a reduction of the poverty rate from 36.0 percent in 1993/94 to 26.1 percent in 1999/2000 (Tables 3-1 and 3-2).

Table 3-1

Trends in India's Real GDP Growth Rates by Sector

Sector	1981/82–1990/91[a]	1991/1992[b]	1992/93–2002/03[c]
Agriculture	3.1	-1.5	2.5
Industry	7.6	-1.2	6.2
Services	6.7	4.5	8.0
GDP at factor cost	5.6	1.3	6.1

[a] *Decade preceding reforms*
[b] *Year of crisis*
[c] *Period of reforms*

SOURCE: *Report on Currency and Finance, 2001/02, Reserve Bank of India.*

Table 3-2

Share of India's GDP by Sector[a]

Sector	1980–1991	1992–2002
Services	39.64	45.65
Industry	26.28	26.74
Agriculture	34.07	27.61

[a] *Simple average of annual shares*

SOURCE: *World Development Indicators, 2004, World Bank.*

The hallmark of India's macroeconomic environment during the past decade has been the strength and resilience of the external sector. This is reflected in a modest deficit or surplus in the current account, strong capital flows in relation to the financing gap and absorptive capacity of the economy, a stable exchange rate, comfortable foreign exchange reserves, and sustainable external debt. Despite this success, challenges remain. India's tariff rates continue to be high. Customs procedures, although simplified, need further rationalization. Reforms need to be intensified in the agricultural sector, in factor markets (e.g., labor) to promote flexibility, and in bankruptcy and market exit procedures, as well as in fiscal consolidation and physical and social infrastructure.

TRADE STRUCTURE AND TRENDS

India adopted an inward-looking development strategy after independence. It focused on stimulating home-grown industrialization, based essentially on the infant-industry policy, which called for shielding production for the domestic market behind high tariff walls and effective protection. This strategy of import-substituting industrialization created self-fulfilling biases against the export-producing sectors, and exports were relegated therefore to the status of a residual sector.

The need to correct the anti-export bias was gradually recognized, and in the 1970s several export promotion measures were put in place to generate higher exports on a sustained basis. In 1985, a three-year Export-Import Policy was introduced to focus the trade sector. This policy enabled easy access to essential capital goods, raw materials, and components from abroad to spur technological advances that would reduce production costs and improve the quality of India's exports. Beginning in the early 1980s, licensing and the highly regulated trade policy started to give way to a more open regime. Between 1985 and 1989, the government reduced import duties and initiated the liberalization of imports of capital and intermediate goods. Notwithstanding these measures, the trade regime in the late 1980s continued to be characterized by a cumbersome licensing mechanism as well as high tariffs.

In the 1990s, trade was further liberalized. India's outward orientation has increased considerably since then. According to the 2002 *World Investment Report* (UNCTAD), India ranks among the top 15 nations in export gains during 1985–2000, even though, in terms of value, exports from India account for less than 1 percent of global exports.

Exports

Shifts in Composition toward Manufactures

The structure of India's exports, mainly primary products, remained unchanged until the mid-1990s. The share of primary products in India's total exports has declined since then, and especially in the 1990s. More than three-fourths of India's total exports in the 1990s were from the manufacturing sector (Table 3-3). Of the top 10 exports from India, nine are from the manufacturing sector and only one (marine products) is in the category of primary products (see Table 3-4).

Some diversification in exports from the manufacturing sector is also evident in recent years. Primary and semifinished iron and steel and pharmaceuticals have registered gains in share and growth rates. The shares in total exports of cotton, leather, tea, and readymade garments, however, have fallen, while the share of petroleum products in India's total exports has risen dramatically since 2000/01 (Table 3-5).

Table 3-3

Composition of India's Exports by Product Type

Product Type	Amount (US$ billion)			Share (percent)		
	1990/91	1995/96	2002/03	1990/91	1995/96	2002/03
Primary products	4.3	7.3	8.3	23.8	22.8	15.8
Agriculture and allied products	3.3	6.1	6.4	18.5	19.1	12.2
Ores and minerals	1.0	1.2	1.9	5.3	3.7	3.6
Manufactured goods	13.0	23.7	38.4	71.6	73.9	72.7
Petroleum products	0.5	0.5	2.4	2.9	1.4	4.6
Others	0.3	0.6	3.6	1.7	1.8	6.9
Total exports	18.1	31.8	52.7	100.0	100.0	100.0

SOURCE: *Report on Currency and Finance, 2002/2003, Reserve Bank of India.*

Table 3-4

Share of India's Leading Exports by Commodity (Percent)

Rank	Commodity	1990/91	1995/96	2002/2003
1	Gems and jewelry	16.1	16.6	16.8
2	Readymade garments	12.3	11.6	10.2
3	Basic chemicals, pharma and cosmetics	6.8	6.8	8.3
4	Cotton yarn, fabrics, made-ups etc.	6.4	8.1	6.2
5	Petroleum products	2.9	1.4	4.6
6	Machinery and instruments	3.8	2.6	3.5
7	Iron and steel	0.9	2.2	3.4
8	Manufactures of metals	2.5	2.6	3.3
9	Marine products	2.9	3.2	2.6
10	Manmade yarns, fabrics, made-ups etc.	1.2	2.4	2.5

SOURCE: Report on Currency and Finance, 2002/2003, Reserve Bank of India.

Table 3-5

India's Major Export Gainers and Losers, 1990/91–2002/03

Item	Share in India's Exports		Growth Rate[a]
	1990/91	2002/03	1990/91–2002/03
GAINERS			
Primary and semifinished iron and steel	0.6	3.0	25.2
Plastic and linoleum	0.6	2.2	21.4
Manmade yarn, fabrics, made-ups, etc.	1.3	2.5	15.8
Electronic goods	1.3	2.2	14.1
Petroleum products	2.9	4.6	13.6
Drugs, pharmaceuticals and fine chem	3.1	4.7	13.1
LOSERS			
Cotton, raw including waste	2.6	0.0	-27.6
Finished leather	5.2	0.9	-5.4
Tea	3.3	0.6	-4.7
Leather footwear	2.8	0.8	-1.7
Iron ore	3.2	1.6	3.3
Readymade garments: manmade fiber	2.5	1.3	3.8

[a] *In US$ terms*

SOURCE: Report on Currency and Finance, 2001/2002, Reserve Bank of India.

When analyzed by factor intensity, despite increases in exports of low- and high-technology-intensive products, India's exports are still predominantly labor- and natural resource-based manufactures (Table 3-6).

Table 3-6

Technology Intensity of India's Exports, 1980–2000 (Percentage of Total Non-oil Exports)

Commodity Group	1980	1990	2000
Primary commodities	40.9	26.6	18.9
Manufactures based on labor and natural resources	38.5	51.1	52.6
Manufactures characterized by:			
Low-technology intensity	5.7	4.8	6.6
Medium-technology intensity	7.0	6.6	6.6
High-technology intensity	5.1	9.3	11.7

SOURCE: *Report on Currency and Finance, 2002/2003, Reserve Bank of India.*

The growth in India's services exports continues to strengthen (Table 3-7). Services exports rose from 7.9 percent annually in the first half of 1990s to 15.3 percent a year during 2000/01–2003/2004. In 2003, India ranked 20th in the world in global exports of services with a share of 1.4 percent. Although the highest share went to traditional services, such as travel and transport in the period 1990/91–1995/96, this changed during the 2000/01–2003/04 period. The latter set of "new economy" services has in fact registered average annual growth of about 37 percent during this period.

Table 3-7

Share of India's Services Exports, 1990–2004

Service	1990/91	1995/96	2000/01	2001/02	2002/03	2003/04
Travel	32.0	36.9	16.8	14.1	12.1	14.3
Transport	21.6	27.4	10.1	9.5	10.1	11.6
Insurance	2.4	2.4	1.4	1.3	1.5	1.5
Government, not included elsewhere	0.3	0.2	3.5	2.3	1.2	0.9
Software	0	10.2	33.6	36.6	38.5	44.2
Miscellaneous	43.7	22.9	34.6	36.3	36.6	27.5

SOURCE: *Annual Report, 2003/2004, Reserve Bank of India.*

Increasing Export Competitiveness

According to the most common approach to assessing competitiveness (i.e., the index of revealed comparative advantage), India has maximum comparative advantage in (in order) organic chemicals; cotton; articles of apparel; accessories not knit or crochet; and nuclear reactors, boilers, and machinery. In 2003 iron and steel emerged as one of India's most competitive sectors.

The World Economic Forum's 2004/05 *Global Competitiveness Report* has two indices: the growth competitiveness index and the business competitiveness index. The growth competitiveness index measures the capacity of an economy to achieve sustained economic growth over the medium term. The index comprises technological capacity, quality of public institutions, and quality of macroeconomic environment. The business competitiveness index,

which examines the microeconomic basis of a nation's per capita GDP that is sustainable in the long term, comprises the degree of company sophistication and the quality of the national business environment. Both measures show that India is relatively well placed, in the middle, higher than other South Asian countries (see Table 3-8).

Table 3-8

Competitiveness Indices Ranking

Competitiveness Index	Sri Lanka	Pakistan	Bangladesh	India
Growth competitiveness	73	91	102	55
Technology	81	87	100	63
Public institution	72	102	104	53
Macroeconomic environment	73	67	74	52
Business competitiveness	68	73	95	30
Company operations and strategy	69	67	97	30
Quality of the national business environment	67	75	94	32

SOURCE: *World Economic Forum.* Global Competitiveness Report, 2004/2005,

Growing Importance of Asia as an Export Destination

The destination pattern for India's exports changed remarkably in the 2000 to 2004 period. The importance of developing countries as markets for India's exports has increased considerably since 2000 (see Table 3-9). Although most major Indian exports are still destined for the United States, exports to Asian countries have increased sharply since 2002, largely because of the improved macroeconomic performance of Asian economies and the consequent increase in demand. Sri Lanka and Bangladesh were among India's top 10 export destinations in 2003/04. India's exports to Bangladesh grew twice as fast in 2004 as in the previous year (see Table 3-10).

Table 3-9

Share of Developing and Asian Countries in India's Trade (percent)

Exports	2000	2001	2002	2003	2004
Developing countries	43.38	43.75	44.19	45.78	53.48
Asia	20.65	23.15	23.49	25.36	28.31

SOURCE: *Direction of Trade Statistics, Yearbook, various issues.*

Table 3-10

India's Top 10 Export Destinations: India's Export Growth Rate and Destinations' GDP Growth

Rank	Country	India's Export Growth		Destination Country's Real GDP Growth	
		2003/04	2002/03	2003	2002
1	United Arab Emirates	52.7	33.5	7.0	1.9
2	People's Republic of China	49.8	107.5	9.1	8.0
3	Singapore	48.9	46.2	1.1	2.2
4	Sri Lanka	43.4	46.0	5.5	3.9
5	Iran	40.1	158.8	5.9	7.2
6	Bangladesh	40.0	17.3	5.4	4.9
7	Indonesia	36.0	54.8	4.1	3.7
8	Italy	25.5	12.5	0.3	0.4
9	Hong Kong	24.4	10.4	3.3	2.3
10	Netherlands	21.9	21.3	-0.8	0.2

SOURCE: *Annual Report, Reserve Bank of India, 2003/2004*

Imports

Shift in Composition as Import Restrictions Ease

The composition and structure of India's imports have changed since 1991 (see Tables 3-11 and 3-12). With the move from import substitution and toward trade based on comparative advantage, the previous policy emphasis on determining which imports are essential and which are not has diminished. The greater competitiveness of Indian industry has led to a decline in imports of low- and medium-technology-intensive products. Simultaneously, imports of high-technology-intensive products and imports used for export production have increased (see Table 3-13). The import intensity of India's manufactured exports seems to be steadily declining; this reflects an increased ability to source inputs domestically rather than by importing them. India's imports of computer goods; electronics; edible oils; textiles, fabrics, and apparel; and cashew nuts (processed for export) grew more rapidly than the norm.

Although petroleum still dominates India's imports, capital goods and other intermediary products for export purposes emerged as important imports in the 1990s. At the disaggregated level, more subtle shifts in the composition of India's imports are visible. For instance, in the petroleum sector, imports have shifted from petroleum products to crude, thanks to a large increase in India's refinery capacity. India in fact transformed itself from net importer to net exporter of finished petroleum products in 2000/01.

Table 3-11

Composition of India's Imports 1990–2003

Item	Amount (US$ billion)			Share (Percentage)		
	1990/91	1995/96	2002/03	1990/91	1995/96	2002/03
Bulk imports	10.8	14.3	24.1	45.1	39.0	39.3
Petroleum, crude and products	6.0	7.5	17.6	25.0	20.4	28.7
Bulk consumption goods	0.6	1.0	2.4	2.3	2.7	3.9
Other bulk items	4.3	5.8	4.1	17.7	15.8	6.7
Nonbulk imports	13.2	22.4	37.3	54.9	61.0	60.7
Capital goods	5.8	10.3	12.7	24.2	28.1	20.8
Mainly export-related items	3.7	5.3	10.2	15.3	14.4	16.7
Others	3.7	6.8	14.3	15.4	18.5	23.3
Total imports	24.1	36.7	61.4	100.0	100.0	100.0

SOURCE: Report on Currency and Finance, 2002/2003, Reserve Bank of India.

Table 3-12

Structure of India's Imports 1990–2003

Item	Amount (US$ billion)			Share (percentage)		
	1990/91	1995/96	2002/03	1990/91	1995/96	2002/03
Bulk imports	10.8	14.3	24.1	45.1	39	39.3
Petroleum, crude and products	6	7.5	17.6	25.0	20.4	28.7
Bulk consumption goods	0.6	1	2.4	2.3	2.7	3.9
Edible oils	0.2	0.7	1.8	0.8	1.9	2.9
Other bulk items	4.3	5.8	4.1	17.7	15.8	6.7
Fertilizers	1	1.7	0.6	4.1	4.6	1
Non ferrous metals	0.6	0.9	0.6	2.6	2.5	1
Metalliferrous ores, metal scrap, etc.	0.9	0.8	1	3.5	2.2	1.6
Iron and steel	1.2	1.4	0.9	4.9	3.8	1.5
Non-bulk imports	13.2	22.4	37.3	54.9	61	60.7
Capital goods	5.8	10.3	12.7	24.2	28.1	20.8
Machinery except electrical and electronic	2.1	3.9	3.4	8.7	10.6	5.6
Electrical machinery except electronic	0.9	0.4	0.6	3.9	1.1	1.0
Electronic goods	–	1.8	5.3	–	4.9	8.7
Transport equipment	0.9	1.1	1.8	3.9	3	2.9
Project goods	1.4	2.4	0.5	5.9	6.5	0.8
Mainly export related items	3.7	5.3	10.2	15.3	14.4	16.7
Pearls, precious and semi-precious stones	2.1	2.1	6	8.7	5.7	9.9
Organic and inorganic chemicals	1.3	2.6	3	5.3	7.1	4.8
Others	3.7	6.8	14.3	15.4	18.5	23.3
Professional, scientific instruments, photographic	0.6	0.7	1.1	2.5	1.9	1.7
Coal, coke and briquettes, etc.	0.4	0.9	1.2	1.8	2.5	2.0
Total imports	24.1	36.7	61.4	100	100	100

SOURCE: Report on Currency and Finance, 2002/2003, Reserve Bank of India.

Table 3-13

Imports: Top Gainers and Losers since the 1990s

Item	Share in India's Imports		Growth rate
	1990/91	2002/03	1990/91 to 2002/03
GAINERS			
Computer goods	0.1[a]	0.5	36.4[b]
Electronic goods	3.9[a]	8.7	21.7[b]
Edible oils	0.8	2.9	21.1
Textile yarn, fabrics, madeups, etc.	1.0	1.6	12
Cashew nuts	0.3	0.4	10.8
LOSERS			
Cereals and cereal preparations	0.4	0.0	-11.2
Project goods	5.9	0.9	-8.1
Fertilizers	4.1	1.0	-4.2
Electrical machinery except electronic	3.9	1.0	-3.2
Iron and steel	4.9	1.5	-1.9

[a] *Import share in 1993/94*
[b] *Growth rate since 1993/94*

SOURCE: Report on Currency and Finance, 2002/2003, Reserve Bank of India.

Rise of Developing Countries as Suppliers

India's traditional import partners, Germany and Japan, are becoming less important while new partners in Africa and East Asia are becoming more important. Commonwealth of Independent States (CIS) countries, ranked seventh in 1990/91, were not among the top 10 in 2002/03 (Table 3-14).

Table 3-14

Major Sources of India's Imports

Rank	1990/91		2002/03	
	Country	Share (%)	Country	Share (%)
1	United States	12.1	United States	7.2
2	Germany	8.0	Belgium	6.1
3	Japan	7.5	China	4.5
4	Saudi Arabia	6.7	United Kingdom	4.5
5	United Kingdom	6.7	Germany	3.9
6	Belgium	6.3	Switzerland	3.8
7	CIS	5.9	South Africa	3.4
8	United Arab Emirates	4.4	Japan	3.0
9	Australia	3.4	Korea	2.5
10	Singapore	3.3	Malaysia	2.4

Note: Figures include petroleum, crude and products.

SOURCE: Report on Currency and Finance, 2002/2003, Reserve Bank of India.

Increased Share of Trade in the Economy

The trade-to-GDP ratio increased from an average of less than 15 percent before reforms to 24 percent after reforms, rising consistently and reaching a maximum of 31 percent in 2002. During 1998–2002, India's trade grew at a rate comparable to those of many high-performing Southeast Asian and East Asian economies (Table 3-15).

Table 3-15

Average Growth Rate of Trade in Selected Countries

Country	1992–2002	1992–1997	1998–2002
China	16.1	14.5	18.1
India	13.5	14.0	12.9
South Korea	12.4	14.0	10.5
Malaysia	9.1	13.4	3.9
Thailand	7.6	8.4	6.5
Philippines	6.9	13.2	-.6
Indonesia	5.2	10.6	-1.4

SOURCE: World Bank .World Development Indicators, 2004.

TRADE WITH SAARC COUNTRIES

India's trade with other SAARC countries has been buoyant, although small in comparison with India's trade with more developed countries (Table 3-16). The share of the SAARC region in India's total trade has also grown steadily. Bangladesh and Sri Lanka have more than a 1 percent share, Nepal a little over 0.5 percent, and the others less than or just about 0.1 percent. To some extent India's participation in regional and bilateral trading arrangements with Asian countries is reflected in the increasing share of these countries in India's trade.

Although India's imports from all SAARC countries increased in 2003/04, imports from Sri Lanka, Bangladesh, and Bhutan grew the most rapidly. India's exports to Bangladesh and Sri Lanka in most years have surpassed its exports to South Korea and all ASEAN nations except Singapore. And imports from Pakistan, which declined in 2002/03, increased in 2003/04.

Table 3-16

Trends in India's Trade with Other SAARC Countries

	1999/2000	2000/2001	2001/2002	2002/2003	2003/2004
Export	1,394.6	1,928.5	2,026.0	2,724.1	4,148.1
Growth (%)	-17.0	38.3	5.1	34.5	52.3
Import	397.6	465.9	571.5	512.0	668.8
Growth (%)	-14.6	17.2	22.7	-10.4	30.6
Total trade	1,792.3	2,394.5	2,597.5	3,236.1	4,816.9
Growth (%)	-16.4	33.6	8.5	24.6	48.8
Share (%)	2.1	2.5	2.7	2.8	3.4

SOURCE: Directorate General of Foreign Trade, India.

India displays a strong regional orientation for exporting manufactured products such as automobiles, pharmaceuticals, and agricultural implements. These highly segmented industrial products accounted for 36 percent of India's regional exports, compared with 7 percent of its exports to the rest of the world. This development is illustrative of India's evolving comparative advantage and ability to fulfill to some extent the region's demand for manufactured goods, a characteristic that has not been demonstrated by other countries in the region.

Trade Balance

India consistently has a trade surplus with Bangladesh, Pakistan, Maldives, and Sri Lanka, and the size of the surplus has grown. The picture is different for trade with Bhutan and Nepal. Nepal maintained a surplus vis-à-vis India from 1999/2000 to 2001. Bhutan registered a surplus from 1999/2000 until 2002/03, but posted a deficit in 2003/04.

The trade deficits of other countries vis-à-vis India has been one of the most contentious issues in South Asian economic integration. However, India's exports and imports are highly diversified compared to those of the smaller countries. In addition, India's scale of production is large, and smaller partners often use its production and export base to overcome short-term imbalances in domestic production. For example, in May 2005, Pakistan, in an attempt to meet domestic demand and bring down prices, allowed private traders to import meat and vegetables directly from India without duty. A trade deficit is therefore a natural outcome of dependence on a larger country. A similar situation exists with South Africa and the other states of the Southern Africa Customs Union and the Southern African Development Community.

Another important aspect of the sustained trade deficit is that most of India's major imports are in the semimanufacture category. The rest of the region has neither the capacity nor the comparative advantage in this product category, and this is reflected in the meager share of the rest of the region in India's imports. For example, although India imports 70 percent of its sugar from the region, these imports account for only 0.4 percent of India's total global imports.

Preferential Trade under SAPTA

India posts a positive trade balance for preferential trade under SAPTA. In analyzing India's preferential trade with Bangladesh, Maldives, Pakistan, and Sri Lanka for the period 1996/97 to 2002/03, Mukherjee (2004) finds that India generally had a positive preferential trade balance with all SAPTA countries except Bangladesh during 1997/98 to 2000/2001. The preferential trade balance, however, is not as much in India's favor as India's overall trade with these countries.

Preferential Imports

According to Mukherjee, India's preferential imports as a percentage of total bilateral imports from Bangladesh increased until 1998/99 and began to decline thereafter in spite of the increase in the number of products offered for concessions to Bangladesh as a least-developed country (LDC). With Maldives, the share of preferential imports increased until 2001/02 and declined in the following year. For Pakistan, the share of preferential imports shows a declining trend until 1998/99 and has fluctuated since then. In 2002/03, although the value of preferential imports decreased, the share of India's preferential imports from Pakistan increased. Preferential imports

from Sri Lanka have been marginal and static, possibly because bilateral trade occurs instead under the terms of the India–Sri Lanka free trade agreement, which has been in operation since March 2000.

Preferential Exports

India's preferential exports to Sri Lanka, Pakistan, Maldives, and Bangladesh have been marginal in relation to the country's bilateral exports. Only in the case of Pakistan is an increasing share observed until 1998/99. A declining share is noted between 1998/99 and 2000/01, with only slight increases since then.

Trade Intensity in Bilateral Trade within the Region

The trade intensity index provides some additional insights into the prospects for economic integration in South Asia.[1] A change in the value of the index over time indicates whether two countries are experiencing an increased or decreased tendency to trade with each other. An increasing tendency may reinforce prospects for further integration while a decreasing tendency diminishes such prospects.

Choudhury and Imran calculated trade intensity for India vis-à-vis the other SAARC economies for six different years between 1980 and 1997. The study found that SAARC members depend increasingly on trade with India. This evolving relationship between SAARC countries and India is confirmed when trade intensity is calculated for 1996–2003. For all three countries except Pakistan, the trade intensity index is greater than one and increasing, indicating that the bilateral trade flow between these countries and India is greater than would be expected given their relative importance in world trade.

Further evidence of this relationship is provided by Pitigala (2005). India's "real" trade intensities, normalized for geographical proximity with other South Asian countries, are stronger than implied by its bilateral trade shares. In 1998, India and Sri Lanka's trade was more than three times what would have been expected on the basis of their shares in world trade; India's trade with Bangladesh was more than five-and-a-half times what would have been expected, and India's trade with Nepal was eight times more than would have been expected on the basis of the countries' shares of world trade.

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[1] The trade intensity index is used to determine whether the value of trade between two countries is greater or smaller than would be expected on the basis of their importance in world trade. It is defined as the share of a country's exports to one partner divided by the share of world exports going to the partner. The index is calculated as:

$$T_{ij} = (x_{ij}/X_{it})/(x_{wj}/X_{wt})$$

Where x_{ij} and x_{wj} are the values of country i's exports and of world exports to country j and where X_{it} and X_{wt} are country i's total exports and total world exports respectively. An index of more (less) than one indicates a bilateral trade flow that is larger (smaller) than expected, given the partner country's importance in world trade.

TRADE POLICY

India moved to a market-determined exchange rate in 1993 and to current account convertibility in August 1994. Major changes in India's trade policy after 1991 are described in the following paragraphs.

Tariffs

Customs duties in India include protective tariffs (basic duties)—which are subject to WTO disciplines under the General Agreement on Tariffs and Trade (GATT)—and equivalents of domestic indirect taxes such as a central VAT (CENVAT) and central excise duty or "additional duty" (CVD in popular parlance).

The central excise duty rate structure was overhauled in 1999, and the 11 rate bands (commonly referred to in South Asia as slabs) of basic excise duty were cut to three rate bands (ad valorem) of 24 percent, 16 percent, and 8 percent. In April 2000, the three rates converged into a single 16 percent rate known as CENVAT.

The additional duty is equal to the excise duty levied on a like product category or a product manufactured in India. Therefore, although it is called a customs duty, the additional duty as applied is not protective. Furthermore, it covers only central indirect taxes, not indirect taxes, which states impose on domestically produced goods. Goods produced domestically are often charged higher state excise and sales taxes than imported products. The excise and sales taxes vary among states and products, making the system extremely complicated and calculating the countervailing duty very difficult. The effective protective duty on imports may therefore be lower than the basic customs duty.

Changes in India's Tariff Structure

Tariff rates in India rose substantially in the 1980s. Tariff revenue as a proportion of imports went from 20 percent in 1980/81 to 44 percent in 1989/90. With the removal of licensing, these tariff rates became effective restrictions on imports. A major task of reforms in the 1990s and beyond has therefore been to lower tariffs.

The peak rate of import duty on nonagricultural imports—150 percent in 1991/1992—was gradually reduced to 25 percent by 2003/04, and to 15 percent in April 2005. Because of concerns for the livelihood of a large section of the population dependent on agriculture, tariff rates in agriculture are higher and more variable. They range from 0 percent to 100 percent but are clustered around 30 percent. For social and religious reasons, special rates apply to alcohol products.

Basic duty rates (both the simple average and the weighted average) declined between 1991/92 and 2004/05 (Table 3-17). Total duties, inclusive of special additional duties and surcharge, also declined over this period. Reductions were made primarily between 1991/92 and 1997/98. Tariff rates increased during the period 1998/99 to 2001/02 when tariffs were applied to some agricultural and processed agriculture-based consumer items, after quantitative restrictions were removed under WTO agreements and additional duties imposed. Reductions in the average total duty rate have been particularly marked in 2004/2005: not only have basic duty rates been

reduced, but a special additional duty was abolished. Tariff duties have also been made more uniform within sectors.

Table 3-17

Average Import Duty Rates in India

Commodity Group	Basic		Total	
	1991/92	2004/05	1991/92	2004/05
WEIGHTED AVERAGE[a]				
Agriculture	47.0	28.7	47.0	29.2
Mining	56.9	5.1	56.9	5.2
Consumer	97.8	49.6	97.8	50.4
Intermediate goods	69.5	19.3	69.5	19.6
Capital goods	94.8	17.8	94.8	18.1
All commodities	81.4	17.7	81.4	18.0
SIMPLE AVERAGE				
Agriculture	108.0	32.3	108.0	32.9
Mining	108.0	12.3	108.0	12.5
Consumer goods	141.0	25.5	141.0	25.9
Intermediate goods	132.0	21.0	132.0	21.3
Capital goods	105.0	20.0	105.0	20.4
All commodities	128.0	22.4	128.0	22.8

[a]*Weights are the level of imports in 1992/93 for 1991/92 and in 2003/04 for 2004/05*

SOURCE: A Mathur and A. S. Sachdeva 2005.

Distribution of Customs Duties

The distribution of duty rates has also undergone substantial changes (Table 3-18). In 1991/92 about 80 percent of all commodities at the Harmonized System's six-digit level had basic duty rates exceeding 100 percent. By 2004/05, almost 98 percent of all commodities had duty rates of less than 50 percent. In fact, 83 percent had duty rates of less than 25 percent. Furthermore, only 96 commodities in 2004/05 had duty rates of above 50 percent, with about half of these more than 100 percent.

In 2004/05 the commodity groups with a duty of 100 percent or higher include coffee, tea, alcoholic beverages, essence and perfumes, sugar items, grapes and juices, motor cars, and motorcycles. Commodities in the 50 to100 percent duty range include edible oils, wheat, rice, and some other agricultural goods. Some commodities in this group were previously in the restricted list of items (i.e., faced quantitative restrictions).

Table 3-18

Number of Commodities within Ranges of Customs Duty Rates in India (HS six-digit level)

Duty Rates (%)	1991/92	1994/95	1999/2000	2004/05
300 and above	38	212	0	0
200–299	183	0	8	20
100–199	3,913	249	12	49
50–99	756	3670	4	47
25–49	24	633	4,546	787
0–24	126	476	569	4,261
Total	5,040	5,040	5,139	5,144

SOURCE: A. Mathur and A. S Sachdeva, 2005.

Comparative Tariff Structure

A comparison of the prevailing tariff structure in India with the tariff structures of some other developing countries reveals that India has among the highest *applied* rates, even though India's *bound* rates, in accordance with the Uruguay Round, are similar to those of other developing countries in South Asia (Table 3-19). India's applied tariffs on agricultural and nonagricultural goods are higher than those of other developing countries—even those of other South Asian countries with higher bound rates than India (e.g., Pakistan and Bangladesh).

Table 1-19

Country Profile of Tariff Structure

Country	Bound Tariff (%)			Applied Tariffs (%)		
	All Goods	Agricultural Goods	Non-agricultural	All Goods	Agricultural Goods	Non-agricultural
India [b]	49.8	114.5	34.3	29.0	36.9	27.7
Argentina [c]	31.9	32.6	31.8	14.2	10.3	14.8
Bangladesh [c]	163.8	188.5	35.7	19.5	21.7	19.2
Brazil [b]	31.4	35.5	30.8	13.8	11.7	14.1
Chile [c]	25.1	26.0	25.0	6.0	6.0	5.9
China [b]	10.0	15.8	9.1	12.4	19.2	11.3
Indonesia [b]	37.1	47.0	35.6	6.9	8.2	6.7
Malaysia [a]	14.5	12.2	14.9	7.3	2.1	8.1
Pakistan [c]	52.4	97.1	35.3	17.1	20.4	16.6
So. Africa [b]	19.1	39.8	15.8	5.8	9.1	5.3
Thailand [a]	25.7	35.5	24.2	16.1	29.0	14.2

[a] *Applied tariff rates for 2001*
[b] *Applied tariff rates for 2002*
[c] *Applied tariff rates for 2003*
[d] *Applied tariff rates for 2004*

SOURCE: A. Mathur and A. S. Sachdev, 2005.

Customs Duty Collection

The share of customs duty in GDP came down from about 3.9 percent in 1987/88 to 1.8 percent in 2002/03. Customs duty collection as a share of total imports, which increased during a large part of the 1980s, reaching a peak of 61.6 percent in 1987/88, declined significantly, and bottomed out at about 15.3 percent in 2002/03. The collection rates fell drastically across all commodity groups in the 1990s, with the largest reduction in chemicals, manmade fiber, and metals.

Nontariff Barriers

Quantitative restrictions on a wide range of goods (mainly consumer goods) were justified in India for several decades, for balance-of-payment reasons, under Article XVIII-2(b) of the GATT. In mid-1991, about 80 percent of the Harmonized System tariff lines at the six-digit level were subject to some form of import licensing restrictions.

India began removing balance of payment–related quantitative restrictions unilaterally in 1996. It removed quantitative restrictions on 488 items in 1996, 391 items in 1997, and 894 items in 1998. To meet its commitments to the WTO, on March 31, 2000, India removed quantitative restrictions on 714 items of the 1,429 items for which quantitative restrictions were maintained on balance-of-payment grounds under the GATT provisions, and a year later removed quantitative restrictions on the remaining items. Quantitative restrictions are still being maintained, however, on 5 percent of tariff lines, as permitted under Articles XX and XXI of GATT on the grounds of health, safety, moral conduct, and essential security.

Reflecting the relaxation of quantitative restrictions, the value of canalized items[2] declined from 27 percent of all imports to 19 percent in the 10 years from 1988/89 to 1997/98. Beginning in April 1998, 340 items were shifted from the restricted list to the “open general license” list. Beginning March 31, 1999, the convention of publishing a negative list for exports and imports was discontinued.

In the initial phase of reforms in 1991/92, about 3,000 tariff lines covering raw materials, intermediate goods, and capital goods were freed from licensing restrictions. In 1996, 6,161 tariff lines at the Harmonized System 10-digit level were freed, out of a total of 10,202 lines. The share of unrestricted products (tariff lines) among imports increased to more than 95 percent in 2003 from about 61 percent in 1996. The progressive removal of nontariff barriers is summarized in Table 3-20 by type of barrier.

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[2] Some commodity imports must be channeled (“canalized”) through state trading enterprises.

Table 3-20

Nontariff Barriers on India's Imports, 1996–2003[a] (No. of Tariff Lines, 10-digit level[b])

Nontariff Barrier	1996	1997	1998	1999	2000	2001	2002	2003
Prohibited	59	59	59	59	59	59	52	52
Restricted	2,984	2,322	2,314	1,183	968	479	554	484
Canalized /state trading enterprises	127	129	129	37	34	29	33	32
Special import license	765	1,043	919	886	226	–	–	–
Free	6,161	6,649	6,781	8,055	8,854	9,582	11,032[c]	11,103
Total	10,096	10,202	10,202	10,220	10,141	10,149	11,671	11,671

[a] *As of April 1.*
[b] *As per Harmonized System of India Trade Classification of export and import*
[c] *Includes 148 items with conditions.*

SOURCE: *Report on Currency and Finance, 2002/2003, Reserve Bank of India.*

Export Promotion

The thrust of export policy in the 1980s and 1990s was manifested through several export promotion schemes. Export processing zones (EPZs), initiated in India in the mid-1960s, provide an internationally competitive duty-free environment for export production.

The export-oriented-unit (EOU) scheme, complementary to the EPZ scheme, was initiated in 1981. This scheme enables a manufacturing unit to be eligible for a package of incentives that include the same entitlements given to those in EPZs. EOUs have greater flexibility than EPZ-based firms because they can locate in an EPZ or anywhere in the country. The premise of this scheme is that exporters are treated as special class and given the required tariff, nontariff, and policy support to facilitate their export efforts.[3]

In addition, schemes were put in place in the 1980s and 1990s for imports by exporters to neutralize the impact of duties on their imports: export promotion of capital goods, duty-free replenishment certificate, duty remission, and duty entitlement passbook.

In March 2000, India reinforced export promotion with a special economic zone (SEZ) scheme. The SEZ scheme provides a more favorable environment to investors than EPZs; both provide duty concessions, but SEZs also simplify procedures. Since the scheme was announced eight EPZs have been converted into special economic zones.

Transparency

India's trade system is transparent in that all terms are defined clearly and accepted globally. Information about policy is easily and readily available both in published form and online. Details

[3] EOUs fall into three categories: (1) EOUs established anywhere in India and exporting 100 percent of their products, except a fixed percentage of sales in the domestic tariff area as may be permissible under the policy; (2) units in free zones in SEZs and exporting 100 percent of their products; (3) EOUs set up in software technology parks and electronic hardware technology parks of India for development of software and electronic hardware.

about applied tariffs for commodities are available in published form. The Central Board of Excise and Customs periodically publishes the Indian Customs Tariff Guide containing the board's tariff rulings. India's transparency in tariffs and domestic taxes contrasts with the lack of transparency in some other countries in South Asia.

Rules and Procedures

Steps have also been taken to simplify the rules and procedures and improve the speed of transactions in the Directorate General of Foreign Trade with the help of information technology aimed at reducing transaction costs. The Directorate General of Commercial Intelligence and Statistics and the Central Board of Excise and Customs have adopted a common commodity classification for imports and exports to eliminate classification disputes. Electronic data interchange and system-based appraisal are being encouraged for use by customs.

NONTARIFF BARRIERS FACED BY INDIA IN SOUTH ASIA

Although formal protective import licensing has been abolished, a number of GATT-compatible import controls that act as protective nontariff barriers, or have the potential to do so, continue to operate in South Asia. India faces the following nontariff barriers in South Asia:

- Pakistan's longstanding ban on imports from India of products not on a limited positive list of some 771 items.
- Pakistan's trade-related investment measures (TRIMS), applied to its auto industry since 1998 to encourage the use of local content. Although Pakistan phased out other local-content requirements by December 2003, as required by the WTO, it applied for a three-year extension on the local-content program in its auto industry until December 2006.
- Bangladesh's restrictive list of products that can be cleared only at certain port and inland customs posts. Transport costs to reach authorized customs posts constrain legal bilateral trade.
- Bangladesh's restrictions on agricultural products (chicks, eggs, salt), packaging materials, and textile products. Nearly 40 percent of quantitative restrictions in Bangladesh apply to textile products.
- Sanitary and phytosanitary and technical regulations to limit imports and protect domestic producers, such as those that prevent or restrict imports of secondhand goods into Pakistan.

BILATERAL AND MULTILATERAL AGREEMENTS

India is a founding member of the General Agreement on Tariffs and Trade (1947) and the WTO (1995). Although it attaches prime importance to a fair and rule-based multilateral trading system, it has since 1992 explored the creation of regional, subregional, and bilateral preferential trading arrangements.

Subregional Cooperation

India participates in two regional trade initiatives, both of which extend beyond South Asia.

- The Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC) comprises Bangladesh, India, Myanmar, Sri Lanka, Thailand, Bhutan, and Nepal—countries from both SAARC and ASEAN. In the ministerial meeting of February 2004, members developed a framework agreement to promote trade and investment among themselves. The first BIMSTEC summit was held in July 2004.
- The Bangkok Agreement was signed in 1975. Its members are Bangladesh, China, India, Republic of Korea, Laos, and Sri Lanka. The agreement covers only tariff concessions on goods. India has offered concessions on 188 items.

Bilateral Cooperation in South Asia

A number of bilateral trade accords link India with other South Asian economies:

- ***Sri Lanka.*** A free trade agreement with Sri Lanka came into effect in 2000 and has boosted trade between the two countries. The balance of trade, which in 1999 favored India 11 to 1, by 2002 had tilted somewhat toward Sri Lanka, and favored India by 5 to 1. In 1999, Sri Lanka's exports to India accounted for 1 percent of the country's entire exports, and in 2002, 3.6 percent. India was the fifth-largest destination for Sri Lankan exports in 2002, compared to a rank in the 20s in the mid-1990s. India is the largest source of imports for Sri Lanka, accounting for 14 percent of all imports. As a consequence of the free trade agreement, Sri Lanka has become a popular destination for foreign direct investment (FDI) because many countries now see Sri Lanka as providing a window of opportunity to the huge Indian market. The agreement is becoming an economic partnership that includes liberalization of services.
- ***Nepal.*** India signed a free trade agreement with Nepal in 2002, building on the Indo–Nepal Trade and Transit Treaty of 1996. The 2002 agreement's duty-free provision encouraged Indian joint ventures to operate in Nepal. The volume of exports from Nepal increased, enabling Nepal to register a trade surplus with India in some years since its entry into effect. India is Nepal's principal trading partner, accounting for 40 percent of Nepal's total trade, as well as Nepal's largest industrial collaborator and foreign investor. Almost 200 Indo–Nepalese joint ventures operate in Nepal, and Indian investments account for 36 percent of total FDI in the country.
- ***Bhutan.*** India's trade agreement with Bhutan dates from 1995.[4] India's trade relationship with Bhutan should be taken as a model for regional cooperation in South Asia. Bhutan maintained a chronic trade deficit with India, and its ability to supply exported goods to India was limited. With India's help, Bhutan developed a hydroelectricity project and exported energy to India. This has addressed the trade deficit of Bhutan in favor of Bhutan.

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[4]Indo–Bhutan trade relations are governed by the trade agreement of 1949 and four Indo–Bhutan trade agreements have been concluded since then (in 1972, 1983, 1990, and 1995).

Trade Agreements with Other Asian Partners

India's trade relationships outside the region could offer SAFTA nations access to Southeast Asian markets. For example

- ***ASEAN.*** India signed a framework agreement with ASEAN during the second India–ASEAN summit in October 2003. The framework covers a free trade agreement in goods, services, and areas of economic cooperation. Negotiations on the free trade agreement in goods are expected to conclude in 2005 and tariff reductions to start on January 1, 2006.
- ***Thailand.*** India signed a framework agreement for the creation of a free trade area with Thailand in October 2003. A zero-duty regime will emerge by 2010.
- ***Singapore.*** India has a comprehensive economic cooperation agreement with Singapore, which is an important facilitator to India–ASEAN ties.

Reconciling Subregional and Bilateral Agreements with SAFTA

Little evidence is available from other regional arrangements to gauge the implications of pursuing both a bilateral agenda and economic cooperation at a regional level. For regional arrangements such as the European Union and ASEAN, the starting point was a degree of cooperation and an agenda and timeframe for integration. South Asia differs in that member nations of an existing regional trade area are entering into more substantial and liberal bilateral agreements. An important aspect of SAFTA therefore is the manner in which the rules of origin and sensitive lists in the bilateral initiatives are reconciled with those of SAFTA. If bilateral agreements continue to operate alongside the SAFTA process, it will create a greater administrative burden as well as a less cohesive South Asian region. This will confuse both exporters and investors unless the countries make the bilateral agreements consistent with each other and with the regional trade agreement.

Positive Implications of Parallel Bilateral and Regional Cooperation Initiatives

Bilateral trade agreements could set a precedent for the regional trade agreement in several respects. In the case of the Indo–Lanka free trade agreement, the timeframe for tariff phaseout, rules of origin, and negative list were designed to accommodate the smallness of Sri Lanka's exports and the island's limited production capacity. If the regulatory framework in a regional trade agreement is designed to accommodate disparities between countries, a small country can gain from the agreement. This sets a precedent for different rules of origin and sensitive lists for LDC and non-LDC members of SAFTA.

Some believe that bilateral agreements stall progress on regional agreements because what a country hopes to gain from a regional association it may often gain through a bilateral agreement. Sri Lanka, for example, already has access to India's large market through its bilateral agreement with India. It has also signed an agreement with Pakistan, its other large trading partner in the region. Is SAFTA then marginal to the country's regional trade interests?

The benefits of the bilateral agreements will be equivalent to those of the regional arrangement only if each country of the region signs a bilateral agreement with the other countries that are

members of the regional trade agreement. In South Asia, all seven members of SAFTA will have to sign a bilateral agreement with each of the other six countries—a total of 21 agreements.

Furthermore, because a regional agreement creates an integrated market, the market can offer potential economies of scale and links between member nations' markets. The creation of a free market of 1.3 billion people with rising purchasing power can be a significant benefit for all SAFTA members. A South Asian regional trade agreement could also alleviate the trade burden of landlocked countries that face high trading costs in transporting goods through a neighboring country to reach a seaport.

Spaghetti Bowl in South Asia?

Some criticize SAFTA, saying the region already has a "spaghetti bowl" of agreements: simultaneous multiple trade arrangements at different levels and of different natures implemented over different periods. But an examination of the situation in South Asia reveals a different picture.

In South Asia, the only comprehensive bilateral agreement that has been in operation for some time (since 2000) is the India–Sri Lanka free trade agreement. The agreement between Pakistan and Sri Lanka came into force only in June 2005 and does not go beyond tariff concessions on goods.

The BIMSTEC initiative is dynamic and offers the prospect of widening the network for outward-oriented growth in this part of Asia. It can be a bridge between the more inward-oriented South Asia and the more outward-oriented Southeast Asia and East Asia. Through BIMSTEC, India and SAARC can reach out to Southeast Asia and beyond to the Asia-Pacific community. BIMSTEC could also contribute to a better understanding of security concerns.

The BIMSTEC draft free trade agreement provides for a two-track program of tariff reduction and elimination, liberalization of trade in services, investment, and cooperation in certain sectors (technology, transportation and communication, energy, tourism, and fisheries). Negotiations on tariff reduction are to be concluded by December 2005 and on investment and services by 2007. Given the scope of and timeframe for liberalization in the draft free trade agreement, the possibility of an overlap with SAFTA does exist. Although it is important that negotiating members be aware of the rules and specifications in the two agreements to prevent parallel functioning, this aspect should also give SAFTA the impetus to adopt a more aggressive timeline for trade liberalization.

The Bangkok Agreement covers only tariff concessions on goods. Although revitalized by the entry of China into the arrangement in 2001, it is limited in scope and may therefore not impinge in any adverse manner on SAFTA.

As for SAPTA, Article 22 of SAFTA states that when trade liberalization is completed SAFTA will supersede SAPTA. Until then, all concessions granted under SAPTA will remain available to the contracting states. The question of an overlap between SAFTA and SAPTA therefore may not arise. The concerns of a spaghetti bowl developing in South Asia appear therefore unwarranted.

India's Approach

India has only recently negotiated comprehensive regional trade agreements; earlier agreements were limited in scope and built on agreements dating from the 1990s. Consequently, coverage of important issues (such as detailed lists of goods and specific rules of origin) is scant. The Indo–Lanka free trade agreement of 2000 contains detailed concessions with rules of origin. With Nepal (2002) the terms of reduction of tariffs and quantitative restrictions on rules of origin and goods subject to preferential treatment are specified. However, the agreement with Bhutan contains no list of goods and no rules of origin.

Only since 2003 has India negotiated preferential trade arrangements outside South Asia. For most of these agreements—as with SAFTA—negotiations on details of rules of origin and elimination of nontariff barriers are either ongoing or have yet to start. India is becoming aware of emerging problems in the process and is likely to try to ensure consistency among these agreements. Furthermore, because many agreements have a wider scope, covering services, investment and broader cooperation, they may set a precedent for including these aspects of trade in SAFTA.

BENEFITS OF SAFTA FOR INDIA

Trade Benefits

Trade Creation

As designed, SAFTA aims to liberalize trade mainly through tariff concessions and elimination. Gains that may accrue to India have been analyzed as follows.

Bandara and Yu (2003), using the Global Trade Analysis Project computable general equilibrium model, analyzed the economic impact of SAFTA on countries in the region. They found that only India would realize a significant welfare gain under SAFTA. India, with its initial high tariffs and biggest manufacturing sector, could be expected to emerge as the biggest winner, as in their analysis. In estimating the welfare gains resulting from more efficient resource allocation, they find that removing all tariffs improves access to cheaper imported goods and increases consumption. Thus, improved allocation resulting from trade liberalization gives rise to welfare gains. Bandara and Yu also find that India's exports to other South Asian countries and export prices increase in two sectors: textiles and apparel. Some possibilities for increased intraregional trade are created, although they may be small in comparison with possibilities arising from unilateral trade liberalization by all SAFTA member countries.

Hirantha (2003) shows strong evidence of trade creation in the region under SAPTA, with no trade diversion effect as far as trade with nonmembers is concerned. Evidence of trade creation with SAPTA bodes well for the proposed SAFTA. Using the gravity model, Srinivasan (1994) found that complete removal of tariffs is likely to result in a 3 percent increase in India's GDP.

Batra (2004) used the augmented gravity model to estimate the trade potential for India and its trading partners throughout the world and more specifically India's partners in regional groupings

such as SAARC. The model explains bilateral trade as a function of distance, economic size, contiguity, and cultural proximity as indicated by a common language and colonial past. The model uses gross national product (GNP) in terms of both purchasing power parity and current international US dollar value. For both versions of the model, estimates indicate positive trade potential for the SAARC region as a whole. The positive trade potential is mainly on account of trade potential with Pakistan when calculated according to purchasing power parity and only on account of trade potential with Pakistan when estimates are made using international US dollar value. The trade potential between India and Pakistan is estimated to be US$6.5 billion more than actual trade between these economies when the model uses GNP current international US dollar value.

Trade Complementarity—Revealed Comparative Advantage Approach

The success of a regional bloc is often considered to be positively related to the diversity in the structure of comparative advantage of member countries (i.e., participants have complementary areas of comparative advantage; they do not all have precisely the same sectors of comparative advantage). Several studies have analyzed the nature and extent of revealed comparative advantage of South Asian economies. Most suggest a similarity in the pattern of comparative advantage and export interests, and most conclude that India, Bangladesh, Nepal, and Pakistan have comparative advantage in similar categories of food and live animals, basic manufactures, and miscellaneous manufactures. But in comparison with other South Asian countries, the range of products over which India has a comparative advantage is wide.

According to Kemal *et al.* (2000), in a study of the period 1985–1995, India can export products ranging from food items to machinery and transport equipment to other countries in South Asia and has reasonable potential to meet their import needs. The degree of trade complementarity has increased for Bangladesh and India and is higher than that of other countries in the region. A reasonable compatibility is also indicated between the trade structures of Sri Lanka and India. Interestingly, complementarity between India and Pakistan is higher than between other countries in the region.

Batra and Khan (2005), using data for 2000, show that India has a comparative advantage in 41 of 97 sectors in the Harmonized System two-digit classification. Analysis of the correspondence between the structure of revealed comparative advantage for India and imports of the other SAARC member nations shows that India can meet the import demand for the region. For example, Pakistan imports cereals, milling products, malts, starches, sugars and confectionary, and textiles—all commodity groups in which India has a high revealed comparative advantage in the global market. None of these products, however, is sourced from India.

Potential Intraindustry Trade between India and Other SAFTA Members

Gains may also accrue through intraindustry trade between India and the other SAFTA nations. Mukherjee (2004) presents India’s intraindustry trade with Bangladesh, Bhutan, Maldives, Nepal,

Pakistan, and Sri Lanka. He has identified joint ventures and wholly owned subsidiaries that Indian entrepreneurs could set up in South Asian countries:[5]

- In Bangladesh, manufacturing of shirts (not hand printed), tanned or crust hides, grains (finished), sacks and bags of other plastic, and other finished tanned leather.
- In the Maldives, manufacturing articles for conveyance or packing goods of plastics, air conditioning machines, and water pumps.
- In Pakistan, joint ventures in cane sugar and some chemical products
- In Sri Lanka, the manufacture of printing and writing paper, plastic goods, and soap cutting and molding machinery

Kemal (2000) shows that in 1995 intraindustry trade between India and Nepal was notable in categories such as chemical and related products, basic manufactures such as articles of textile and clothing, leather, rubber tires, and some miscellaneous manufactures such as articles of women's clothing. Between India and Pakistan a high degree of intraindustry trade is indicated in medicinal and pharmaceutical products and soap and cleansing preparations in the chemical and related products category; leather, articles of paper and paperboard in the basic manufactures category; and a number of products in the category of machinery and transport. With Sri Lanka, significant intraindustry trade is indicated for chemicals and basic manufactures. The study indicates, however, that the proportion of intraindustry trade in total trade in the region is low. The exception is India–Nepal intraindustry trade, which is about 14 percent of their bilateral trade.

Some scope for vertical integration of different stages of production in SAFTA member nations exists in sectors such as textiles, leather goods, light engineering, rubber products, automobiles, and exploitation of bio-resources.

Industrial Restructuring

A liberalized investment regime under SAFTA can help South Asian countries exploit the efficiency-seeking restructuring of industries in the region. Das (2004) shows how regional cooperation and trade–investment linkages can induce efficiency-seeking industrial restructuring through intra-South Asian FDI flows in the textiles and clothing sectors. Kumar (2001) states that the free trade regime under the India–Nepal free trade arrangement has facilitated the restructuring of production by certain companies that moved their production base to Nepal to serve the north Indian market as well as third-country exports. Examples include Dabur India setting up its production unit for fruit juices in Nepal. Evidence of efficiency-seeking restructuring is also evident from the India–Sri Lanka free trade agreement. These include Ceat India and production of automotive tires in Sri Lanka for markets in South Asia and beyond.

These examples illustrate the potential for restructuring in South Asia. The potential for efficiency-seeking restructuring that is inherent in the economic integration of South Asia can of

[5] Categories are based on the Harmonized System at the eight-digit level.

course be expected to go beyond what is possible under bilateral agreements alone. Simultaneously, a regional accord may increase the international competitiveness of the region and attract FDI from outside the region.

Other Benefits

Regional economic integration through SAFTA may yield benefits that go beyond trade and investment.

Joint Stand in WTO. By forming a regional bloc, South Asian countries will have more leverage in the global trade system if they work out a common position on issues of common concern, keeping a long-term perspective in view.

Peace Dividend. SAFTA can help ease regional conflict. Experience with regional economic integration in ASEAN and the European Union, and between China and India supports the notion that interdependence of economies can help ease, if not resolve, political and territorial issues. In South Asia, Pakistan's granting of MFN status to India, trade facilitation, and Kashmir are linked. Economic integration is expected to provide a favorable environment for resolving these issues.

Cross-border Water Management. Greater cooperation in the use of transboundary rivers (the Ganges, the Brahmaputra, and the Meghna) and river basin development is needed to address water problems. Regional integration can help the countries develop improved cross-border flood-warning systems. India and Bangladesh have long needed to work together on water management. Watershed management and water storage in Nepal would have flood-control benefits for Bihar in India. Northeastern India will also benefit from storage efforts through hydropower and flood control.

Gains for Smaller Countries

Many fear that the smaller, less-developed countries (Nepal, Bhutan, Maldives, and Bangladesh) will gain less through SAFTA than India and Pakistan. But the experience of other trading blocs and free trade areas demonstrates that smaller as well as larger trade partners gain. Sri Lanka's trade with India following the free trade agreement increased remarkably. In 2002, Sri Lanka's exports to India grew by about 137 percent.

Concerns that Indian goods will flood the SAARC markets if trade is liberalized are unfounded as has already been shown by the experience of Bhutan and Nepal. Both countries have received Indian goods and investment, and India is the most important export market for both countries.

Evidence also does not support the hypothesis that a trade arrangement with a larger, more developed, country always works to the detriment of the smaller, poorer country. Not too long ago, Indian industry was reluctant to trade with China for fear of cheaper Chinese goods flooding the Indian market. However, trade volumes between India and China have increased tremendously. The North American Free Trade Area is another example. The intraregional exports of all the members increased substantially from 1993 to 2002. Regional economic integration can be beneficial for all.

SUGGESTIONS FOR IMPROVING SAFTA

Many issues that are critical for the success of SAFTA have not been negotiated: the formulation of the rules of origin, preparation of the negative list, creation of a fund for compensating less-developed countries for loss of revenue from the elimination or reduction of customs duties, and identification of areas for technical assistance. No date has been fixed for concluding these negotiations.[6] Some aspects of deeper integration that the SAFTA agreement has not included—services, infrastructure development, and energy—would benefit the members.

The concessions granted under SAPTA did not cover a large portion of tradable goods between member nations because it was notified under a more liberal GATT clause applicable to developing countries.[7] This has often been cited as a reason for the negligible impact of SAPTA on intraregional trade. Although this remains a possibility because such a provision exists under the GATT 1994, most serious regional trade arrangements are notified under Article XXIV of the GATT. So to be a successful regional trade arrangement, SAFTA should be notified under Article XXIV of GATT.

Timeline

The SAFTA agreement is to be ratified in January 2006, two years after the signing. The SAFTA trade liberalization process will commence only then and will take 10 years to complete. This is a long time, and the agreement lacks a provision safeguarding the process against the political vicissitudes to which the region is so susceptible and that have blocked cooperation in the past. Other preferential trade arrangements are also being negotiated in the region (e.g., BIMSTEC). The extended timeline of the SAFTA agreement might weaken SAFTA's impact if other arrangements supersede it. The SAFTA's trade liberalization should therefore be completed in 3 to 5 years rather than 10.

Trade Liberalization

Nontariff and Paratariff Restrictions

According to SAFTA, all quantitative restrictions are to be eliminated for products included in the trade liberalization program. The agreement, however, makes no mention of a timetable for eliminating the nontariff and paratariff restrictions. In most free trade agreements the period in which all nontariff barriers are to be eliminated is clearly indicated. A similar provision should be made in SAFTA.

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[6] The exception is the date for the compensation fund for less-developed members, which must be put in place before the liberalization program begins January 1, 2006.

[7] SAPTA, the precursor to SAFTA, was notified to the WTO under the more flexible Enabling Clause of the text of the 1979 GATT decision allowing preferential trade in goods among developing countries. The impact of SAPTA on to intraregional trade has been negligible. This has been attributed to the SAPTA concessions offered on goods not actually traded among member nations. GATT Article XXIV specifies that all concessions regarding duties and regulations for trade in goods be applied to "substantially all trade," with "substantially" often interpreted as 85 percent. For SAFTA, notification to the WTO under Article XXIV thus implies that concessions will cover 85 percent of trade.

Negative Lists and Sensitive Lists

Another drawback of the SAFTA agreement is that it does not set a deadline for phasing out the negative list, but provides only for a review of the list every four years. It fixes a ceiling of 20 percent for the negative list. India has specified fewer than 1,000 items in the negative list. In addition, the agreement provides for flexibility in drawing up the sensitive list for LDCs that are signatories. Two lists therefore will probably be made—a shorter one for the LDCs, and a longer one for the other countries. This situation would create the possibility of trade deflection and flouting of the rules of origin. A time-bound phaseout of the negative list would curtail the period over which this could happen, while accommodating the export interests of the LDCs.

Specifically, it is not desirable to put the entire agriculture and agroprocessing sector on the negative list. If barriers to trade are eliminated under SAFTA, intraregional trade in this sector offers considerable potential, especially in high-value agricultural products such as cut flowers and vegetables and in processed agricultural products such as canned fruit and fruit juices. Economic cooperation in agriculture could go beyond trade to the transfer of technology and the restructuring of production of jute and jute goods.

Neither should textiles and garments should be put on the negative list because traditional and high-value textile and garment items offer great potential for regional trade. But cooperation can take also the form of a transfer of technology or regional trade in raw material, components, and machinery. Liberalization might also enable market forces to determine where production of a particular product may be located most efficiently.

Rules of Origin

SAFTA members have not agreed on rules of origin. Although India agrees to a 40 percent value-addition clause along with a change in the tariff heading, Pakistan wants a 50 percent value-addition clause. All the others want a 35 percent value-addition clause accompanied by a change in the tariff heading at the four-digit level. Setting rules of origin is problematic in South Asia largely because of asymmetry in the export production capacity of the countries.

The rules of origin in SAPTA are one-dimensional. They rely only on the percentage of value-addition criterion. This could encourage the substitution of more costly domestic inputs for cheaper foreign inputs. Mukherjee (2004) suggests that in certain sectors the percentage-test criterion could be supplemented with a change in tariff heading and the specific-process test criterion. In these sectors then, the percentage-test criterion could be relaxed. The rules of origin could also be relaxed without encouraging trade deflection by encouraging greater regional-input sourcing, for example by providing for inputs sourced within the region to count toward the required rule of origin (i.e., through so-called regional cumulation). Even if the tariff-heading criterion is accepted, it could be dispensed with when the concession-receiving country uses less than a certain percentage of inputs (e.g., 10 percent) from nonmember states or when it sources more than 80 percent of its inputs from other member states. Products of regional joint ventures could be permitted more favorable rules of origin.

The rules of origin that now apply under India's bilateral agreements are more liberal than those in preferential trading arrangements such as the ASEAN Free Trade Area (AFTA), Southern

Common Market (Mercosur) in South America, or the European Union. One possibility to be explored therefore is to carry forward the most liberal of the bilateral rules of origin to the SAFTA agreement and apply them to imports from the LDCs in the region.[8] Separate rules of origin can be negotiated for imports from the other countries.

Investment Cooperation

The SAFTA agreement does not address liberalization of investment. This is a severe shortcoming. The point of a free trade area in South Asia is for small economies with narrow markets such as Nepal, Bangladesh, and Sri Lanka to leverage the incentive of the larger markets, particularly India's market, to stimulate domestic investment and attract foreign investment. The smaller nations' trade deficits with their larger neighbors can be compensated for by the movement of capital from the large to the small. The agreement should include a provision for facilitating a larger flow of investment within the region.

India is an important source of investment in the region, and its capital account convertibility[9] policy creates a favorable environment for increased investment flows, particularly from India to other countries in South Asia. On the Indian side, the policy framework for direct investment in other countries was liberalized during the 1990s: Indian companies may invest up to $100 million abroad annually with automatic approval by Indian authorities.

Integration of Services

The SAFTA agreement does not include provisions for the liberalization of trade in services. This is a serious omission because of the importance of services in the GDPs of member countries. Services also figure prominently in informal trade in the region, particularly between India and other countries. SAFTA should therefore consider the ways and means to regularize and regulate trade in services.

India has emerged as a major global exporter of information technology services. It can play an important role in enhancing capacity and investment in this sector in all the countries of the region to enable them to connect with the global and regional information technology markets.

Some social services, particularly education and health, also offer considerable scope for cooperation among SAFTA members. These services are already provided on a substantial scale by some member countries to others, through Mode 2 of service provision under GATS—that is, the movement of consumers seeking services. This movement generally goes in one direction, to India. No rules, regulations, or procedures exist at the regional level for providing services under Mode 2 or facilitating the cross-boundary consumption of services. The movement of people in the social sector can be facilitated by the gradual conclusion of mutual recognition agreements on standards, qualifications, and degrees, as well as harmonization of standards.

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[8] LDC refers here to the countries that meet United Nations criteria for least-developed country plus Maldives, which is specified as an LDC in the SAFTA agreement.

[9] The extension of currency convertibility to capital account transactions.

Another service sector with great potential is tourism. Although member countries cooperate to some degree in this sector, cooperation needs to be strengthened. Tourist infrastructure could be jointly developed, as could a plan for promoting cross-country tourism for specific purposes such as religious pilgrimages.

Liberalization in the services sector also needs to be factored into the SAFTA agreement. Regional economic integration will help smaller countries overcome the market-size constraint and develop specialized manpower in specific fields.

Regional Energy Trade

The energy endowments of the countries in the region (gas, hydropower and coal) complement each other but are underexploited. National systems are autarkic, and compared with the rest of the world, the countries trade very little in electricity or gas. Rapidly increasing demand driven by economic growth will increase the opportunity costs of keeping the national energy systems isolated. All the studies carried out on this topic have concluded that a common distribution system is needed, one based on a single regional energy grid connecting the national grids. The beneficial outcome for both Bhutan and India of cooperation on the Chuka hydroelectricity project has been an eye-opener for the region. Coordinated action is also required in laying pipelines for transporting gas from Iran, Qatar, and Turkmenistan in the west and from Bangladesh and Myanmar in the east to the energy-deficit countries of the region, mainly India and Pakistan.

Institutional Structure

The SAFTA agreement stipulates establishment of the SAFTA Ministerial Council as the highest decision-making body. This council is to be supported by the Committee of Experts, made up of one senior economic official from each contracting state. This institutional structure needs to be strengthened because the Committee of Experts may be limited by other obligations. To overcome the possibility of limited expertise and research capabilities, steps may be undertaken to induct professionals and establish a standing network of centers of excellence, which might be particularly useful when SAFTA member states attempt deeper integration.

Geographic Expansion

New dimensions of economic cooperation need to be explored through the geographic expansion of SAFTA. With the entry of Afghanistan in the west, SAFTA will encompass the complete South Asian region. Afghanistan, Pakistan, and India all stand to benefit from this move. Afghanistan is a landlocked, low-income country. Expansion of SAFTA will give the poor in Afghanistan access to Indian goods through Pakistan and could reduce transaction costs substantially. Even a small drop in prices for imported goods will improve their welfare. At the same time, Pakistan would benefit from transport and transit fees and the consequent employment generation. Similarly, India would benefit from greater exports to Afghanistan.

Trade Facilitation

A review of trade facilitation and transport logistics (World Bank 2004) illustrates the weakness of port and transport infrastructure, regulatory environments, and service-sector infrastructure. Inadequate trade facilitation mechanisms keep SAARC member states from realizing their trade potential. Delays at seaports, caused by outdated infrastructure and congestion, increase costs for exporters throughout the region. Measures to facilitate trade and lower logistics costs are among the most important steps to promote intraregional trade in South Asia. By making complementary investments in infrastructure and continuing regulatory reform, the region can expand intraregional trade.

Overview of Conditions in South Asia

Ports

Port inefficiency in South Asia is reflected in a number of problems: congestion in regional hub ports (e.g., Nhava Sheva) and even longer delays at regional seaports (e.g., Kolkata and Haldia in India and Chittagong in Bangladesh).[10]

Port efficiency is highly correlated with shipping costs and estimates. Clarke, Dollar, and Micco (2004) indicate that improving port efficiency from the 25th to the 75th percentile lowers shipping costs by more than 12 percent. Air and maritime ports in South Asia are generally less efficient than those in East Asia. At ports in Bangladesh, for example, clearing a vessel takes two to three days, in contrast with the couple of hours that it takes to clear a vessel at Singapore or at Laem in Thailand. Arnold (2004) has found that the major barrier to export logistics in Bangladesh is the inefficient port and shipping sector. The cargo dwell time at the Delhi airport averages 2.5 days whereas the norm is 12 hours.

Some progress has been made in this area, and global container terminal operators are upgrading facilities in South Asia. India has instituted a policy to encourage private sector investment in ports, including inland waterway ports. India has awarded $460 million in contracts to upgrade the Rajiv Gandhi container terminal in Cochin and build a new terminal at Vallarpadam. A shipping company has been awarded the concession for the second private container terminal at Jawaharlal Nehru Port in Mumbai.

Land

The lack of road connections across the region significantly hinders intraregional trade. In the absence of road connectivity Nepal–India–Bangladesh, Nepal cannot access ports in Bangladesh. Likewise, India cannot use Bangladesh roads to access its northeastern states. The southern border of Tripura is only 75 km from Chittagong port. But because access for Indian goods is not allowed at Chittagong port, goods from Agartala have to cross 1,645 km to reach Kolkata. If transit were allowed through Bangladesh, and Indian goods were allowed through Chittagong

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[10] Subramaniam and Arnold (2001) describe the delays through Kolkata and Chittagong.

port (which was the traditional route), the journey to port of Assam tea, for example, would be 60 percent shorter.

Although India has a 3.3 million km road network—one of the largest in the world—and roads are an important means of moving goods across South Asia, a number of road corridors in the region are not maintained and have only limited capacity. Aging bridges and a lack of capacity limit truck and cargo weight, obliging countries to impose load limits; reduce efficiency in freight movement; and make moving commodities long distances expensive. As Das and Pohit (2004) estimate, average transport costs on the Kolkata–Petrapole route between Bangladesh and India are Rs 2,543, which is 40 percent higher than on other highways.

It takes 45 days to transport a container from Delhi to Dhaka. No container trains run between India and Pakistan or between India and Bangladesh. If railway traffic were permitted, the same trip would take only two to three days.

Border Crossings and Customs

Border-crossing problems arise when customs clearance centers are located far from other border-crossing facilities such as customs clearance truck waiting areas, storage depots, rail yards, and loading or unloading areas at ports. The sanitary and phytosanitary testing lab in Kolkata is 1,000 km from the customs facility at Birgunj, Nepal. Exporters must wait for weeks for test results and in the process pay additional fees while vehicles are detained (World Bank 2004). This not only increases costs but also affects the quality of exports.

The preparation of customs documents and customs inspections also create delays at the border. Each country requires different documents such as transit, export, and import declarations. Requirements add up: at the India–Bangladesh border, a consignment needs at least 22 documents, more than 55 signatures, and 116 copies for final approval. Another significant factor driving up costs is that at every border the goods must be transferred among carriers (i.e., cargo must be unloaded from Indian trucks and loaded onto Bangladeshi vehicles).

According to Pohit and Taneja (2000) the main reasons for transaction costs in Indo–Nepalese and Indo–Bangladeshi trade are delays caused by complex customs and transit procedures. This has led to informal trade and a consequent loss of revenue for the governments.

Gains from Capacity Building in Trade Facilitation

The World Bank (2004) has estimated the potential gains from building South Asia's capacity in four categories of trade facilitation—port efficiency, customs environment, regulatory environment, and service sector infrastructure—for both intraregional and inter-regional trade. Estimated gains are significant, and the country with the largest projected gains is India. Trade flows for India are expected to increase by US$1.1 billion, and capacity building of the service-sector infrastructure makes the largest contribution to this trade flow enhancement. The study also notes that India, with 80 percent of the region's total GDP, can be the catalyst to advance the reform agenda for trade facilitation. Although port and service sector infrastructure improvements have the highest priority, collective action to streamline regulations and improve customs will also produce gains to trade.

It is imperative that South Asian countries work together on facilitating trade. Collaborative programs have been part of other regional integration initiatives. The Asia Pacific Economic Cooperation (APEC) forum has targeted achieving paperless trading among all member countries by 2010. Customs procedures are being computerized according to the UN Rules for Electronic Data Interchange for Administration Commerce and Transport (UN/EDIFACT) and by reducing the number of documents required. Each member country has incorporated strategies to achieve paperless trading. South Asia could accelerate the development of information technology infrastructure and lower transaction costs through a similar regional initiative. It could also consider undertaking other cooperation initiatives according to the model of the World Bank–supported Trade and Transport Facilitation on customs and border reform in southeast Europe. Other initiatives are described in the following paragraphs.

Regulatory and Institutional Requirements for Trade Facilitation

Customs Clearance Procedures

South Asia, except India, continues to lag behind in information technology deployment for customs administration. Electronic data interchange allows the electronic exchange of documents and forms and thereby the streamlining of clearances. It is widely used in East Asia, although not in Bhutan, Nepal, or Sri Lanka. The adoption of the UNCTAD-developed ASYCUDA system in the Philippines has led to a reduction in paperwork transactions, and the same can be done in South Asia.

Standards and Technical Regulation

The harmonization of standards has played a critical role in the development of regional blocs and the global marketplace because standards provide a common framework for commerce and economic development. Standards were the principal element of the European Union's Single Market Program.

South Asian countries have recognized the importance of harmonizing standards for facilitating trade. India and Nepal included standards in discussions on their bilateral agreement. More work is required for Nepal and the rest of South Asia to harmonize standards in the region while they simultaneously strive to follow international standards. Indeed, regional harmonization could help South Asian exports meet global standards. India and Bangladesh face similar problems with respect to exports of textiles, leather goods, and marine products in the global market. Cooperation could lead to the exchange of information and joint development of expertise for compliance with global standards.

Transport and Communications Infrastructure

Arrangements to facilitate the movement of goods across borders should be put in place. This can be done through regional cooperation. The framework for cooperation in South Asia, however, should be coordinated with the programs and action plans of the South Asia Growth Quadrangle (SAGQ, made up of Bangladesh, Bhutan, eastern India, and Nepal) and BIMSTEC because they may overlap.

South Asia inherited a common infrastructure of railways, roads, and inland water transport from the colonial period. Much of this infrastructure has been disrupted or fragmented and gaps have appeared because of neglect. Economic integration in the region can be greatly facilitated if the missing links can be restored and outmoded infrastructure updated. In this context SAFTA member nations need to implement specific bilateral, subregional, and regional agreements for linking rail, road, inland water, and coastal shipping. An important initiative in this context would be to identify all pre-partition rail, road, and sea links and re-establish them.

Furthermore, the gauge system—the distance between two rail tracks—varies from country to country and should be harmonized. This will lead to the use of rail transport instead of land transport.

Inland waterways could play a more prominent role in the transport of low-value bulk cargo between Kolkata and north and east Bangladesh, which is not yet served by broad-gauge rail.

Finally, improving information technology services is as important to trade facilitation as developing physical infrastructure. Continuing to deregulate telecommunications, opening markets to competition, and investing in and financing infrastructure will not just lead to better quality of services but will also lower transaction costs and expand trade across the region.

POLITICAL DYNAMICS

Political will and a perception of common economic interests are driving forces behind the success of any regional trading arrangement. For example, Franco–German political rapprochement was the anchor for economic cooperation in the European Community. In South Asia, political distrust, especially between India and Pakistan, has blocked trade in the past and remains a potent deterrent to trade. The political sensitivity of other countries to India's status and power also affects regional economic relations. In 1989, India–Nepal relations were at a difficult stage and the border was almost closed for a number of months for both political and economic reasons. This led to a sharp drop in India's exports to Nepal in 1991. The political upheaval that shook Sri Lanka, as the second anniversary of the India–Sri Lanka accord drew close in July 1989, was marked by threats to shopkeepers selling Indian goods. Export figures to Sri Lanka dwindled in 1990/91.

India has granted MFN status to Pakistan. Pakistan does not, however, grant India MFN status on a reciprocal basis. Pakistan allows only 771 items to be imported from India. Pakistan argues that if it grants MFN status to India, Indian goods will flood Pakistan's market. Some fear that Pakistan's exports to India may not grow as fast as India's exports to Pakistan, and this they say, is largely on account of the high MFN tariffs in India. Trade data for the past two years, however, do not support this argument. After relations were normalized, Indian exports to Pakistan increased in both 2002/03 and 2003/04, with the growth rate lower in the second year. India's imports from Pakistan, however, after falling in 2002/03, rose dramatically in 2003/04. Furthermore, these numbers represent just a fraction of the potential trade volumes between the two economies.

Pakistan also cites its adverse balance of trade as a reason for refusing India MFN status. Although the import of high value-added goods such as textiles, machinery, engineering goods, pharmaceuticals, iron and steel products, automobiles, and chemicals is likely to increase Pakistan's trade deficit with India, it is less likely to have an impact on the country's overall trade balance, mainly because it already imports these commodities from other countries at higher costs than it would pay for similar goods from India. Enhanced trade with India may, therefore, result only in cost savings for Pakistan. Lower costs for inputs would also increase Pakistan's exports to all countries.

India's trading status with Pakistan is a critical issue for SAFTA's operation, and will need to be resolved in a way consistent with WTO requirements.

CONCLUSIONS

India's policy shift toward bilateral and regional trade partnerships in Asia and beyond has been evident since the early 1990s. In South Asia, bilateral arrangements with Nepal, Bhutan, and Sri Lanka have had positive effects on trade and investment. India is now exploring even deeper integration with Sri Lanka through a comprehensive economic partnership agreement. Many therefore question the usefulness of SAFTA when so many other trade arrangements at different levels are already in place. But these arrangements are not likely to preempt SAFTA. In fact, as awareness of the multiplicity of rules in these arrangements rises, policymakers in the region surely must make efforts to ensure consistency among them. Furthermore, because the bilateral agreements have a wider scope than the SAFTA agreement, they could set precedents for deeper integration that can be incorporated into SAFTA.

Some studies have predicted that benefits of SAFTA will include the expansion of trade for India. But gains from intraindustry trade, possible vertical integration, and industrial restructuring are likely to be larger than gains from expanded trade. Gains from SAFTA can be augmented if its scope is broadened in the long term to include infrastructure development and liberalization of investment and services. And in the short term, SAFTA needs to have a clear schedule for trade liberalization and a shorter timeframe for implementation than what is now in the agreement.

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4. Bangladesh

Mohammed Ali Rashid

This report examines the likely impact of SAFTA on Bangladesh, one of the four least developed country (LDC) member states of SAARC. First, we present an overview of Bangladesh's economy, emphasizing the structure of its trade as well as its trade and investment policies. Next, we examine the SAFTA agreement from Bangladesh's perspective, focusing on perceived political and administrative obstacles to regional trade expansion raised by the agreement. We analyze benefits to Bangladesh likely under the SAFTA agreement (1) as conceived and (2) if the design is improved. We consider trade expansion, employment creation, vertical integration of the country's production system with the regional production structure, fiscal impact, and impact on poverty. We also explore possible structural changes in Bangladesh's economy resulting from SAFTA. We discuss the need for trade facilitation to enhance the benefits of SAFTA. Finally, we examine whether Bangladesh is likely to benefit from expanding the geographic and sectoral scope of the agreement.

OVERVIEW OF THE BANGLADESH ECONOMY

Immediately after gaining independence from Pakistan in December 1971, Bangladesh pursued a growth strategy in which the large-scale nationalization of economic activities led to the public sector's dominance of the economy, and import-substituting industrialization was set in motion. From 1976 onwards, economic reforms were instituted under the IMF's stabilization program and the World Bank's structural adjustment program. Reforms were implemented sluggishly in the late 1970s and the 1980s but accelerated in the 1990s; they have faltered somewhat since the late 1990s.

Strong GDP Growth

In the 1990s, Bangladesh accelerated its integration into the global economy: imports increased because of import liberalization, export growth increased, foreign direct investment (FDI) increased, and more and more Bangladeshi workers entered the global labor market. The private sector now leads the economy and exports drive economic growth. The consensus is that policy reforms have enabled Bangladesh to markedly improve its economic and social development. Some economic improvements achieved since fiscal 1992 are presented in Table 4-1. Most notably, a pickup in GDP growth, combined with slowing population growth, resulted in accelerated growth in average per capita GDP; just 1.1 percent a year from 1972 to 1975, it rose

to 1.6 percent annually from 1976 to 1990 and to between 2.9 percent and 4.9 percent annually after 1999. Per capita GDP rose from US$298 in fiscal 1992 to US$389 in fiscal 2003.

Table 4-1

Bangladesh Macroeconomic Indicators by Fiscal Year

Indicator	1992	1995	1999	2000	2001	2002	2003
GDP growth (%)	5.0	4.9	4.9	5.9	5.3	4.4	5.3
GDP growth per capita (%)	3.0	3.1	3.6	4.9	3.7	2.9	4.0
Per capita GDP (US $)	298	313	354	357	371	372	389
Gross domestic saving (% of GDP)	14.1	12.7	17.7	17.9	18.0	18.2	18.2
Gross national saving (% of GDP)	16.9	16.3	22.3	23.1	22.4	23.4	23.7
Private investment (% of GDP)	10.3	12.4	15.5	15.6	15.8	16.8	16.5
Public investment (% of GDP)	7.0	6.7	6.7	7.4	7.3	6.4	6.7
Total govt. revenue (% of GDP)	8.3	9.3	9.0	8.5	9.0	10.2	10.3
Total govt. expenditure (% of GDP)	12.7	14.6	13.8	14.7	14.1	14.8	13.8
Overall budget balance (% of GDP)	4.5	-5.2	-4.8	-6.2	-5.1	-4.7	-3.5
Exports (% of GDP)	6.4	9.2	11.6	12.2	13.6	12.5	12.5
Imports (% of GDP)	11.3	15.4	17.5	17.8	17.4	16.3	15.9
Trade balance (% of GDP)	-4.9	-6.2	-5.9	-5.6	-3.8	-3.8	-3.4
Current account balance (% of GDP)	-0.4	-1.8	-0.9	0.0	-2.2	0.5	0.6
External debt (% of GDP)	39.5	44.6	32.7	34.0	30.8	36.5	32.8
External debt service ratio (% of export earning)	15.8	11.5	8.4	8.0	6.4	6.1	5.5
Real effective exchange rate (1990=100)	95.4	90.9	104.4	102.6	101.2		
Rate of inflation (%) (year on year)	4.6	8.8	8.9	3.9	1.6	2.4	5.2

SOURCE: World Bank

Bangladesh recorded GDP growth of more than 4 percent consistently throughout the 1990s, and growth performance improved further after 2000. The country was able to improve its growth performance in fiscal 2000 because of the performance of both the agricultural and industrial sectors. In 2001/02 and 2002/03 the global economic slowdown, which led to a decline in exports and overseas workers' remittances, caused GDP growth rates to decline. In addition to these external factors, stagnant agricultural output resulting from adverse weather and depressed wholesale and retail trade due to subdued export-oriented manufacturing and transport and communication also contributed to the general decline. Growth improved subsequently because of positive developments in both domestic and external demand and because export performance and workers' remittance increased with the recovery of the world economy. Inflation was brought down from an average of 47 percent per year in the 1972–1975 period to 5.6 percent per year during the 1991–2000 period, then to 1.6 percent in fiscal 2001, before rising in 2004 to 5.9 percent.

Dependence on Agriculture

The government's development strategy has focused on industrializing the economy and reducing dependence on agriculture. As a result, the share of agriculture (including forestry and fishing) in GDP declined steadily from 48 percent in 1975 to 29.5 percent in 1991 and 21.9 percent in 2002. Between 1991 and 2002, the share of industry increased from 21.1 percent to 25.5 percent. Although manufacturing accounts for a small proportion of GDP, it is rising; the share of manufacturing value added in GDP increased from about 11 percent in 1975 to 12.2 percent in 1990, 14.8 percent in 2000, and 15.2 percent in 2002. The share of large- and medium-scale industry in GDP rose from 4.8 percent in 1975 to 8.9 percent in 1990 and 11 percent in 2000. The share of small-scale industries declined from 6 percent in 1975 to 3.6 percent in 1990, but then increased to 4.4 percent in 2000. The share of services in GDP rose from 49.4 percent in 1990 to 52.6 percent in 2002.

Manufacturing growth averaged 8.2 percent per year in the first half of the 1990s[1] but tapered off to an average of 5.6 percent in the second half, to end the decade with average annual growth of 6.9 percent, compared to 5 percent in the 1980s. These data indicate clearly that readymade garment enterprises, which had grown by more than 20 percent, had driven manufacturing growth in Bangladesh. Some import-substituting industries stagnated, or even declined. Sustained average growth of 6.8 percent in the small-scale industry sector, compared to 5 percent growth in the previous decade, was notable. The average growth rate of large- and medium-scale industries increased from 4.9 percent in the 1980s to nearly 7 percent in the 1990s.

Industrial dynamism in Bangladesh has expressed itself in the emergence of modern industries, which have grown faster than traditional industries. Modern industries that are capital and knowledge intensive, such as machinery and capital goods industries, have grown faster than traditional industries such as food, beverage, tobacco, and textile and clothing. Thus, between 1990 and 2000, the share of the food, beverage, and tobacco industry declined in total manufacturing value added from 24 percent to 22 percent and that of the textile and clothing industry declined from 38 percent to 33 percent. During the same period, the share of the machinery and transport equipment industry more than doubled from 7 percent to 16 percent. However, the share of the chemicals industry declined from 17 percent to 10 percent during the same period.

The agricultural sector has failed to show dynamism. The average growth rate of agriculture (including forestry) rose from about 1 percent during 1972–1975 to 2.6 percent during 1976–1990, but stayed at this level during the 1999–2000 period. Agriculture continues to depend heavily on rice; Bangladesh became self-sufficient in rice in the early 1990s. But a growing agricultural segment—vegetables and horticulture—is geared toward export markets. Export volumes for such products, though modest in relative terms (about US$40 million in fiscal 2002), have risen rapidly recently. Furthermore, commercial fishing grew at a record pace in the 1990s, driven largely by export-oriented shrimp production.

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[1] The growth rate was only 4.3 percent for manufacturing enterprises outside the readymade garment industry.

Growing Exports but Uncertain Future

Bangladesh's exports registered real average growth of more than 10 percent per annum during the 1990s—double the growth rate of real GDP. Robust export growth continued in fiscal 2001, at a rate of 12.8 percent. Although export growth dipped somewhat in fiscal 2002, it recovered in fiscal 2003, with a rate of 14 percent. Export earnings, however, have depended heavily on the export of readymade garments, whose share in total export earnings has been about 75 percent.

The structure of Bangladesh's exports has changed remarkably in the past two decades, from primary commodities to manufactured goods. Data published by the Export Promotion Bureau show that the share of primary exports in total exports declined from 24.7 percent in fiscal 1984 to 21.2 percent in fiscal 1990, 13 percent in fiscal 1995, 8.2 percent in fiscal 2000, and 7.3 percent in fiscal 2004. The shares of raw jute and tea, two traditionally important export items, in total exports have declined consistently; by fiscal 2004, the shares of raw jute and tea had fallen to 1 percent and 0.21 percent, respectively.

Meanwhile, the share of manufactured exports has increased, from 65.3 percent in fiscal 1984 to 78.8 percent in fiscal 1990, to 87 percent in fiscal 1995, 91.8 percent in fiscal 2000, and 92.7 percent in fiscal 2004. The major manufactured exports of Bangladesh are woven and knitted readymade garments, jute goods, leather, and chemical products (mainly chemical fertilizers). Exports of both woven and knitted garments have grown rapidly, and their shares in total exports in fiscal 2004 stood at 46 percent and 28 percent, respectively. Exports of jute goods and chemical fertilizers declined from US$317.8 million and US$104.1 million respectively in fiscal 1997 to US$245.6 million and US$80.6 million respectively in fiscal 2004. Leather exports increased from US$195.5 million in fiscal 1997 to US$253.9 million in fiscal 2001, but then declined to US$211.4 million in fiscal 2004. The shares of jute goods, leather, and chemical fertilizer declined from 7 percent, 4 percent, and 2 percent, respectively in fiscal 1997 to 3 percent, 2 percent, and 1 percent, respectively, in fiscal 2004. In fiscal 2004, four export items—readymade garments (woven and knit), frozen seafood, jute goods, and leather—accounted for nearly 85 percent of Bangladesh's total exports. This reflects a high degree of product concentration in the country's exports.

Bangladesh's readymade garment industry was launched in the late 1970s. It now employs 1.8 million workers, about 90 percent of whom are women, and its exports amounted to nearly US$5.7 billion in fiscal 2004. Quota restrictions in Europe and North America on textile and apparel imports under the Multifiber Arrangement (MFA), together with Bangladesh's preferential access to the European Union under its Generalized System of Preferences (GSP), spurred the growth of readymade garment exports from Bangladesh, which was not subject to the restraints applied to other major textile and apparel exporters (such as China and India). The European Union absorbs 46 percent of Bangladesh's garment exports and the United States absorbs 51 percent.

As an LDC, Bangladesh will continue to enjoy GSP concessions until 2010. The value of those concessions, however, is gradually falling because of tariff cuts resulting from liberalization commitments made under the Uruguay Round of multilateral trade negotiations. Global textile and apparel import quotas were eliminated on January 1, 2005, in accordance with the World

Trade Organization (WTO) Agreement on Textiles and Clothing. Bangladesh now faces more intense competition in the global apparel market; maintaining—much less expanding—its share of this market (2.6 percent) will be a challenge.

About two-thirds of readymade garment exports from Bangladesh are woven garments; one-third are knitted. The knitwear subsector sources nearly 80 percent of its raw materials and intermediates from local producers, while the woven subsector sources about 80 percent of its inputs from imports. The industry is organized mainly on a cut-make-and-trim basis, in which orders come through buying agents and Bangladeshi producers have few direct links to foreign retailers.

Despite healthy export performance in a restricted market, Bangladesh's readymade garment sector suffers from long delivery lead times, poor quality, and dependence on buying agents. Transforming a comparative advantage based on low labor costs into a competitive advantage in a post–MFA world will require structural changes, such as in trade policy, to allow readymade garment producers to obtain inputs from the cheapest source. If Bangladesh fails to do this, output and employment could suffer because the manufacturing and service sectors depend so heavily on readymade garments. Readymade garment-related jobs account for nearly half the formal labor force.

Bangladesh's exports are also characterized by market concentration. In fiscal 2003, 50 percent of exports were directed to the EU market and 36 percent to the North American market (mainly the United States). The combined share of these markets remained at 86 percent in fiscal 2004, although EU countries' share rose to 56 percent while the North American share declined to 30 percent. The share of the Asian region remained nearly the same in these two years at about 7.5 percent. The share of SAARC countries in Bangladesh's total exports remained at about 1.9 percent in these two years. The shares of India, Pakistan, and Sri Lanka in these two years were respectively about 1.2 percent, 0.6 percent, and 0.1 percent; shares of the other SAARC countries were negligible.

Rising Imports

Imports registered average annual growth of about 8 percent in the 1990s but reached about 16 percent in fiscal 2004. Bangladesh's major imports are food grains, edible oils, textiles and textile articles, iron and steel, and capital goods; the shares of these imports in 2001 were 4 percent, 2 percent, 13 percent, 4 percent, and 25 percent, respectively. Asian countries as a group were the largest source of Bangladesh's imports in 2003–2004. The shares of imports from Asian Clearing Union countries, SAARC, ASEAN, and Organization of Islamic Conference in Bangladesh's total imports in 2003–2004 were 17.8 percent, 17.3 percent, 16.5 percent, and 15.1 percent, respectively. Other Asian countries' share was 31.3 percent. The shares of the EU and the North American Free Trade Area were 9.1 percent and 3.1 percent, respectively.

Effect of Remittances

The merchandise trade balance of Bangladesh has been in chronic deficit. However, export growth faster than import growth reduced the trade deficit–to–GDP ratio from 4.9 percent in fiscal 1992 to 3.4 percent in fiscal 2003.

The flow of remittances was robust through the 1990s, rising from US$764 million in fiscal 1991 to US$1.949 billion by fiscal 2000. Remittances declined in fiscal 2001 by about US$70 million, and then increased again in fiscal 2002, to US$2.50 billion, and in fiscal 2003 to US$3.06 billion. About 40 percent of total export earnings in fiscal 2003, remittances are as an important source of foreign exchange in Bangladesh. The inflow of remittances has helped Bangladesh reduce the current account deficit—in fact, the country has enjoyed a small surplus in recent years.

Increased Foreign Direct Investment

FDI in Bangladesh was negligible in the 1980s, but increased in the 1990s when the government encouraged foreign private investment in the power, gas, and telecommunications sectors. FDI in Bangladesh averaged only US$8 million per year during 1991–1996 but picked up to US$249 million in 1997–1998, when foreign companies invested in the power and gas sectors. FDI inflows averaged about US$200 million per year from 1998/99 to 2000/01. The most investment has come in the natural gas and power sectors. The telecommunications, cement, and textile sectors have also received notable amounts of FDI. About 40 percent of FDI in export processing zones is in the textile and garment industries. The major sources of FDI in Bangladesh are the United States, the United Kingdom, Malaysia, and Japan.

Modest Reduction in Poverty

It is estimated that Bangladesh has achieved a modest poverty reduction rate of about 1 percentage point per year since the early 1990s. One estimate shows that poverty (head count index) declined from 58.8 percent in 1991/92 to 49.8 percent in 2000, while another estimate shows poverty declining from 49.7 percent to 40.2 percent during the same period. Other data sources tend to support the lower estimate. Preliminary estimates suggest that the poverty situation in Bangladesh had improved further by 2004. Poverty declined faster in the 1990s, a period of intensive reform, than in the 1980s, because of faster growth in income and consumption. Reductions in urban and rural poverty accelerated in the 1990s, though rural poverty remains higher than urban poverty. The incidence of extreme poverty is higher among females.

Income inequality has increased in Bangladesh. The Gini coefficient for urban areas increased from 0.33 in 1991/92 to 0.44 in 2000. In rural areas the Gini coefficient rose from 0.27 to 0.36 in the same period. It thus appears that Bangladesh has entered the stage of relatively high income inequality.

TRADE AND INVESTMENT POLICY

Bangladesh has made progress in trade policy reform, reducing and rationalizing tariffs, reducing nontariff barriers, removing quantitative restrictions, and moving to a flexible and unified

exchange rate and current account convertibility of the currency, the taka. Reforms stalled in the second half of the 1990s, so Bangladesh's trade regime remains restrictive.

Trade Policy

The maximum tariff rate was reduced from about 500 percent in 1989 to 37.5 percent in 1999/2000 and 25 percent in 2004/05. In 1986 Bangladesh had 24 tariff bands ("slabs" in South Asia), but by 1993/94 had rationalized these into 12 slabs, then to 6 by 1996/97, to 4 by 1999/00, and to 3 in 2004/05. The average nominal protection rate fell from 89 percent in 1990/91 to 25 percent in 1995/96 and 17 percent in 2003.

High Paratariff Barriers

Paratariff barriers and relatively high tariff dispersion have nullified much of the liberalizing effect of tariff reform. In addition to customs duty, other taxes are applied on imports (e.g., supplementary duty, infrastructure development surcharge, and value-added tax [VAT]). None of these is applied in a trade-neutral manner. The VAT is 15 percent, an infrastructure development surcharge is 2 percent, and the supplementary duty varies from product to product. The VAT and supplementary duty are imposed on duty-paid value. When these taxes are imposed on imports in addition to customs duty, the commodity concerned ends up with substantial protection (Table 4-2).

Table 4-2

Total Tax on Typical Imported and Domestically Produced Goods in Bangladesh (Taka)

Tax	Amount
IMPORTED PRODUCT	
Value of imported item (CIF basis)	100
Customs duty (at 25 percent)	25
Infrastructure development surcharge (at 2 percent)	250
VAT (at 15 percent)	18.75
Supplementary duty (at 50 percent)	62.5
Total cost	208.75
Total tax	108.75
Nominal rate of protection, customs duty only	25%
Nominal rate of protection, all import taxes	109%
DOMESTICALLY PRODUCED GOOD	
Ex-factory value	100
VAT (at 15 percent)	15
Total cost	115
Total tax	15

Table 4-2 shows an imported product that is subject to the highest customs duty rate of 25 percent (typical of most imported consumer goods), the infrastructure development surcharge of 2 percent, VAT of 15 percent, and supplementary duty of 50 percent (which is common). Thus, total tax on the imported product is Tk. 108.75; if only the customs duty were imposed, the total tax would be Tk. 25. By contrast, the total tax on a similar commodity produced locally would be only Tk. 15. This shows clearly the additional protection afforded to domestic production by parataiff measures. The nominal rate of protection increases from 25 percent when customs tariff is the only protective instrument used to 108 percent when parataiff measures are combined with tariff protection.

Parataiffs in Bangladesh, particularly supplementary duty, are nontransparent and complex, and their use has increased since fiscal 1998. The tariff structure has been made less transparent and more complex by the prevalence of tariff concessions and even exemptions based on end use. The result has been a high degree of tariff dispersion, which has remained about 80 percent (measured by the coefficient of variation) in the past three to four years. Import permits are required for these concessions, and this has given rise to rent-seeking behavior.

In a country where import taxes constitute about half of total tax revenue, it is easy to understand how fear of losing tax revenue has prompted the government to prolong tariff liberalization and introduce parataiffs to compensate for lost tariff revenue. Such fears, however, may be largely unfounded for at least two reasons. First, because import demand—particularly for imported consumer goods, which attract the highest duty rate—is price elastic, the rise in import volume is likely to offset the decline in tariff rates. Second, if lower tariff rates attract imports from illegal to legal channels, tariff revenue might not fall (and might even rise) in the face of tariff liberalization.

Onerous Quantitative Restrictions

The coverage of all quantitative restrictions was brought down from 15.6 percent of four-digit tariff headings in 1991 to 5.1 percent in 2003. The coverage of trade-related quantitative restrictions declined from 6.4 percent of four-digit tariff headings in 1991 to 1.9 percent in 2003. The 2003 import policy order proposes to slash the number of items covered by quantitative restrictions by almost half but also adds many procedural restrictions, thus leaving in place many trade-related quantitative restrictions (World Bank 2004).

The Politics of Trade Reform

The politics of trade policy reform are important. Pressure from the business community has led to lower tariff rates on intermediate and raw materials, and this has slowed the decline in effective rates of protection. Effective rates of protection at the firm level average more than 100 percent and exceed 200 percent for many items (such as edible oils and chemicals) (World Bank 2004). The principal beneficiary of quantitative restrictions has been the primary textile sector, which continues to lobby for them. Finally, the import of yarn through land ports is banned. Domestic spinning industries benefit directly from this damaging policy, so it is not difficult to understand the influencing hand behind it.

The Critical Role of Exchange Rate Policy

To stimulate growth, tariff liberalization needs to be accompanied by appropriate exchange rate policy. The management of the exchange rate has been a positive aspect of Bangladesh's economic management in an era of globalization. High inflation in the 1972–1975 period caused sharp appreciation in the real exchange rate. This was reversed in 1980, when that rate depreciated noticeably. From 1980 to 1997, the rate moved upward gently, indicating slight depreciation. By avoiding significant real exchange rate appreciation in the 1980s—despite double-digit inflation—Bangladesh preserved its export competitiveness. Stable macroeconomic conditions enabled an orderly float of the taka on May 31, 2003, after which the value of the taka held steady until March 2005, when it began to depreciate again.[2]

Foreign Investment Regime

By all standards, the private foreign investment regime of Bangladesh is liberal. Laws governing FDI began to be liberalized in the early 1980s. The Foreign Private Investment (Promotion and Protection) Act of 1980 provides the legal framework for foreign investment in Bangladesh. The act (1) provides for nondiscriminatory treatment for both foreign and local investment, (2) protects foreign investment from expropriation by the state, and (3) ensures repatriation of proceeds from the sale of shares and profits. To attract foreign investment in export-oriented industries, export processing zones were established. These zones provide infrastructure facilities and administrative and other incentives such as the duty-free import of inputs.

The 1991 Industrial Policy permitted wholly foreign-owned ventures as well as joint ventures. A 1992 amendment incorporated additional terms and incentives. The 1999 Industrial Policy encouraged FDI in all industrial activities, including service industries, but excluding industries on the "reserved" list (garments, banks, insurance companies, and other financial companies). Preregistration clearance is required for investment in reserved industries. Investment guarantee and dispute settlement are guided by international arrangements and provisions. Bangladesh is a member of the Multilateral Investment Guarantee Agency, the arm of the World Bank that insures investment against political risks.

Other incentives for foreign investment are available:

- Remittance of approved royalties and technical fees
- Income tax exemptions
- Unrestricted issuance of work permits
- Treatment of reinvested repatriatable dividend as new investment
- Working capital loans from local commercial banks
- Tax exemption on the interest on foreign loans
- Avoidance of double taxation
- Tax holiday or accelerated depreciation.

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[2] The taka depreciated about 10 percent against the U.S. dollar from March to August 2005 (from about 60 taka to 66 taka per dollar).

According to stakeholders, FDI inflow is poor despite a liberal foreign investment policy because of a poor investment climate characterized by (CUTS 2003):

- Poor infrastructure
- Political instability
- Poor law and order
- Bureaucratic inefficiency that drives up transaction costs and the general cost of doing business
- Anti-investment bias
- Inadequate, outdated, and improperly applied business laws
- Limited market size and wealth
- Negative image of the country.

The government must address these issues to attract more FDI.

BANGLADESH'S PERSPECTIVE ON THE SAFTA AGREEMENT

In January 2004, the SAARC member states signed the SAFTA agreement. The decision to strengthen regional integration is undoubtedly a positive step. Although Bangladesh is a member of other multilateral and regional trade arrangements (see Box 4-1), SAFTA might very well hold the most promise for increasing Bangladesh's trade.

The SAFTA agreement has a 10-year implementation period and clear provisions on tariff reduction (Article 7); procedural aspects of the application of balance of payments measurers (Article 15) and safeguard measures (Article 16); and a dispute settlement mechanism (Article 20). Within three years, the tariff for LDC members' exports will be reduced to 0–5 percent; this is encouraging. The agreement, however, appears weak in tariff liberalization, nontariff and paratariff barriers, rule-of-origin criteria, sensitive lists, revenue compensatory mechanism and technical assistance for LDC members, investment promotion, unfair trade practices, and harmonization and mutual recognition of standards and institutions. All these issues are important from Bangladesh's point of view.[3]

Tariff peaks. The agreement specifies the rate and ceiling of tariff reduction, but leaves it to individual members to decide the peak tariff and distribution of tariffs. If tariffs are distributed so that Bangladesh's major exports (such as garments and leather goods) face high tariffs in developing member-country markets, then the benefits of integration will be sharply reduced.

Nontariff measures, including standards. Under SAPTA, the benefits of tariff liberalization have been reduced or negated through nontariff measures, including technical and health standards under the WTO Technical Barriers to Trade Agreement and Sanitary and Phytosanitary Standards Agreement. India's standards system requires payment of fixed and ad valorem fees and possibly links with an office in India to oversee the standards clearance process. This has sometimes discouraged export from Bangladesh (e.g., hilsa fish).

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[3] The analysis in this section is based on Rashid and Rahman (2004).

Box 4-1

Bangladesh's Multilateral, Bilateral, and Regional Trade Agreements and Negotiations

In addition to being a member of the WTO and the South Asia Preferential Trade Area (SAPTA), Bangladesh is a member of the Bangkok Agreement and BIMSTEC.

The Bangkok Agreement includes Bangladesh, India, Lao People's Democratic Republic, the Philippines, Republic of Korea, Sri Lanka, and Thailand, all members of Economic and Social Commission for Asia and the Pacific (ESCAP). As a preferential trading arrangement it reduces restrictions on trade among member states in a phased manner through negotiations. As is common in such arrangements, the Bangkok Agreement includes a national list of concessions. Special concessions are granted to LDC member states. The agreement took a cautious approach to liberalization in the beginning—the number of products in the national list of concessions was small and tariff cuts were shallow. The Bangkok Agreement has had little impact on Bangladesh's trade. The value of imports by Bangladesh under the Bangkok Agreement declined systematically from Tk. 163 million in 1991/92 to about Tk. 50 million in 1999/2000.

BIMSTEC, initiated in 1994, is a cooperative arrangement between five South Asian countries (Bangladesh, Bhutan, India, Nepal, and Sri Lanka) and two Southeast Asian countries (Myanmar and Thailand). Members agreed in June to conclude negotiations on framing a free trade agreement by December 2005 so the free trade area would be operational in July 2006. Areas of cooperation are trade and investment, technology, transportation and communication, energy, tourism, fisheries, education, culture, agriculture, health, combating terrorism, curbing women and child trafficking, anti-drug campaign, disaster management, and biodiversity. The BIMSTEC Framework Agreement was signed in February 2004 and covered goods, services, and investment. The technical committee reportedly has made progress in negotiating the rules of origin and dispute settlement issues.

Bangladesh has also been discussing bilateral free trade agreements with India, Pakistan, and Sri Lanka. Bangladesh and India are considering duty-free entry for all goods except those in a short negative list and eliminating all nontariff barriers in a time-bound framework (*The Business Line* 2003). Bangladesh held consultations with both Pakistan and Sri Lanka in 2003. None of these free trade agreements has yet been signed.

SAFTA must ensure that technical and health standards are not used as protective measures. The SAFTA agreement does not specify a timeframe for identifying and eliminating nontariff measures; moreover, the provision about withdrawing paratariff and nontariff measures (Article 7(4)) is a "best endeavor" clause. Bangladeshi exporters' primary concern is not so much duty reduction as removal of nontariff barriers. To achieve meaningful trade liberalization, paratariff and nontariff measures must be eliminated in a short and definite timeframe.

Sensitive lists and exclusions. The deadline for negotiations of the sensitive lists and the ceiling on the number of products to be included in this list were not finalized when the SAFTA agreement was signed. As a result, negotiations on finalizing the sensitive lists are limping along with just a few months before the agreement is to be put into effect. According to press reports quoting Commerce Ministry officials of Bangladesh, the size of the sensitive lists that have been submitted and that are being negotiated are as follows:

Country	***No. of products***
Bangladesh	1,306
India	927
Pakistan	1,157
Sri Lanka	1,065
Nepal	1,315
Bhutan	136
Maldives	582

The sensitive lists of the three developing country members are large, and if products of major export interest to Bangladesh are included in these lists, then export expansion of Bangladesh (and also other member states) will be curbed. One hopes for the sake of intraregional trade expansion that negotiations to reduce the size of the sensitive lists are successful. The list for each country should be short and include only essential goods. Moreover, in view of their lesser development, LDCs should be allowed to keep larger sensitive lists than non-LDC developing country members.

Rules of Origin. One problem in the Bangladesh manufacturing sector is the low level of domestic value addition. Hence, the rule-of-origin criteria to be incorporated into SAFTA are crucial to Bangladesh. Trade negotiators of SAARC countries have not been able to forge a consensus on the percentage of domestic value addition in the rule-of-origin criteria. According to newspaper reports, Bangladesh favors a 35 percent value-addition criterion for LDC members and 40 percent value addition for developing country members. India and Pakistan have not yet submitted their proposals for rule-of-origin criteria.

The rule-of-origin requirement under SAPTA stands at 40 percent of domestic value addition for non-LDC member states and 30 percent for LDC members. These criteria have proved restrictive given the limited resource base of LDC member states and have eroded the effectiveness of tariff preferences. Although the possibility of trade diversion needs to be guarded against by having suitable rule-of-origin criteria, a high domestic value addition percentage can hardly be justified because this will likely frustrate the objective of setting up a free trade area—that is, to expand trade. In addition, SAARC cumulation[4] should be allowed. Although powerful industry groups in each country that cannot compete with imports are likely to oppose this, each government must strive to overcome such opposition.

Taking all these aspects into consideration, a cumulative rule-of-origin requirement of 30 to 35 percent for non-LDC member states (which is close to rule-of-origin requirements under existing bilateral agreements in the region) and 20 to 25 percent for LDC members in SAFTA appears warranted. Only then will meaningful benefits of regional cooperation accrue to LDC members such as Bangladesh.

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[4] When the value added in any of the SAARC countries may be used in determining whether the product meets the rule-of-origin criteria.

Revenue compensation. The SAFTA agreement provides for compensation to be provided to LDC member states for loss of revenue resulting from tariff reduction (Article II(e)). But what constitutes an "appropriate" compensatory mechanism has been left open. In theory, revenue loss will result not only from tariff reduction but also from trade diverted from a third-country source (with positive and higher tariff) to a partner-country source (with a zero tariff). According to reports, negotiations on revenue compensation for LDC members have not progressed.

At present, trade taxes make up about half of Bangladesh's tax revenue. It is therefore likely that Bangladesh (or any other LDC member) will be discouraged from adopting fast-track liberalization (e.g., by keeping a large sensitive list) if it is not compensated for revenue loss. This will impede intraregional trade expansion. The answer to the question of who is going to pay this compensation could be that because, in theory, the revenue lost is largely transferred to partner country exporters, the countries with major surpluses in regional trade may provide the funds for this purpose. In the ultimate analysis, compensation for revenue loss should be considered in the light of "shared development," which is the spirit of SAARC.

Regulatory harmonization. The harmonization of rules, regulations, and standards has not received much attention in SAFTA negotiations. This is not encouraging from Bangladesh's point of view because Bangladeshi exporters have faced market-access problems in SAARC member countries, particularly in India, emanating from application of technical and health standards under the WTO Technical Barriers to Trade and Sanitary and Phytosanitary Standards agreements.

Trade remedies. The SAFTA agreement has no concrete provision to deal with unfair trade practices, and therefore no rules on the use of antidumping and countervailing measures. This exposes small LDC member states, such as Bangladesh, to antidumping or countervailing duties illegally imposed by the larger and more powerful developing country members. For example, India recently imposed antidumping duties on accumulator battery exports from Bangladesh, then withdrew the duties after Bangladesh threatened to resort to dispute settlement under the WTO because such a duty was not consistent with the WTO Agreement on Antidumping/ Countervailing Duties. Taking up the case under the ambit of SAPTA had failed to solve the problem.

SAFTA'S IMPLICATIONS FOR BANGLADESHI ECONOMIC DEVELOPMENT

Impact on Poverty

Exportables likely to be stimulated by SAFTA are mainly labor-intensive manufactures. Therefore, if SAFTA succeeds in increasing Bangladesh's exports, employment opportunities will increase. Furthermore, because many commodities whose exports are expected to increase are products of small-scale industries (e.g., melamine products, home textiles, food items such as biscuits, juice, pickles, light engineering products), the employment-creating effect of export expansion is likely to be stronger.

Bangladesh sources a significant part of its imports from SAARC countries, particularly India. Such imports doubtlessly will increase with implementation of the SAFTA agreement. How will this, along with export growth likely after SAFTA comes into force, affect employment and poverty in Bangladesh? The answer depends on the nature of the imported commodities. Because India has been the main source of Bangladesh's imports from the region, an examination of the product composition of imports from India is instructive (Table 4-3).

A large portion of Bangladesh's imports from India are capital goods, intermediate inputs, and industrial raw materials. Besides prepared foodstuffs and food grains, another major import category is producer goods. These imports have facilitated an increase in manufacturing activity and have therefore increased employment. Conversely, if imports of consumer goods (found mainly under "products of chemical and allied industries," "plastic articles," and "others"), which displace domestically produced goods, predominate, employment would probably be reduced. In the actual case, the net effect on employment is likely to have been positive.

Table 4-3

Changing Pattern of Commodity Composition of Bangladesh's Imports from India, 1991–2001 (3-year Moving Average)

Major Commodity Group	1991–1993	1993–1995	1995–1997	1997–1999	1999–2001
Textile and textile articles	52.52	43.53	35.12	30.82	26.00
Vegetable products	6.69	8.55	19.27	29.46	31.06
Mineral products	10.22	11.88	9.64	9.16	7.56
Machinery and mechanical appliances	7.45	5.80	6.69	6.65	8.00
Products of the chemical and allied industries	5.15	7.35	7.98	6.72	7.08
Base metal	4.66	7.31	5.93	4.89	5.54
Vehicles, aircrafts	3.16	5.26	7.01	4.07	4.28
Prepared foodstuffs	1.01	1.49	1.83	2.34	3.24
Plastic and articles thereof	4.70	3.06	2.24	2.25	2.19
Others	4.43	5.78	4.29	3.66	5.05

SOURCE: Bangladesh Bank.

Implementation of SAFTA is likely to increase exports and have a positive effect on economic growth in Bangladesh. Export growth, in turn, will lead to an increase in employment opportunities. How import growth will affect employment once SAFTA becomes operational is less clear; however, because most imports from India are producer goods, which increased manufacturing production, it is likely that SAFTA will exert a net positive effect on employment by enabling imports.[5] Thus, the overall effect of trade liberalization under SAFTA on employment in Bangladesh is likely to be positive. This, in turn, is expected to have a salutary

[5] The negative effect on employment is also likely to be reduced through inclusion of important consumer goods in the negative list.

effect on poverty. In the unlikely event that export incomes increase faster than manufacturing wages, inequality would worsen, creating other perceived as well as real social problems.

Adverse effects on income distribution and on employment can be mitigated by (1) creating remunerative jobs for the poor; (2) educating and teaching appropriate skills to the poor; and (3) creating infrastructure (e.g., electricity and all-weather roads) and improving poor people's access to these facilities.

Encouraging Agricultural Diversification

Dominating Bangladesh's agriculture sector, rice cultivation alone accounts for nearly 70 percent of gross farm revenue from crop production. Although the country is proud of having achieved self-sufficiency in rice, the sustainability of agricultural growth with rice as the dominant crop has been questioned Crop diversification has assumed importance in Bangladesh's agricultural development strategy.

Projections of the profitability of crops other than rice, such as potato, vegetables, onion, and cotton, show economic and private returns significantly higher than those of rice (Mahmud *et al*. 1993). Jute also has a competitive edge over local-variety rice at the prevailing world price of jute. Wheat, sugarcane, and oilseeds show very low, even negative, economic returns. This indicates that Bangladesh does not have a comparative advantage in those items, which compete with imports of those products. Crops with potentially high profitability, such as potato and vegetables, are produced entirely for the domestic market or have only limited access to the world market.

The domestic market for noncereal crops, especially the high-value ones, is limited because of low living standards. This underscores the need to export the noncereal crops in which Bangladesh has a comparative advantage—vegetables, potato, fruits, and spices. SAFTA offers Bangladesh the opportunity to export noncereal crops. This will allow specialization in agriculture and bring about a structural change in crop agriculture. Furthermore, calculations show that certain farm produce, such as milk, vegetables, fruits, and flowers, have scope for value addition through agroprocessing. SAFTA preferences may enable Bangladesh to export these products to other SAARC countries.

Regional trade liberalization under SAFTA will clearly affect the structure of Bangladesh's industry. On the one hand, inefficient domestic industries making jute, cotton textiles, paper, chemical products, metal products, and rubber products, as well as light engineering, will be forced to contract or even close down. On the other hand, industries with export potential such as ceramic tableware and tiles, melamine products, pharmaceuticals, and some food industries, are expected to expand when SAFTA becomes operational

MAXIMIZING SAFTA'S BENEFITS TO BANGLADESH

A consideration of the probable impact of SAFTA on Bangladesh's expanding trade begins with an examination of the recent trade pattern of Bangladesh with SAARC countries (Table 4-4). Compared with its global exports, Bangladesh's exports to SAARC countries are not significant.

The value of Bangladesh's exports to SAARC countries increased from US$102.7 million in 1998/99 to US$147 million in 2003/04. Although exports in 2003/04 increased 21.5 percent over 2002/03 exports (US$102.8 million), export growth in earlier years was modest, and even negative in 2000/01 and 2001/02. In 2003/04, only 1.9 percent of Bangladesh's total exports went to SAARC countries, with the European Union and North American countries being the major export destinations.

The situation is quite different with regard to imports from SAARC countries. Imports from SAARC countries amounted to US$1.3 billion in 1998/99 and rose to over US$1.7 billion in 2003/04, and the share of imports from SAARC countries in Bangladesh's total imports rose from 12.2 percent in 1998/99 to 15.9 percent in 2003/04. The result of faster import growth was that Bangladesh had trade deficits with all SAARC countries. Bangladesh's total regional deficit increased from US$1.2 billion in 1998/99 to nearly US$1.6 billion in 2003/04. The bulk of the deficit was with India; Bangladesh's trade deficit with India rose from US$1.2 billion to US$1.5 billion between 1998/99 and 2003/04.

Table 4-4

Structure of Merchandise Trade of SAARC Countries, 2000

Country	Food (% of total)	Agricultural Raw Materials (% of total)	Fuels (% of total)	Ores and Metals (% of total)	Manufactures (% of total)
EXPORTS					
Bangladesh	7	2	0	0	91
Bhutan	-	-	-	-	-
India	13	1	4	3	77
Maldives	-	-	-	-	-
Nepal	10	0	0	0	67
Pakistan	11	2	2	0	85
Sri Lanka	21	2	0	0	77
IMPORTS					
Bangladesh	15	5	7	2	69
Bhutan	-	-	-	-	-
India	5	3	37	5	48
Maldives	-	-	-	-	-
Nepal	13	4	16	3	49
Pakistan	12	4	29	3	50
Sri Lanka	14	1	9	1	74

SOURCE: Research and Information System for the Nonaligned and Other Developing Countries (2004) based on World Bank World Development Indicators, 2003.

Two factors are primarily responsible for the low volume of exports to other SAARC countries: a narrow range of exports on the supply side, and nontariff and parataiff barriers restricting market access on the demand side. The implementation of SAFTA is likely to lead to more Bangladeshi

exports to the rest of the region, particularly by enhancing market access, and by strengthening Bangladesh's export supply capacity, attracting more FDI, and encouraging vertical integration of the regional production structure. Export diversification, however, will depend largely on domestic policies.

The Supply Side: Improving Bangladesh's Competitiveness

Bangladesh's exports are characterized by a high degree of product concentration. Only four categories of goods (woven and knitted garments, jute goods, leather, and frozen food) account for about 85 percent of the country's exports. All these, with the exception of jute goods, are exported to non-SAARC countries. This is explained largely by similarities in comparative advantage among the SAARC countries. This suggests that Bangladesh must develop new export products to increase exports to SAARC countries.

The import structure of SAARC countries sheds some light on which export items Bangladesh might develop. Table 4-5 shows that the greatest regional demand is for (in order) manufactured goods, fuels, food, and agricultural raw materials. Under SAPTA, Bangladesh's major exports to SAARC countries have consisted of manufactured goods such as accumulator batteries, jute goods, soap, biscuits, ceramics, and fruit juice. To increase its exports of these and other manufactured goods under SAFTA, Bangladesh must boost the competitiveness of its production.

Table 4-5

Value of Bangladeshi Exports to SAARC Countries under SAPTA, 2003/04 (US$ thousand)

Commodity	India	Pakistan	Sri Lanka
Battery and battery parts	544.5	-	-
Jute and jute goods	665.3	676.8	127.5
Biscuits	223.8	-	-
Ceramic goods	221.4	-	-
Soap	1,543.1	-	-
Juice	805.1	-	-
Books	9.2	-	-
Molasses	15.5	-	-
Soyabean oil	3.3	-	-
Betel nut	157.8	-	-
Furniture	109.5	-	-
Betel leaves	-	312.6	-
Others	702.6	-	-
Total	5,001.1	989.5	127.5

Note: These commodities make up about 85 percent of total Bangladeshi exports under SAPTA.

SOURCE: Export Promotion Bureau.

According to Export Promotion Bureau reports, Bangladesh has achieved export quality in melamine products, home textiles, cement, pharmaceutical products, leather footwear, light engineering products, pickles, and more. Given unrestricted market access under SAFTA, these products are likely to be exported. Natural gas could also be exported, but experts say that the recoverable reserve will be used up by 2019 under the forecast level of usage, and hence there is a general feeling in the country that gas should not be exported, at least not in unprocessed form. In fact, the export of gas has become politically sensitive.

Because Bangladesh possesses similar comparative advantages as other SAARC countries, and in a much narrower group of commodities than India—the largest potential market for Bangladesh's exports—a policy of interindustry specialization and export will achieve only limited success. But Bangladesh can expect to make headway by producing commodities with competitive advantage. There are two types of competitive advantage—lower average costs and product differentiation. With competitive advantage, Bangladesh can engage in intraindustry trade with India and other SAARC countries. At present, intraindustry trade is limited, but if Bangladesh can develop the technical capacity to produce differentiated products at declining average cost, which will be facilitated by the larger market made possible by SAFTA, the volume of intraindustry trade can be expected to increase, to the country's benefit.

Bangladesh can also benefit by engaging in vertical specialization through regional production-sharing arrangements. For example, in the textile sector, cotton can be produced in one country, yarn and fabrics in another country, and garments in a third.

Without adequate and appropriate production capacity, Bangladesh cannot expect to make much headway in the regional export market. Building this capacity will necessitate FDI and joint ventures whose products target the regional market. But investment cooperation has received little attention in the SAFTA agreement. Bangladesh and the other LDC members will benefit in particular if the agreement emphasizes investment cooperation because this will enable the LDCs to increase their exports, which are constrained currently by inadequate production capacity.

The Demand Side: Dismantling Regional Barriers to Bangladeshi Exports

Many of Bangladesh's potential exports cannot enter the markets of other SAARC countries, particularly India, because of proliferating nontariff barriers such as costly documentation, widely varying methods of assessing duties, and lack of branding. In addition, a lack of adequate physical infrastructure at border checkpoints, lack of transit rights, and lack of financial infrastructure have kept Bangladesh exportables from India's market.

Bangladeshi exporters have complained that goods entering India face extra duties and nontariff measures in the form of expensive mandatory certificates. These certificates relate to technical and health standards and must be obtained from places far from their place of import, such as Delhi and Kolkata, even for exports to northeastern India. Bangladeshi exporters also allege that India imposed unfair restrictions on fish exports through West Bengal and northeastern India, including the closure of all land ports (later opening only two). Moreover, India allegedly has not met the commitment it made at meetings of SAPTA joint working groups to recognize

Bangladesh's certification and testing laboratories. Furthermore, the meaningfulness of allowing Bangladesh transit through Indian territory to Nepal was lost because of India's long delay in providing this facility.

These are the areas in which the SAFTA agreement can contribute to Bangladesh's regional export expansion. However, as noted, the agreement does not specify a timeframe for phasing out nontariff and paratariff barriers. Unless this is done immediately, Bangladesh's exports under SAFTA will remain far below potential.

Improving Trade-related Transport and Border Procedures

Nontariff and paratariff measures are greater obstacles to trade than are tariffs. Inefficient customs procedures, lack of transit facilities, inadequate infrastructure, and inconsistent standards also inhibit trade. Thus, trade facilitation measures that address all of these challenges are needed to augment trade flows, whether regional or multilateral.

We have seen how nontariff measures and lack of harmonization in the SAARC region constrain Bangladesh's export expansion. How does lack of infrastructure in South Asia affect Bangladesh's trade?

Trade between India and Bangladesh is conducted by road and sea, although transportation by sea is more cost-effective. But sea transportation requires that Kolkata and Chittagong ports make coordinated efforts to improve their productivity and connections to inland waterways. Most containerized traffic is handled by Kandha, Mumbai, and Jawarlal Nehru ports on the coast of India. This obviously increases the cost of transportation. Transporting goods to Narayanganj in Bangladesh would be cheaper if the Kolkata and Chittagong ports and then inland waterways were used. Bangladesh and India should cooperate in facilitating such multimodal operation.

Bangladesh and India can also cooperate on the road network and improved clearance procedures for mutual benefit. By road, a trade consignment takes at least four to six days for clearance from India's border to Bangladesh and vice-versa. Generally, a consignment needs at least 22 documents (total for both sides) for approval. Such complex and cumbersome procedures create opportunities for pilferage, which often changes the composition and direction of trade (Subramanian 1999). Procedural complexities often deter trade between the two countries. Moreover, after cargo has been cleared, other road transport–related obstacles arise. For example, the current legal arrangement between India and Bangladesh prohibits vehicles from crossing the border to deliver consignments.

Rail transport between Bangladesh and India is also difficult. The lack of a container train between India and Bangladesh curtails trade in bulk items such as cement, logs, food grains, and salt. If Bangladesh Railway Authority connected Mongla port with Bongaon (in India) via Khulna by broad-gauge railway track, export cargo would reach Delhi or Mumbai in 4 to 5 days instead of the 15 days it now takes by road or the 18 days it takes by sea.

Expansion of the Scope of the SAFTA Agreement

Will expanding the scope of the SAFTA agreement in geographic or sectoral terms, or both, benefit Bangladesh? The agreement might be expanded to include Afghanistan and Myanmar, but Bangladesh's trade links with these two countries are very weak. In 2002/03 and 2003/04, Bangladesh's exports to Afghanistan amounted to US$3.09 million and US$4.22 million, respectively; the corresponding shares in total exports were 0.05 percent and 0.06 percent. Trade with Myanmar was similarly light: US$1.44 million and US$3.93 million, respectively, corresponding to a 0.02 percent and a 0.05 percent share. Imports from both Afghanistan and Myanmar have been negligible. Given these negligible levels of existing trade, Bangladesh would not derive any significant benefit if the SAFTA agreement were extended to include Afghanistan and Myanmar.

The SAFTA agreement involves trade in goods only. It makes no reference to trade in services, one of the fastest-growing components of world trade. Although an agreement modeled on the WTO General Agreement on Trade in Services may not be possible, SAFTA members can and should agree on liberalizing the entry of professionals and skilled and semiskilled workers. Including unskilled workers would be ideal. The cross-border movement of natural persons (Mode 4 in the WTO agreement) would be mutually beneficial in education, information technology, medical services, and technical services. Allowing such movement would definitely benefit Bangladesh because it has a surplus of unskilled workers, and an exportable surplus of semiskilled workers can be easily created. In fact, as noted, remittances from Bangladeshis working abroad are a major source of foreign exchange in Bangladesh.

CONCLUSIONS

With rapidly increasing intraregional imports, Bangladesh is important to trade in South Asia. It has been slow, however, to expand its exports. This is likely to change when SAFTA becomes operational if issues involving nontariff measures, rules of origin, negative lists, and investment cooperation are addressed. Nontariff measures in other SAARC countries, particularly India, have hampered the expansion of Bangladesh's exports. Strict rules-of origin criteria would adversely affect Bangladesh's export supply capacity. Such criteria must not be too stringent for LDC members (a minimum domestic content requirement of 20 to 25 percent may be appropriate). In addition, negative lists should be kept to a minimum, with commodities of export interest to LDC members kept off the lists to the extent possible. Investment cooperation should also be encouraged to generate the regional FDI needed to enable Bangladesh to produce exportables.

If these issues are addressed, Bangladesh's intraregional exports should increase significantly. Along with increased imports, which will enhance manufacturing capacity, an increase in exports is likely to boost employment when SAFTA comes into force. In turn, rising employment will alleviate poverty.

The structure of the agriculture and manufacturing sectors is likely to change after SAFTA becomes operational. Crop diversification, so urgently needed in Bangladesh, will be facilitated. The manufacturing sector will become more specialized along the lines dictated by comparative advantage.

Bangladesh will benefit if the agreement is enlarged in scope to cover cross-border movement of natural persons. However, Bangladesh would benefit little from an expansion in geographical coverage of the agreement to include Afghanistan or Myanmar.

Finally, trade facilitation measures can play an important role in expanding Bangladesh's intraregional trade and thereby benefit the country.

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5. Nepal

Binod Karmacharya

Landlocked between India and China, Nepal has much to gain from regional cooperation and has been pursuing economic integration for well over a decade. In the early 1990s, Nepal undertook market-oriented economic reforms to facilitate integration with the global economy—opening up to trade in goods and services, technology, and investment—after many years of inward-looking, import-substituting industrialization. Its commitment to participate in the South Asian Free Trade Area (SAFTA) under the Islamabad Declaration adopted at the 12th South Asian Association for Regional Cooperation (SAARC) Summit in January 2004 has paved the way for regional cooperation.

What opportunities and challenges does SAFTA hold for Nepal? Tariff liberalization will improve its access to SAARC markets and open its own market, generate trade, and offer beneficial secondary effects arising from economies of scale, structural transformation, investment flow, and efficiency resulting from greater competition and technological change. At the same time, some trade may be diverted and some government revenue lost. Thus, trade liberalization can be a net social benefit only if trade creation and secondary effects are large enough to offset trade and revenue losses. Benefits, especially secondary benefits, could be much greater if Nepal's free trade agreement with India—its main trading partner among SAARC countries—is integrated into SAFTA. Such integration, however, would cut Nepal's customs revenue substantially.

Realizing the potentially larger gains of tariff liberalization under SAFTA will require enforcing simpler and less restrictive safeguard measures; offering compensation for customs revenue losses; eliminating paratariff and nontariff barriers; improving trade facilitation and transport connectivity, regional transit agreements, extending the agreement to encompass trade in services; and strengthening the SAARC Secretariat. SAFTA should set a deadline for implementing all these measures.

In this paper we analyze these issues while reviewing Nepal's trade performance and trade regime, the details of the SAFTA agreement, and the implications of the agreement for Nepal. We conclude by suggesting policy adjustments for deepening and widening Nepal's regional integration.

TRADE PERFORMANCE AND STRUCTURE

Nepal is one of south Asia's most trade-dependent economies, with a trade-to-GDP ratio of more than 50 percent, high by south Asian standards but only about 80 percent of that in similarly sized economies, indicating the country's potential for trade growth. Nepal's proximity to the large economies of China and India offers opportunities for trade that could help Nepal accelerate economic growth and poverty reduction.

Performance Determinants

Nepal's economic reforms of the early 1990s increased its integration into the world economy. Major reforms encompassed liberalization of trade and industrial policies and rationalization of the foreign exchange regime, including a substantial depreciation vis-à-vis the U.S. dollar. Nepal's trade-to-GDP ratio increased from 23 percent in the 1980s to more than 50 percent by the end of 1990s. The ratio fell markedly after 2000 because of the global economic slowdown and the escalating violence of the Maoist insurgency in Nepal.

The country's improved business environment also contributed to rapid export growth. Exports, mainly manufactured goods, grew 30 percent annually from 1991 to 1995; exports of carpets and garments together rose by 77 percent in U.S. dollar terms in the early 1990s. Growth in exports of garments resulted, initially, from spillovers of Indian exports arising from the global system of quotas on textiles and apparel imports from the largest producers, like China and India, trade under the Multifiber Arrangement (MFA). The quota regime attracted Nepali industrialists as well as foreign investors to the industry; they were able to export to the U.S. and EU markets without fear of unrestrained competition from Indian and Chinese producers.

In the second half of the 1990s, weak demand, quality problems, and importing countries' concern over child labor slowed growth in exports of carpets. Many problems have been resolved, but carpet exports have not recovered. At roughly the same time, exports of ready-made garments (RMG) suffered as competition intensified with the dismantling of the quotas on imports from China and India.

Merchandise exports rebounded during 1999–2000 because of increased exports of RMGs to third countries and increased exports to India. Some export increases were transitory. Unstable political conditions in Bangladesh, for example, diverted RMG orders to Nepalese manufacturers (World Bank 2000). Nepalese manufacturers have also taken advantage of prevailing tariff differentials between Nepal and India to boost exports to neighboring Indian states. For example, exports of vegetable ghee to India have increased rapidly, accounting for about 25 percent of Nepal's India-bound exports. Other such exports include acrylic yarn, copper wire, zinc oxide, and mild steel pipes. India considers all these items as sensitive to its domestic industry. In response to the substantial growth of Nepal's exports of these items, formal, recorded exports to India continue to be subject to difficulties that might be described as nontariff barriers (Karmacharya 2001a). Overall, however, Nepal's export performance in the 1990s was impressive, doubling the country's share in world markets.

The deteriorating export performance of 2001–2002 was attributable to softening world demand, policy changes in importing countries, faltering competitiveness, rising transport costs, and the

Maoist insurgency, which seems to have deepened the effects of external shocks. Weak demand seems to have affected Nepal's exports to third countries, particularly those from the United States and Germany. Imports from developing countries into these markets declined in 2001 by 5 percent and 1 percent, respectively, compared with respective increases of 24 percent and 14 percent in 2000. In particular, U.S. apparel imports declined by 1 percent in 2001, compared with an increase of 13 percent in previous years. Similarly, growth of imports from developing countries into India also slowed to less than 2 percent in 2001 from 13 percent in 2000. Constraints on competitiveness related to geography, policy, and institutions have also harmed Nepal's export performance (Karmacharya 2000; HMGN 2004). After improving through most of the 1990s, Nepal's competitiveness seems to be deteriorating.

Imports grew at an average rate of 20 percent per year in the 1990s. In the last half of the 1990s, imports declined because of the massive depreciation of the rupee and falling demand for third-country goods.

Trade Composition and Concentration

Exports

Despite structural changes in its merchandise exports in the past two decades, Nepal, like other South Asian countries, still depends on a few exports and a few markets. This has made it vulnerable to external shocks arising from shifting demand and policy in destination markets.

Manufacturing now dominates Nepal's exports, though exports of agricultural products have increased in recent years (Table 5-1). The export share of primary goods fell from nearly 70 percent in the 1980s to 17 percent in 2001, while the share of manufactured goods rose from 30 percent to 75 percent. Manufactured exports are concentrated in garments, carpets, and pashmina, which together accounted for more than 50 percent of Nepal's exports in the late 1990s. Carpets are exported primarily to Germany and garments to the United States. Since renewing its trade treaty with India in 1996, Nepal has been exporting new products to India: vegetable ghee, toothpaste, toilet soap, acrylic yarn, copper rod, zinc oxide, mild steel pipe, *Hazmola*, *Chyawanprash*, noodles, and biscuits. Other exports comprise about 20 agricultural products and consumer goods, which also go primarily to India.

In the past decade, Nepal has also become more dependent on the same few markets. At present, 90 percent of its exports go to India, Germany, and the United States. In the past few years, its exports to India have increased more than 50 percent (Table 5-2). This rise is due to (1) long porous borders, (2) the free movement of people and capital, (3) the preferential trade treaty signed in December 1996, (4) a special payments regime between the two countries, (5) a slowdown in exports to other key markets, and (6) limited success in penetrating other regional markets, despite SAARC membership. In the last eight years, Nepal's exports to other SAARC countries have accounted for only about 1 percent of its exports (Table 5-2).

Table 5-1

Nepal's Structure of Merchandise Exports and Imports (in percentage)

Commodity Groups	1980	1985	1990	1995	2000	2002
Exports ($ mil)	(134)	(148)	(171)	(353)	(727)	(648)
Primary goods	69.5	56.2	17.0	13.0	16.4	17.4
Manufactured goods	30.1	42.4	82.7	85.2	75	74.7
Others	0.5	1.4	0.2	1.9	8.7	7.9
Total	100	100	100	100	100	100
Imports ($ mil)	(373)	(459)	(534)	(1350)	(1713)	(1496)
Food	16.7	12.7	12.6	11.0	15.0	14.8
Intermediate goods	13.5	16.7	23.9	18.2	19.8	18.2
Fuels	11.1	11.3	8.3	7.5	8.3	14.3
Manufactured goods	58.7	59.3	55.2	63.3	56.9	52.7
Total	100	100	100	100	100	100

Notes: Figures in parentheses are in absolute terms.

SOURCE: Author's calculations from Quarterly Economic Bulletin (various issues), Nepal Rastra Bank.

Table 5-2

Direction of Nepal's Merchandise Export Trade

Region/ Country	US$ Million						Share in Exports (%)					
	1970	1995	2000	2001	2002	2003	1970	1995	2000	2001	2002	2003
S. Asia	39.0	73	360	380	350	432	99.0	20	48	61	54	58
Bangladesh	(.)	6.9	7.0	3.0	5.3	5.7	(.)	2	1	0.9	0.8	0.8
Bhutan	(.)	(.)	0.3	0.3	0.7	1.1	(.)	(.)	(.)	(.)	(.)	0.1
India	39	66	353	376	343	421	99	18	47	60	53	57
Maldives	(.)	(.)	(.)	(.)	(.)	0.2	(.)	(.)	(.)	(.)	(.)	(.)
Pakistan	(.)	0.1	0.3	0.8	1.0	3.8	(.)	(.)	(.)	0.1	0.2	0.5
Sri Lanka	(.)	0.3	(.)	(.)	298	(.)	(.)	(.)	(.)	(.)	(.)	
Rest of the world	(.)	287	395	238	298	306	(.)	80	52	39	46	42
Total	39	360	755	618	648	738	100	100	100	100	100	100

Note: (.) means negligible.

SOURCE: Quarterly Economic Bulletin (various issues), Nepal Rastra Bank; Nepal Overseas Trade Statistics (various issues), Trade Promotion Center.

Nepal's exports are also subject to volatility. Compared to other South Asian countries, Nepal's exports are least correlated with overall changes in imports by the United States; its market share varies with yearly export performance; and its exports are more volatile (IMF 2000). While exports from other South Asian countries to the United States generally follow variations in U.S. demand, Nepal faces larger fluctuations, making its market share sensitive to export performance.

Over concentration makes Nepalese exports vulnerable to changes in the import policies of destination countries and international competition. In 2001, for example, the U.S. Africa Growth and Opportunity Act and the Caribbean Basin Trade Partnership granted producers in sub-Saharan Africa and the Caribbean preferential access to the U. S. market, possibly harming Nepal's garment exports. Nepal's growing dependence on India as a destination for its exports is also risky. Its renewed trade treaty with India is more restrictive than its 1996 predecessor. The renewed treaty imposes more stringent rules of origin and tariff rate quotas, requires clearly specified safeguard clauses, and requires that Nepal submit information about the basis for calculating rules of origin to the Indian government annually. This change in policy from free to restricted trade has had an immediate negative effect on Nepal's export performance.

Imports

No significant changes have occurred in Nepal's import structure. Machinery and transport equipment are its most important imports, underpinning much of its manufacturing export capacity. Intermediate goods have the second largest share of imports, followed by food and fuels. The nearly stagnant structure of Nepal's imports reflects the slow and narrow growth of its manufacturing sector. If industrial deepening had occurred, imports of capital goods would have increased markedly. Nepal's import sources, however, are more diversified than its export markets. More than 10 countries supply 90 percent of the country's imports. But, despite a concerted effort in the 1970s to diversify its foreign trade partners, Nepal still turns to India for more that 50 percent of its imports (Table 5-3). Imports from other SAARC countries make up about 1 percent of Nepal's imports.

Table 5-3

Direction of Nepal's Merchandise Import Trade

Region/ Country	US$ Million						Share in Imports (%)					
	1970	1995	2000	2001	2002	2003	1970	1995	2000	2001	2002	2003
S. Asia	61	464	756	772	929	1,093	88	34	43	52	58	59
Bangladesh	(.)	12.0	2.7	8.2	4.3	9.2	(.)	0.9	0.1	0.5	0.3	0.5
Bhutan	(.)	5.3	0.7	1.1	0.5	0.3	(.)	0.4	(.)	(.)	(.)	(.)
India	61	444	747	759	921	1,079	88	33	42	51	57	58
Maldives	(.)	(.)	(.)	(.)	(.)	(.)	(.)	(.)	(.)	(.)	(.)	(.)
Pakistan	(.)	2.4	1.4	1.7	2.0	2.6	(.)	(.)	0.1	0.1	0.1	0.1
Sri Lanka	(.)	0.5	4.0	2.1	1.4	2.0	(.)	(.)	0.2	0.1	0.1	0.1
Rest of the world	8	886	1,017	724	686	774	12	66	57	48	42	41
Total	69	1,350	1,773	1,496	1,615	1,867	100	100	100	100	100	100

Notes: (.) means negligible.

SOURCE: Quarterly Economic Bulletin (various issues), Nepal Rastra Bank; Nepal Overseas Trade Statistics (various issues), Trade Promotion Center.

Informal Trade

Unrecorded or informal trade is an important aspect of Nepal's trade with India. It operates both through and outside legal channels. Informal trade through legal channels is carried out through

false invoicing, which partially evades export and import tariffs, domestic taxes, and nontariff barriers. Informal trade through unofficial channels totally evades tariffs, taxes, and nontariff barriers. Such trade takes place along Nepal's border with India and the Tibet Autonomous Region of China. The following discussion concerns only the border crossings of goods between Nepal and India and is based on estimates from Indian and Nepalese territories (Karmacharya 2002a; Taneja and Pohit 2002; Taneja, Sarvananthan, Karmacharya, and Pohit 2004).

Estimates of India–Nepal Informal Trade

Contrary to the belief that informal trade between India and Nepal takes place largely from Nepal to India (Muni 1992), recent studies show that informal trade is two-way (Table 5-4). In fact, data suggest that informal exports from India to Nepal in 2000–2001 average US$180 million, while those from Nepal to India average US$157 million, implying Nepal has a slight deficit in informal trade. Total two-way informal trade ranges between US$368 million (Nepalese estimates) and US$408 million (Indian estimates). Interestingly, the two countries' estimates of informal trade lie within a small range, whereas their estimates of formal trade as expressed in national trade statistics present a large discrepancy.

Table 5-4

Summary Estimates of Formal and Informal Trade Balance, Indian and Nepalese Territories, 2000–2001(US$ million)

Territory	Export(X)	Imports(M)	X+M	X-M
Indian Territory				
Formal	141	255	396	-114
Informal	180	228	408	-48
Share of informal trade to formal trade (%)	128	89	103	54
Nepalese Territory				
Formal	359	614	973	-255
Informal	157	211	368	-54
Share of informal trade to formal trade (%)	44	34	38	21

Notes: The reference period for India (formal and informal) is April 2000–March 2001; for Nepal, June/July 2000–-May/June 2001(formal), and April/May 2000–March/April 2001(informal).

SOURCES: *Karmacharya, B. K. 2002a. Nepal's Informal Trade with India. South Asia Network Economic Institutes; Taneja, N., M. Sarvananthan, B.K. Karmacharya, and S. Pohit. 2004. India's Informal Trade with Sri Lanka and Nepal: An Estimation,* South Asia Economic Journal, *Volume 5, Issue 1.*

Policy Distortions and Transactions Costs

The conventional position is that informal trade is a response to trade and domestic policy distortions. This holds true for goods exported from Nepal to India that originated in third countries. Nepal's Most Favored Nation (MFN) rates are lower than India's by 5 to 30 percent making Nepal a conduit for third country goods to India. Furthermore, Nepal's trade regime has few nontariff barriers. Under the Nepal–India bilateral agreement, third countries do not meet the rules of origin requirement and are traded informally from Nepal to India. Tariffs differences might not be such a strong influence on informal imports from India, which consist mostly of rice

and other unprocessed food products that face no tariff or nontariff barriers in Nepal. Factors other than policy-related distortions are apparently more important in influencing informal trade. One survey by Taneja and Pohit (2000) showed that trade policy barriers, such as tariffs and quantitative restrictions between Nepal and India, were less significant than institutional factors—quick realization of payments, no paperwork, no procedural delays, and lower transport costs—in driving traders to informal channels on both sides of the border (Table 5-5).

Table 5-5

Reasons for Informal Trade between Nepal and India

Reason	Percent of Respondents	
	Nepal to India	India to Nepal
Low transportation costs	43	55
Less time to reach destination	20	28
Imported from third country into Nepal	70	0
No paperwork	62	78
No procedural delays	42	66
Lower bribes	60	48
Quick realization of payments	44	70
Presence of haats/bazaars	13	36
Absence/shortage of storage/warehousing facilities	8	17
Ethnic ties across the border	15	31
Absence of trading routes	1	8
Leakage of administered price goods	1	3
Presence of high duty in official channel	34	27
Quantitative restrictions	10	17
Easier to meet demand from across the border rather than the domestic market	25	23
Nexus between Border Security Forces personnel and the traders	27	35
Nexus between traders and politicians	4	4

SOURCE: Taneja, N. and S. Pohit. 2001. India's Informal Trade with Bangladesh and Nepal: A Qualitative Assessment. ICRIER.

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Taneja and Pohit (2000) also showed that informal traders bear relatively low transaction costs in comparison to formal traders. Most informal traders bear transaction costs of less than 10 percent of turnover, few bear costs of more than 20 percent, and none bear costs of more than 30 percent. But formal traders can bear total transaction costs of more than 30 percent of their turnover (Table 5-6).

Table 5-6

Transaction Costs of Formal and Informal Traders in Nepal–India Trade

Transaction Cost as Percent of Turnover [a]	Formal Traders[b]		Informal Traders	
	India	Nepal	India	Nepal
Less than 10%	33	18	72	61
10% to 20%	13	42	10	36
20% to 30%	18	24	3	3
More than 30%	36	16	0	0

[a] *Transaction cost here includes total payment as bribes to officials at various stages as well as transportation and credit costs.*

[b] *Figures for formal and informal traders are the percentages of survey respondents.*

SOURCE: *Taneja and Pohit (2000).*

TRADE REGIME AND REFORMS

Determinants of Trade Policy

Geography has had a much more significant effect on economic development in Nepal than in most other countries and will continue to do so. Nepal relies on trade policy to achieve economic, social, and political objectives; complement broader industrial and development policies; and to raise government revenue. Trade policy has also shaped its relationship with its South Asian neighbors, especially India. In fact, the influence of India on Nepal's economy in general and its trade regime in particular is difficult to overestimate. Several factors have put Nepal in the situation of *de facto* economic integration with India.[1] The virtually free movement of labor and capital between these two countries makes this an unusual and highly sensitive economic relationship. Thus, at least three key factors must be considered while formulating Nepal's trade regime.

- ***Border.*** A long and relatively porous border in the south separates the Terai and northern India. The eastern Terai has become one of Nepal's more industrialized areas, largely in response to commercial opportunities afforded by access to the Indian market.
- ***Preferential market access.*** The longstanding preferential trading relationship between Nepal and India permits most exports to enter India duty free and allows imports from India to enjoy significantly reduced duties.
- ***Exchange rate.*** The free convertibility between the Nepalese and Indian Rupees occurs under a fixed, nominal exchange rate.

Given their relative sizes and the strong ties between Nepal and India, it would be difficult for Nepal to pursue a trade and development strategy that deviated much from India's strategy. When it has deviated, opportunities for exploitative rents have emerged as well as retaliatory measures.

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[1] For a detailed account of these arguments, see Blejer and Szapary (1991), Karmacharya (2001), and Khan (2001).

Policymakers, therefore, need to take into account the benefits as well as the costs of Nepal's close economic relationship with India.

Reforms in the Trade Regime[2]

Nepal's economic reforms of the early 1990s aimed to spur economic growth and social development through integration with the global economy. Key measures included reducing and restructuring import duties, eliminating most quantitative restrictions and import licensing requirements, and introducing full convertibility for current account transactions. The country's 1992 industrial policy emphasized deregulation, competition, and reliance on market forces. Export promotion measures included reducing export service fees, allowing exporters to retain export earnings in convertible currency accounts, improving duty drawback and bonded warehousing arrangements, and granting income tax concessions on income from exports.

The reforms of the early 1990s appear to have substantially reduced tariff levels and variation. Rates fell from 32 percent in the early 1990s to about 14 percent in 2001/02 (though new duties and charges added in the past three years have raised nominal protection to about 18 percent). More than 70 percent of rates exceeded 25 percent in 1990, but most now fall in the 5–25 percent range. The current most favored nation (MFN) tariff rate structure—applying to countries other than India and China and complicated somewhat by the preferential trade arrangements with India—falls mainly into five rate bands ranging from 5 percent to 40 percent. The few rates outside this framework are high rates set for revenue purposes. For example, the government replaced an excise tax on vehicles in 2000 with two additional tariff bands (80 percent and 130 percent). Since no vehicles are manufactured or assembled in Nepal, the tariff and excise rates are equivalent. Few nontariff barriers exist.

Nepal also imposes other duties and charges. These include a local development fee of 1.5 percent; a special fee of 1 percent when customs duties are equal to or below 5 percent and 3 percent when they exceed 5 percent; a 10 percent tax on cars and bicycles; and a fee of 5 percent on some processed agricultural products (10 percent for rice and paddy). These taxes and duties discriminate against foreign trade in the same way as general tariffs because they are not levied on domestic production.

All exports are subject to an export service fee of 0.5 percent of f.o.b. value to cover the costs of services provided by customs and other trade facilitation agencies. As such, it should not be a major disincentive to exporters. Raw hides and unprocessed wool are also subject to some export restrictions in order to encourage domestic value addition for these goods.

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[2] For a more detailed discussion, see Karmacharya (2001b) and Karmacharya and Sharma (2003).

Trade and Transit Agreements

India—Preferential Trade Agreement[3]

Trade between Nepal is India is governed by treaties and an agreement to cooperate in controlling "unauthorized" (informal) trade. Nepal signed its first trade and transit treaties with India in 1950. These were renewed in 1960, 1971, 1978 (when trade was unlinked from transit), 1991, 1996, and 2002. These treaties

- Exempted on a reciprocal basis imports of primary products from basic customs duties and quantitative restrictions;
- Granted some Nepalese manufactured exports duty-free access to the Indian market without quantitative restrictions or the need for reciprocity (items on the negative list did not enjoy this access); and
- Granted preferential entry to manufacturing goods imported from India to Nepal, without quantitative restrictions.

Preferential access for Nepalese manufactured exports to India is governed by rules of origin that have changed over time. The 90 percent value-added rule of the 1960 trade treaty was reduced to 50 percent in 1992, then replaced by a requirement for a certificate of origin from the Federation of Nepalese Chambers of Commerce and Industry (FNCCI) in 1996. The 1996 treaty also narrowed goods excluded from preferential treatment to alcoholic beverages and concentrates (except industrial spirits), cigarettes, tobacco, and perfumes and cosmetics with non-Nepalese/ non-Indian brand names. The renewed treaty of March 2002 introduced more stringent rules of origin and tariff rate quotas and requires clear specification of safeguard clauses, as well as annual submission of information on how origin is calculated. New provisions for rules of origin cover value addition requirements of 30 percent of ex-factory prices (from March 2003) and changes in tariff heading (CTH) at the four-digit level of the harmonized system code. For Nepalese manufactured exports that do not meet CTH criteria the new provision requires products to have undergone a "sufficient manufacturing process within Nepal," determined case by case, to qualify for preferential access.

Under the amended clause of the renewed treaty India imposes the following fixed annual tariff rate quotas on Nepal's exports: 100,000 tons for vegetable ghee; 10,000 tons for acrylic yarn; 10,000 tons for copper; and 2,500 tons for zinc oxide. If exports exceed the quotas, which are lower than recent export levels, they are subject to MFN treatment. In addition, exporters of vegetable ghee must channel their products through India's state trading company and pay a service charge. The new treaty also provides safeguards against damages to domestic producers from an export surge. Nepal's exports to India are subject to a countervailing duty that makes the prices of the exports comparable to those of Indian counterparts. Trade transactions are in local currencies. Nepal, however, permits imports of few intermediate inputs or machinery for local industry from India against payment in convertible currency.

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[3] For a more detailed discussion, see Karmacharya (2001c; 2004); and His Majesty's Government of Nepal (2004).

BIMSTEC Free Trade Agreement

Nepal is also a signatory to the free trade agreement of the Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC). Bangladesh, India, Myanmar, Sri Lanka, and Thailand formed BIMSTEC in 1997. Nepal and Bhutan were admitted as members in February 2004. The agreement aims for broad economic integration by encompassing goods, services, and investment. The accord on trade in goods is to be launched in June 2006; accords on trade in services and investment promotion are to be launched in July 2007. Complete elimination of tariffs is under two schedules—fast and normal—and least developed countries will have more time to eliminate some tariffs.[4] (Table 5-7).

Table 5-7

BIMSTEC Tariff Phase Down Schedules

Non-least Developed Countries		Least Developed Countries	
2006-2009 Fast Track	Tariffs on products from least developing and non-least developing countries reduced to zero.	2006-2007 Fast Track	Tariffs on products from least developing countries reduced to zero.
2007-2010 Normal Track	Tariffs on products from non-least developing countries reduced to zero at equal annual rate.	2006-2011 Fast Track	Tariffs on products from non-least developing countries reduced to zero.
2007-2012 Normal Track	Tariffs on products from least developing countries reduced to zero at equal annual rate.	2007-2015 Normal Track	Tariffs on products from least developing countries reduced to zero at equal annual rate.
		2007-2017 Normal Track	Tariffs on products from non-least developing countries reduced to zero at equal annual rate.

Other Agreements

Under a limited preferential trade agreement with Pakistan, Nepalese tea has duty-free access to Pakistan's markets. Under a preferential trade agreement with the Tibet Autonomous Region of China, imports from China that enter Nepal through the region enjoy a 10 percent rebate of the customs duty. This does not include goods for which specific duties apply. The South Asian Growth Quadrangle—Bangladesh, Bhutan, India, and Nepal—was formed in 1996 under the SAARC charter to accelerate economic development among the four countries.[5] Nepal also joined the World Trade Organization in September 2004.

SAFTA TARIFF REDUCTION AND MARKET ACCESS

Potential Benefits

Because Nepal's trade with India is governed by a bilateral trade agreement, tariff-free access under SAFTA will not affect its access to India's markets or its exports to India unless the treaty

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[4] NLDM includes India, Sri Lanka, and Thailand.

[5] The Asian Development Bank's South Asia Sub-regional Economic Cooperation Program is helping Bangladesh, Bhutan, India, and Nepal facilitate initiatives in transport, tourism, trade and investment, information and communication technology, energy and power, and environment (ADB 2001, 2002).

is not integrated into SAFTA. Under the agreement, Nepal's export will face a maximum tariff of 5 percent in NLDMs, such as Pakistan, by 2009 and Sri Lanka by 2011, and in all LDMs, including Bangladesh, Bhutan, and Maldives, by 2015. Tariff-free access to these markets could significantly expand Nepal's exports and boost foreign direct investment (FDI) in the country. After Nepal and India signed their agreement in 1996, for example, Nepal's exports to India has expanded by 5 to 7 times, and Indian investment in Nepal increased, with Dabur, Hindustan Lever, and Colgate-Palmolive locating production bases in Nepal to serve the North India market. Lower or zero tariff access to other SAARC countries, especially Bangladesh and Pakistan, is an appealing feature of SAFTA. Nepal's exports to Pakistan, mainly large cardamom and leather, are likely to benefit from reduced tariffs, as are its exports to Bangladesh (lentils, weaning foods, vegetable seeds).

Tariff-free access could also present producers opportunities to export more or new goods to existing or new partners in the SAARC region (Karmacharya 1999a). The resulting increase in output is likely to give rise to several secondary benefits (Cline 1978; Schiff and Winters 2003). The more important secondary benefits would include structural transformation, economies of scale, and investment. The extent of secondary benefits is likely to be much greater if Nepal's bilateral agreement is integrated into SAFTA.

Issues

Several issues, however, need to be addressed to realize the potential benefits of tariff-free access under SAFTA: safeguard measures—sensitive lists and rules of origin; paratariff and nontariff barriers; trade facilitation; and transit and transport logistics. These barriers are a main cause of informal trade between Nepal and India (Karmacharya 1999b, 2002a, and 2004; Taneja and Pohit 2001).[6]

Sensitive Lists

Despite eight rounds of negotiations, sensitive lists are not final. So far, Bangladesh, Bhutan, India, Maldives, Pakistan, and Sri Lanka have prepared lists covering respectively 27 percent, 3 percent, 18 percent, 11 percent, 32 percent, and 20 percent of tariff lines. It is possible that the lists cover items that Nepal now exports or that hold great promise for export. If so, Nepal will benefit little and will be discouraged from integrating its bilateral agreement with India into SAFTA. As mentioned, the 1996 Nepal–India bilateral agreement substantially reduced the sensitive list to only a few items.

Rules of Origin

Rules of origin have yet to be finalized. SAFTA's Committee of Experts has agreed in principal on two criteria for establishing rules: value added and change in tariff heading (CTH)/change in tariff subheading (CTSH). Details, such as percentage of value addition and whether to allow provision of derogation in value addition for LDMs, are not yet agreed. As a smaller country,

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[6] For more detailed account of various barriers, see Karmacharya (1996), Khanna (2001), Alburo (2004), Nefarmer (2004), and Wilson and Ostuki (2004).

Nepal is interested in being able to export processed goods made from imported raw material and intermediates. It is therefore seeking liberal rules under SAFTA and a derogation similar to the one under its bilateral agreement with India. Rules of origin might also affect primary products that Nepal exports to SAARC countries. Restrictive rules could rule out the dynamic benefits of SAFTA for Nepal by excluding its manufactured exports from preferential access. While a rules of origin provision is desirable in any free trade agreement, it can also be a covert means of protection.

Paratariffs and Nontariff Barriers

SAFTA, in its initial design, emphasizes tariff reduction to expand trade among SAARC members. But Nepal faces other constraints in expanding trade, including paratariffs and nontariff barriers.

Pakistan, Bangladesh, Sri Lanka, and Nepal impose paratariffs in addition to customs duties. India eliminated its last paratariff in February 2004.[7] Pakistan and Sri Lanka apply para-tariffs across-the-board to all or most tariff lines, but as a general paratariff of this type. Bangladesh uses three other protective taxes for selected products. India, Pakistan, and Sri Lanka impose specific tariffs that correspond to very high and ad valorem equivalent rates, depending on import prices. By this indicator, Bangladesh has by far the highest protective tariffs in South Asia (World Bank 2004). They are about the same in Pakistan and slightly lower than in India. With the important exception of agriculture, Sri Lanka is a relatively low-to-medium low-tariff country by the general standard of developing countries.

In addition, all South Asian countries, except Bhutan and Nepal, impose nontariff barriers such as state trading enterprises (STEs), tariff rate quotas, technical standards and regulations, sanitary and phytosanitary rules, other health and safety regulations, antidumping and countervailing duties, and restricted port of entry and inland customs points (Table 5-8).

While the SAFTA agreement aims to address paratariff and nontariff barriers, no timeframe or mechanism is specified for doing so, nor does the agreement make a positive statement about compliance or systematic elimination of nontariff barriers. Continuation of these barriers could nullify the value of tariff reduction. Nepal's exports to India, for example, declined sharply when the trade agreement between two countries changed trade from nearly free in 1996 to restricted in 2003. In addition to newly stringent rules of origin and tariff rate quotas imposed in 2003, Nepal's exports to India face some nontariff barriers (Karmacharya 2004):

- Delays in laboratory testing of vegetable ghee and tea (laboratories are in Patna/Kolkata, far from Nepal's border).
- Compulsory quarantining of agricultural items. India had allowed quarantine checks only at Panitanki in far eastern Nepal, which drove up transport costs; more entry points now exist but not enough.

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[7] India briefly imposed a special additional duty on all imports from Nepal and state-duties on selected products.

Table 5-8

Nontariff Barriers and Parataiffs in SAARC Countries

Country	Nontariff Barriers	Parataiff
Bangladesh	Health, religious, environmental and balance of payment purposes: Quantitative restrictions (QRs); quasi-QRs Import through state trading enterprises (salt) Restricted port of entry	Infrastructure development surcharge Supplementary duties Regulatory duties VAT exemptions for specified domestic products
Bhutan	None	None
India	Import through STEs Tariff rate quotas Health and sanitary regulations (quarantine fees) Restricted ports of entry and inland customs posts Antidumping and countervailing duties Customs valuation	None
Nepal	None	Special fee Local development fee Agricultural development fee
Pakistan	Information not available	Income withholding tax Extra protection for some products through sales tax (a VAT style tax) Regulatory duties (now mostly phased out)
Sri Lanka	Import ban (tea and certain spices) Import monopoly (wheat) Health and sanitary regulation	

SOURCE: *World Bank. 2004.* Trade Policies in South Asia.

- Luxury and state taxes.
- Channeling of imports from Nepal (vegetable ghee) through India's state trading enterprises (STE).
- An STE service charge on imports from India.

These barriers are largely responsible for declining growth in Nepal's exports to India. In 2003, Nepal endured negative growth of about 4 percent, and its exports of vegetable ghee, which account for the largest share of exports to India, declined by 26 percent in the three years, from about 97, 000 MT in 2003 to about 71,000 MT in 2005.

Trade Facilitation

Trade transaction costs and behind-the-border barriers also impede improvements in market access in South Asia. Such costs and barriers consist of choke points at border crossings and in the customs and regulatory environment, as well as in service sector infrastructure.[8] Major choke points involve poor infrastructure and facilities, complicated procedures, excessive documentation requirements, and poor governance. Nepal, for example, requires 15 documents for imports and about 11 for exports (HMGN 2004). Three separate forms are required for

[8] For a more detailed account, see Wilson and Ostuki (2004).

business, income tax, and VAT registration for imports and exports—where a single business number could suffice for all three purposes.

In all countries, customs procedures are cumbersome and time consuming, requiring the trader to provide several certificates in multiple copies. Even minor mistakes can add substantially to transportation costs. Documentation such as export and import declarations and transit documents vary from country to country and must be prepared separately for each border and submitted in multiple copies (see Table 5-9). Poorly defined and complex procedures and varying documentation and certification reduce transparency and enable harassment and corruption. A standard format would reduce paperwork and enable consistency and coordination between custom officials on both sides of a border.

Table 5-9

Border Crossing Documentation

Cargo Routes	Documents Required
India to Bangladesh Import cargo	India. Customs export declaration, bill of lading, invoice, packing list, letter of credit
	Bangladesh. Import permit, bill of lading, packing list, letter of credit, consignment insurance cover, certificate of registration (VAT), importer pass book. For goods entering the export processing zone, bonded warehouse licenses, value-bonded form, risk and duty bond.
Nepal to India Transit cargo	Nepal. Customs transit declaration, customs export declaration, duty insurance certificate, invoice, packing list, certificate of origin, certificates of registration (income tax, VAT company), letter of credit.
	India. Customs transit document, duty insurance, invoice, packing list, letter of credit, certificate of origin.
Bangladesh to Nepal	Bangladesh. Export registration certificate, invoice, letter of credit, packing list, certificate of origin, truck receipt
	Nepal. Customs import declaration, invoice, packing list, certificate of origin, import license, letter of credit, health/quarantine certificate, equipment interchange receipt, and duty insurance coverage for containers.
Bangladesh ports	Exports. Export bill of entry, invoice, packing list, export permit, undertaking by export company, outpass statement, export permit, risk bond.
India ports	Imports. Customs transit declaration, bill of lading, invoice, packing list, certificate of origin, import license, letter of credit, health/quarantine certificate, equipment interchange, receipt and duty insurance coverage for containers.

SOURCE: *World Bank. 2001. Forging Subregional Links in Transportation and Logistics in South Asia.*

Some border crossings lack proper customs facilities (Subramanian and Arnold 2001). For example, Bangladesh's custom office on the Phulbari–Banglabandh crossing, through which cargo from Nepal also moves to Bangladesh, lacks permanent staff. The nearest customs office in Bangladesh is at Panchagarh, 58 kilometers away. The custom officer must be informed of the expected time of arrival of a Nepalese consignment. This arrangement sometimes adds two days to the time required to cross the border and transfer cargo and often damages cargo, such as apples and vegetables (World Bank 2001). Differences in working hours can also delay border crossings. For example, customs offices at Indian borders operate less than 9 hours per day.

Moreover, customs clearance centers are sometimes far from other border facilities. For example, the sanitary and phytosanitary laboratory in Kolkata is 1,000 kilometers from the customs facility at Birgunj, Nepal. Exporters incur additional vehicle detention fees waiting for test results

(Karmacharya 2002b). This not only raises the costs but also erodes the quality of export products.

Administrative problems with customs—such as discretionary power, valuation procedures, and non-transparent inspections—give rise to corruption. Informal payments, such as of 30 percent of invoice value for a consignment on the Kakarbhitta–Phulbari/Banglabandh corridor or of US$150 per consignment on imports and exports via Haldia, are not unusual (Subramanian and Arnold 2001). Along the border of Nepal and India, total transaction costs, including bribes, can be more than 30 percent of traders' turnover (Taneja and Pohit 2000).

Varying standards among South Asian countries and the failure to recognize other standards also hinders trade in the region. Some Nepalese products, for example, cannot enter Indian markets because they cannot obtain the Indian Standard Institute (ISI) mark, nor are Nepalese standards recognized in India. This is particularly affecting exports of packing materials and edible goods (CII-FNCCI 1995). Nepal's agricultural and herbal exports are also subject to a high fee for the quarantine test.

Likewise, incompatibilities in customs' information technology systems increase transaction costs. For example, Nepal and Bangladesh use ASYCUDA++; India uses the India Customs Electronic Data Interchange System (ICES); and Bhutan uses the Bhutan Automated Customs System (BACS), specifically designed for the country's unique location.

All these transactions costs and behind-the-border barriers can nullify the positive effects of tariff reduction under SAFTA. Simplifying and harmonizing procedures for cross-border movement of goods would do much to facilitate trade and ensure realization of SAFTA's benefits.[9] While the SAFTA agreement mentions addressing trade facilitation issues, it does not specify any mechanisms.

Transit and Transport Logistics

Removing tariffs and nontariff barriers and facilitating trade will improve market access, but improving transport infrastructure and transit facilities will be more critical for the smooth movements of goods for Nepal. To reach a port, Nepal must rely on the infrastructure and transit facilities of other countries. It needs to reach a seaport via India or via India and Bangladesh. Nepal also faces high transit times and logistics costs in reaching ports. Line haul movements by road, rail, or inland waterway together with the modal interface (if transfer to different modes is required) can account for 40–60 percent of the logistics costs of Nepal's exporters. Intermediate hauling of freight at border crossings, including costs of time in transit, can account for 10–30 percent of logistics costs (Subramanian and Arnold 2001).

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[9] Wilson and Ostuki (2004) have shown that improved trade facilitation will increase intraregional trade in South Asia by 60 percent.

India is a very important as a transit country for Nepal.[10] Under its transit treaty with Nepal, India provides port facilities at Kolkata and Haldia (which is 1,056 km from Nepal's border) for Nepal's trade with third countries and facilities at 15 points on the border and as many transit routes to Kolkata and Haldia.[11] The key corridor is Kathmandu–Birgunj (Nepal)/Raxaul (India)-Kolkata/Haldia. The following problems in the corridor drive up costs:

- Long transit from Kolkata to Raxaul due to avoidable long distance and poor roads.
- Higher hauling costs.
- Inefficiency of Kolkata/Haldia port.
- Bribes ("facilitation speed" money).
- Administrative decentralization in India.

Two and half days are lost on both the outward and inward journeys between Kolkata/Haldia and Raxaul/Birgunj. The very poor quality of some sections of road, especially in Bihar, slows trucks to 20 km per hour for 180 km. And, to avoid penalties for traveling overweight and numerous unofficial charges, drivers take many time-consuming measures to avoid checkpoints. Likewise, roads in some sections of Nepal are also poor.

Despite the provisions of the transit treaty, drivers are harassed. They must carry numerous documents and pay bribes to police patrols and others at road barriers on both sides of the border. Indian states also impose restrictions on Nepalese vehicles at whim. Even though the treaty does not require Nepalese vehicle to pay fees to enter India's territory, the Road Transport Unit of Bihar recently took over 10 Nepalese oil tankers and imposed fines ranging from IRs 68,000 to 105,000 for failure to pay road tax even though the tankers had received permission to not pay the tax from the Indian Embassy in Kathmandu. The issue was resolved only through diplomatic means.

A World Bank-assisted project completed in December 2000 provided Nepal with three border facilities to handle containerized cargo. Of these, the principal Inland Container Depot (ICD) at Birgunj was provided a direct rail connection to Kolkata Port by means of India's broad-gauged railway network, and began operating in July 2004.[12] Its operation was expected to reduce transaction costs by 30 percent; however, it is not operating at full capacity for various reasons: low frequency of cargo train (twice a week), inadequate information on the schedule of cargo

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[10] Among WTO members, landlocking countries such as India are obliged to provide landlocked countries such as Nepal at least one transit route to the sea. Between March 1989 and May 1991, however, India closed key trade and transit points with Nepal, blockading a number of commodities, including petroleum products. This occurred because of a breakdown in Nepal–India relations resulting from political, security and military concerns. The blockade ended in 1991 with Nepal's constitutional crisis and change of government. This experience has been a dominant influence on subsequent political and economic relations between the two countries.

[11] India has also provided 22 entry/exit points along the border for bilateral trade and Nepal–Nepal transit.

[12] The Birgunj ICD has been closed for three and half years because of prolonged negotiations between the governments of India and Nepal on customs procedures and management of the facility.

train movement to trace exact locations, and pilferage. India has agreed to increase cargo train frequency by operating one train for every 30 containers, compared to every 60 to 70 at present.

Located in the eastern part of SAARC region, Bangladesh could provide Nepal with alternative access to seaports. India has also provided road transit routes to vehicles carrying goods from Nepal to Bangladesh through the Kakarbhitta–Phulbari (India)/Banglabandh (Bangladesh)–Dhaka/Mongla corridor, across a narrow portion of its territory known as the "chicken's neck." A major problem in this corridor is the restrictive transit agreement among Bangladesh, India, and Nepal (Khanna 2001). Bangladesh's reluctance to provide transit through its territory for goods and vehicles has prompted India to deny similar privileges to Bangladeshi carriers. Hence, Nepalese trucks carrying goods into Bangladesh need to be convoyed in India by Indian authorities and transshipped at the Phulbari–Banglabandh border, causing delays and adding substantially to transaction costs.

A regional transit agreement among SAARC countries could help mitigate the high transit times and logistics costs facing Nepal. Such an agreement should guarantee Nepal transit rights by possible alternative sea route(s) in India[13] for intra- and interregional movement of goods. While the SAFTA agreement aims to address transit issues, it does not specify any mechanisms. As a SAFTA member, Nepal should make resolution of these issues a top priority—without better transit facilities the benefits of tariff reductions will be greatly reduced.

But guaranteed transit rights alone will not remove the disadvantage of being landlocked. Regional transit agreement need to be accompanied by the creation of a well developed regional network of multimodal transport and administrative infrastructure in Nepal, India, and Bangladesh. This task can be approached within SAFTA.

OTHER IMPLICATIONS

Implementation of the SAFTA agreement will also open Nepal's markets to SAARC countries and affect customs revenue as well as the application of Nepal's other trade agreements.

Opening Nepal's Markets

Nepal's trade with India is governed by a free trade agreement so tariff-free access under SAFTA will have no direct effect on market access unless the agreement is incorporated into the SAFTA agreement.

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[13] Nepal could also reduce its transit cost and travel time by opting for an alternative sea route in India (Mumbai). The container terminal at Mumbai, operated by the Jawaharlal Nehru Port Trust (JNPT), can provide direct sailings to Europe or other destinations, including Pakistan. Transit costs could be cut by about US$400 per 20-foot-equivalent unit (TEU), by avoiding transshipment at Singapore and the feeder service. Apart from JNPT being more efficient port than Kolkata, Mumbai businessmen are considered trustworthy and the requests for facilitation payments are reported to be much less frequent than in Bihar and West Bengal.

Under the SAFTA agreement, Nepal does not need to commit to zero tariffs but only tariffs no greater than 5 percent by the end of 2015—64 percent of Nepal's tariff lines already meet this standard. Thus, as a least developed member, Nepal would have to reduce the rates on the remaining 36 percent of its tariff lines to 5 percent in the next 10 years.

Opening its borders to SAFTA country imports can benefit Nepal directly by creating trade and indirectly through secondary effects.[14] Consumers and producers in newly developing sectors will be able to enjoy more imports at lower prices, and increased competition will spur efficiency among domestic producers. The extent of such benefits could increase if the agreement with India is incorporated into the SAFTA agreement. At the same time, trade could be diverted if the lure of tariff-free access ends up replacing cheaper world market supply with more expensive regional partner supply. It is unlikely that, for most products, the world's most efficient suppliers are in the region (Panagariya 2003). If trade creation and improved efficiency offset trade diversion, opening borders will be beneficial overall.

Because it has no or few nontariff barriers, Nepal is concerned about allowing tariff-free access to its markets. Without such barriers, Nepal could witness a surge in imports from SAARC countries, such as Bangladesh and Pakistan, while not being able to export much to them. Hence, Nepal is believed to have listed most of the currently imported goods from SAARC countries[15] as sensitive items ineligible for preferential access.

Customs Revenue

According to 2004 figures, Nepal's imports from all the SAARC countries generated US$96 million in tariff revenue or about 63 percent of its all customs collections of US$152 million. India alone accounts for 62 percent of Nepal's tariff revenue. In Nepal, tariffs make up 69 percent of customs revenue, 22 percent of tax revenue, and 17 percent of all government revenue.

The SAFTA agreement does not mandate zero tariffs, but rather sets a target of between 0–5 percent. Thus, Nepal is likely to retain all tariffs at or below 5 percent. The extent of customs revenue loss to Nepal associated with SAFTA agreement would depend upon whether Nepal integrates its bilateral agreement with India or not. If Nepal does not integrate its bilateral agreement with India into the SAFTA agreement, it will not lose customs revenue. If it does integrate the agreement, it will lose substantial revenue. Assuming Nepal eliminates all tariffs on India's products, revenue losses would be about 11 percent of all government revenue. Assuming Nepal eliminates all tariffs on the products of other SAFTA members, the revenue loss would be about 0.11 percent of government revenue (given that about one-fifth of revenue comes from customs duties alone). The SAFTA agreement considers providing a mechanism for compensating for customs revenue losses among least developed members, but no final decision has been made yet.

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[14] For a detailed account on effects of regional trade agreements, see Cline (1978), Hoekman and Schiff (2002), and Schiff and Winters (2003).

[15] Nepal and India have also exchanged sensitive lists on some products under SAFTA negotiation.

Overlapping Trade Agreements

SAFTA overlaps with Nepal's bilateral free trade agreements with India and with the BIMSTEC FTA. Should these FTAs operate simultaneously, administering parallel preferential tariffs, rules of origin, and negative lists will be difficult, confusing, and costly (Bhagwati 2002). Is tariff-free access under the SAFTA agreement more attractive for Nepal than its other agreements?

Nepal–India Bilateral Free Trade Agreement

Trading in South Asia means trading with India. Nepal's bilateral agreement with India is relatively more attractive to Nepal than the SAFTA agreement. The main attraction is non-reciprocal, zero tariff access to India's markets for Nepal's manufactured products. If SAFTA does not compensate financially for customs revenue losses, Nepal would prefer to continue trading with India under the bilateral agreement—especially because SAFTA's "sunset clause" phases out compensation for revenue loss. The bilateral FTA will also remain more attractive so long as the nature and the extent of its safeguard measures in terms of rules or origin and sensitive lists would be more liberal than those under SAFTA. The bilateral FTA is also believed to allow Nepalese exporters to be the "first movers" into the Indian market. At present, Nepal's access to India's markets is the least restricted in the world.

These benefits notwithstanding, India imposes nontariff barriers and changes rules unilaterally in implementing the bilateral FTA, creating an uncertain business environment for Nepal. Moreover, the commercial importance of Nepal's preferential access to India is relative. Trade agreements between India and Sri Lanka are coming closer to granting equal preferences. If India enters into similar agreements with other countries or introduces more liberal policies generally, Nepal's relative advantage will weaken. Producers in Nepal would have to compete on equal footing with producers elsewhere. With such increasing uncertainty, Nepal may prefer switching to SAFTA if major provisions of the bilateral FTA are integrated into it.

BIMSTEC Free Trade Agreement

The BIMSTEC FTA covers goods, services, and investment while the SAFTA agreement deals only with trade in goods. Nepal will find the BIMSTEC FTA relatively more attractive to SAFTA for a number of reasons:

- The BIMSTEC FTA will provide zero tariff access for Nepal's exports to some SAFTA members including Bangladesh, Bhutan, and Sri Lanka—countries that could still impose tariffs as high as 5 percent under SAFTA.[16,17]
- The BIMSTEC FTA will also provide zero tariff access for Nepal's exports to two South East Asian countries—Myanmar and Thailand. Nepal is likely to have more complementarity in comparative advantage structure, and more possibilities to expand exports to them than to SAFTA members.

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[16] Zero tariff access under BIMSTEC FTA, however, must be accompanied by safeguard measures (e.g., rules of origin and sensitive lists) that are more relaxed than SAFTA's.

[17] Nepal is likely to find its FTA with India still more attractive than the BIMSTEC FTA on the grounds of its more relaxed safeguard measures.

- The BIMSTEC FTA also intends to improve trade facilitation among members through mutual recognition arrangements, customs cooperation, trade finance, e-commerce, and other such measures. Moreover, it provides deadlines for most of these issues, something Nepal may view as a positive feature.

The BIMSTEC FTA raises some concerns for Nepal as well, the major concern being substantial loss in customs revenue. The BIMSTEC FTA has no provision for compensating for revenue losses due to tariff reductions and elimination. Nepal will lose substantial customs revenue if its bilateral FTA with India is integrated into the BIMSTEC FTA for the reasons discussed above. In addition, Nepal's desire for revenue loss compensation under SAFTA becomes irrelevant in relation to this agreement. India and Sri Lanka, for example, will both find it more attractive to access Nepal's market under the BIMSTEC FTA because they will be not required to compensate for any customs revenue loss.

Finally, while liberalization of trade in services under the BIMSTEC FTA will help Nepal's firms cut costs and identify new foreign markets, it is more complicated than liberalization of goods—practically, politically, and economically. Moreover, Nepal's agreement to investment liberalization under the BIMSTEC FTA is incompatible with its stand in WTO negotiations.

CONCLUSIONS

Tariff liberalization under SAFTA will improve Nepal's access to SAARC markets and open its own markets, generate trade, and offer beneficial secondary effects arising from economies of scale, structural transformation, investment flow, and efficiency resulting from greater competition and technological change. At the same time, some trade may be diverted and some government revenue lost. Thus, trade liberalization can be a social benefit only if trade creation and secondary effects more than offset trade and revenue losses. Benefits, especially secondary benefits, could be much greater if Nepal's free trade agreement with India—its main trading partner—is integrated into SAFTA. Such integration, however, would cut Nepal's customs revenue substantially.

Realizing the broader benefits of tariff liberalization under SAFTA will require implementing a number of initiatives that deepen and widen integration and that have deadlines. They include following:

1. ***Make general safeguard measures simple, transparent, and liberal.*** In particular, rules of origin should be on par with those in Nepal's bilateral agreement with India. Likewise, allowances for sensitive items should be time-bound and phased out.
2. ***Establish a mechanism to compensate for lost customs revenue.*** This is particularly important if SAFTA intends to incorporate Nepal's bilateral agreement with India.
3. ***Ensure that tariff liberalization is accompanied by elimination of paratariff and nontariff barriers and by improved trade facilitation***. This can be accomplished through (a) policy changes and programs that have tangible effects on trade (e.g., provision of border facilities, multimodal physical connectivity, synchronized business and banking services, computerized information sharing, removal of non-tariff barriers.); (b) procedural changes (e.g., mutual recognition of processes and testing procedures including certification and accreditation,

common border facilities, simplification and harmonization of documents); and (c) investment promotion for improving physical infrastructure (e.g., cargo handling and containerization, transport services).

4. ***Seek to improve physical infrastructure such as transport, communication, and transit facilities***. Sound infrastructure is critical to the movement of goods and people for landlocked countries such as Nepal. Better infrastructure and regional connectivity will cut transportation costs and boost the region's competitiveness.[18] Bilateral transit treaties between countries, however, are no longer in accordance with modern customs procedures. Likewise, exporters from Nepal are demanding transit facilities from India for trade with Pakistan. In this context, SAFTA needs to extend its scope by considering regional transit agreements among SAARC countries.

5. ***Extend SAFTA to cover trade in services***. Trade in services is inseparable from trade in goods. Free trade in goods will be ineffective without free trade in services. Trade in services must be freed so intraregional trade can expand. In addition, most SAARC countries are WTO members who have already opened up their service sectors. Extending SAFTA to cover trade in services would make the agreement as or more attractive than the BIMSTEC FTA.

6. ***Consider extending membership to other neighboring countries, particularly China***. South Asian countries—especially Nepal, Bangladesh, Bhutan, and India—can gain much from extended regional cooperation that includes China. Nepal has been the traditional corridor for trade between China and India. Recent efforts to strengthen these ties include improving the road to the Tibet Autonomous Region (TAR) of People's Republic of China. This road could connect India to China via Nepal. India's recent request that Nepal provide transit access to TAR has heightened the importance of extending SAARC membership to China.

7. ***Strengthen the SAARC Secretariat***.[19] SAARC's institutional base is weak. The Secretary General's mandate is narrow, affording little participation in formulating agreements or work programs. Directors seconded from national administrations for three-year periods lack the expertise to supervise the work with which they are tasked. SAARC's administrative costs are covered by fixed contributions from member states, but the work program is funded by voluntary contributions on the basis of annual pledges. The procedure for consulting member states in relation to grants from external donors is very cumbersome. The status of the Secretary General should be elevated, and SAARC should have a professional and diversified Secretariat. The Secretary General should have greater financial authority, including control of a central fund to which voluntary contributions by member states are paid. India, for example, pledged US$100 million for social development, but this remains unused. A trustee board could be established to administer this contribution impartially and effectively. The

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[18] The SAARC Secretariat is conducting the SAARC Regional Multimodal Transport Study with technical and financial assistance from the Asian Development Bank. The study will analyze constraints on and potential benefits of regional transport connectivity through different transport modes; provide a map for promoting regional cooperation and a matrix of possible assistance in the transport sector; and conceptualize regional projects in the transport sector. For more details, see ADB (2004).

[19] For a detailed account on this, see Wilton Park Conference (2004); Sobhan, R. (2005).

national focal point for SAARC is a senior civil servant from foreign services; the focal point should be broadened to include parliamentarians, businesses, and civil society. The possibility of a SAARC civil society forum, and its relationship to the intergovernmental structures, should also be considered. South Asia's vibrant civil society could contribute much toward the development of SAARC. The Asia-Pacific Economic Cooperation (APEC), which brings together government, businesses, civil society, and academia, could serve as a model.

8. ***Develop constituencies for cooperation and a regional community.*** The greatest hindrance to cooperation appears to be the belief that sovereignty is sacrosanct. People have to be persuaded of the value of pooling sovereignty in regional groupings, a global trend. Bureaucratic roadblocks countervail civil society demands for cooperation, and artificial obstacles are often created to save face when things go wrong.

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6. Sri Lanka and Maldives

Sanath Jayanetti

South Asia is one of the world's least economically integrated regions. Home to 1.4 billion people, more than one-fifth of the world's population, it accounts for only 1.5 percent of world GDP and 1.2 percent of world trade. Average GDP per capita in 2003 was US$520. More than 31 percent of South Asians—430 million people—live in extreme poverty.[1] India's dominance is obvious—it accounts for more than 78 percent of the region's GDP and 76 percent of its population. It also commands a leading position in international trade while being the least open to trade[2] with the rest of the world.

The South Asian Association for Regional Cooperation (SAARC) was formed almost two decades ago, and the South Asian Preferential Trade Arrangement (SAPTA) was put in place almost a decade ago to encourage dismantling of trade barriers and economic integration. Signatories have concluded four rounds of negotiations.[3] During the first three rounds—1995, 1996, 1998—more than 4,700 tariff lines (not mutually exclusive) were covered by preferential access. Laborious and time-consuming negotiations were restricted to product-by-product and sectoral approaches, but had no impact on intraregional trade. Even ten years later, intraregional trade was a mere 5 percent, thanks to tariff preferences irrelevant to trading interests, inadequate tariff cuts, restrictive rules of origin, and nontariff barriers. In January 2004, SAARC members signed the Framework Agreement on the South Asian Free Trade Area (SAFTA) at the 12th SAARC Summit in Islamabad. The agreement is expected to go into effect on January 1, 2006.

Because SAARC member states are at various stages of economic development, economic cooperation under SAFTA is likely to be complex and gradual. To benefit from the agreement and to further economic integration, all countries in the region must undertake fiscal, monetary, and trade reforms. Sri Lanka, for example, will need to accelerate trade reforms and further liberalize its services sector. Maldives will need to reform its system of domestic taxation to accommodate the agreement, while deepening trade reforms. This study examines in detail

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[1] The calculation of the poverty line is based on the Head Count Ratio (HCR) proportion of population below nationally defined poverty line. See "Poverty in South Asia," South Asian Alliance for Poverty Eradication (2003).

[2] Trade share of GDP was about 25.9 percent in 2003/2004.

[3] The fourth round's consolidated list of concessions is not yet final.

concerns about SAFTA and its potential impact on Sri Lanka and Maldives as well as issues that must be dealt with if the agreement is to be successful. It begins with an overview of the economies and trade regimes of Sri Lanka and Maldives.

OVERVIEW OF THE ECONOMY

Sri Lanka

Located in the sea routes of the Indian Ocean and 50 kilometers off the southeast tip of India, Sri Lanka has an area of 65,610 square kilometers and a population of 19.5 million (mid-year 2004), growing 1.1 percent annually. Though it is one of Asia's first "welfare" democracies,[4] it has fallen far short of income potential—the head count ratio of poverty was 22.7 percent in 2002. That ratio has been declining at only a moderate pace, and unevenly across sectors and provinces. Over the past decade, however, the island's economy has been growing on average about 5 percent annually. Per capita GDP exceeded $1,000 for the first time in Sri Lanka in 2004.[5]

The services sector dominates the economy, accounting for more than 55 percent of GDP and 44 percent of employment in 2004, as well as 77 percent of economic growth. Agriculture's share of GDP has been declining, standing at 17.9 percent in 2004, while its share of employment is 34 percent. The industrial sector's share of GDP was 26.5 percent in 2004 and its share of employment 21.4 percent.

Sri Lanka was the first country in South Asia to move from an inward-looking, public sector-led growth strategy to an outward-looking, market-oriented, and private-sector led growth strategy. Liberalization began in 1977 and was followed by a massive increase in public investment as the government embarked on a major irrigation project, leading to a rise in expenditure. The ethnic strife of 1983 became a civil war and, by 1987, a state of chronic militancy persisted in the south. Defense spending increased as a consequence, boosting total expenditures and weakening attempts at fiscal consolidation. The Central Bank of Sri Lanka estimates that war cost the country 1–2 percentage points in growth each year.

Early reforms concentrated on trade and payment liberalization. The government removed export and import controls and export duties, reduced tariffs, eliminated licensing requirements for agricultural imports, bound agricultural tariffs at modest rates, and bound textile and apparel tariffs at low rates.[6] Sri Lanka also signed the region's first major bilateral trade agreement with India, a Trade Investment Framework Agreement (TIFA) with the United States, and a free trade agreement with Pakistan. Sri Lanka is now negotiating a comprehensive economic partnership

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[4] Sri Lanka was one of the first developing countries to provide free and universal health and education services, accompanied by commitments to gender equality, social mobilization, and an extensive food subsidy.

[5] In the mid-1950s, Sri Lanka's per capita GNP was on par with that of some Southeast Asian countries such as Korea, Malaysia, and Thailand.

[6] Sri Lanka is a founding member of both GATT and WTO.

agreement with India that will cover services and has been discussing a free trade agreement with the United States.

One consequence of reforms was a drastic decline in revenue from trade-related taxes. Revenue from import taxes fell from 7.6 percent of GDP in 1980 to 1.9 percent by 2003; while direct taxes did not offset the decline.[7] To boost revenue, Sri Lanka increased import duties through cesses[8] and other paratariffs by the end of 2004, nudging revenue from import taxes up to 2.1 percent of GDP for 2004. In the early stages of liberalization, the government maintained a tax–GDP ratio of 20 percent. This ratio fell to 13.2 percent by 2003 (then rose to 14.8 in 2004 because of an increase in taxes). Rising expenditure coupled with declining revenue caused successive high fiscal deficits, growing public debt, and a heavy debt service burden. The size of the public debt now exceeds the country's GDP (about 107.5 percent of GDP in 2004)[9] and debt service payments are almost equal to total revenue.[10]

Since liberal trade policies were adopted in 1977, the external and import sector have both grown, with growth in the import sector outpacing export growth and leading to a negative trade balance. Surpluses in capital accounts, however, have offset the negative balance so the overall balance of payments has been positive. Service sector growth and rising remittances have also contributed to substantial surpluses in the balance of payments for several years. Export diversification would make the country less vulnerable to external shocks than would be the case if Sri Lanka continued to depend on a limited basket of exports to a few export destinations.

In the late 1970s, Sri Lanka replaced its multiple exchange rate regime with a unified regime with a managed float exchange rate system. From 1977 onwards Sri Lanka was able to relax its foreign exchange controls on current account transactions while accepting the IMF's Article VIII obligation in 1994. In 2001, the exchange rate regime moved to a free float system.

Since 1987, Sri Lanka has privatized hotels, development banks, plantations, and cement, tire, ceramics, hardware, fertilizer, and textile companies. Over the past decade, it privatized the state-owned telephone company, some state-owned agricultural and livestock farms, the national airline, and gas, insurance, and steel enterprises.

Sri Lanka also has a fairly liberal foreign investment regime.[11] Restrictions on foreign ownership in banking, finance, insurance, air transportation, and coastal shipping were recently relaxed. In 2004, foreign investment was equivalent to 25 percent of GDP; national savings accounted for 21.6 percent as a share of GDP.

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[7] Revenue from import taxes increased to 2.1 percent of GDP in 2004 after rates were increased.

[8] For more than 100 goods.

[9] Foreign debt was a bit more than domestic debt.

[10] The ratio of total debt service payments to government revenue was 96.5 percent.

[11] Private investments are constrained because of ownership ceilings on land and housing, rigid title arrangements, and associated taxation.

Maldives

An archipelago of 1,192 coral islands in the Indian Ocean with a land area of 300 square kilometers, Maldives is 480 kilometers south of India and 720 kilometers south west of Sri Lanka. The highest elevation is six feet above sea level, and only a few islands exceed 2.5 square kilometers. Maldives is surrounded by an exclusive economic zone (EEZ) of 859,000 square kilometers. The EEZ grants the Maldives exploration and exploitation rights in addition to conservation and maritime management responsibilities for this area.

In 2003, the population was about 285,000 and the average population growth rate is less than 2 percent.[12] The GDP was US$645 million with a per capita GDP of US$2,261.[13] In the past decade the economy has been growing at about 7 percent annually. Imports average about 61 percent of GDP and exports about 11 to 15 percent. About 43 percent of the population still lives below the poverty line of Rf 15 (US$1.17) per day. A large expatriate labor force has played a key role in the development of the economy.[14]

The leading sectors are tourism and fishing, followed by transport, communications, construction, and wholesale and retail trade. Together, fisheries and tourism account for almost 40 percent of GDP and more than one-third of employment. Such dependence makes the economy very vulnerable to international and environmental conditions. Tourism accounts for 34 percent of GDP directly and 27 percent of government revenue (2004). Twenty-five percent of tourism's revenue contribution is in the form of a bed-night tax and 31 percent of its non-tax revenue is resource lease rent. Fisheries accounted for 6 percent of GDP in 2004; the distribution and the construction sectors each accounted for 4 percent of GDP.

The trade and investment regimes are liberal. Residents and non-residents freely import or export capital through the foreign exchange market; residents do not need permission to maintain foreign currency accounts locally or abroad; and profit transfers from inward direct foreign investment are unrestricted. Since 1994, Maldives has maintained a managed fixed exchange rate using its national currency Rufiyaa (Rf),[15] where the Rufiyaa is fixed at Rf12.80 per U.S. dollar with a spread of 10 laari[16] between buying and selling rates, which remain at 12.75 and 12.85, respectively. Structural weaknesses include the state's dominant role in the economy, the narrow tax base, and fiscal constraints.

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[12] More than a quarter of the population lives in Male, the capital, on about 2.5 square kilometers.

[13] Despite high per capita GDP (almost twice that set by UN for classification as an LDC) the UN classifies Maldives as a least developed country (LDC.) The Maldives holds the status of a Small Island Developing State (SID) a group which is characterized by small size and narrow economic base that render them economically vulnerable to external shocks. The UN folds SIDs into LDCs.

[14] Expatriates make up a high proportion of teachers, medical workers, other professionals, domestic helpers, and construction workers. By the end 2004, 38,619 expatriate workers were in Maldives—25 percent in tourism and 23 percent in construction.

[15] The Rufiyaa is fully convertible for current and capital account transactions.

[16] 100 laari for 1 Rf.

The government has partly privatized the Bank of Maldives Ltd., Maldives Transport and Contracting Company and State Trading Organization Plc. It has also formed joint ventures with foreign partners to enhance managerial and technical expertise.

Maldives depends on profit transfers from public enterprises for 52 percent of revenue, with the remainder derived from a very narrow tax base. Of tax-based revenue, 63 percent is from import duties and 28 percent from tourism taxes. Personal income, capital gains, wealth, real estate, and business profits are not taxed (except for bank profits). Non-tax revenue includes lease rent on resort islands (35 percent) and public enterprise profits (31 percent).

Government expenditures on social services (41 percent) and economic services (16 percent) have exceeded revenue and increased the budget deficit. External debt stock has averaged 40 percent of GDP in the past two years (US$310 million at the end 2004). Debt-service ratio (as a percentage of exports) was about 4 percent in 2004. The government abolished quantitative restrictions on trade in 1989 and rationalized tariffs in 2000.

According to the government's vision statement, by 2020 the Maldives "will have established the most conducive conditions for brisk commerce and economic activity, and will have become the hub of regional free trade. The country will have a more diversified economy with export-oriented trade in services and industrial development."[17]

Maldives' three-year graduation period from LDC status began in December 2004. After the tsunami, however, it requested that the UN reconsider graduation. When Maldives does graduate, it will face a number of changes in market access, foreign aid, debt burden, and access to other special arrangements (Republic of Maldives 2002). For example, tuna exports to the EU that now enjoy duty-free access will be subject to a 24 percent tariff and stiff competition, while loss of preferential market access under the Generalized System of Preferences (GSP) will curb inflows of foreign direct investment. In 2002, 60 percent of development expenditure and 80 percent of total expenditure on socioeconomic services derived from foreign grants and concessional loans. Decline in aid due to graduation would affect some development and infrastructure projects. The country's debt servicing burden would also increase, with repayment installments increasing by 100 percent of the amount of each maturity due thereafter. Maldives would also lose access to some technical assistance programs (e.g., WTO special and differential treatment).

TRADE AND INVESTMENT COOPERATION

Sri Lanka

Trade Policy

Sri Lanka's economy is very open, with trade in goods in 2004 equivalent to more than 65 percent of GDP. In 2000, Sri Lanka had the lowest import duties in South Asia and a simple and transparent tariff structure devoid of quota ratios, parataríffs, and other nontariff barriers. The

[17] Vision 2020 address by HE the President of the Maldives on the 34th Anniversary of Independence.

highest tariff band was 25 percent.[18] More than 50 percent of the tariff lines in Sri Lanka's tariff schedule carried rates of 5 percent or below, while 73 percent had rates of 10 percent or below. Almost one-fifth carried rates of zero. Trade restrictions applied only for health, security, phytosanitary, and environmental reasons. About 71 percent of imports entered the country duty free. (In addition to the duty-free items on the schedule, these items included imports for certain projects approved by the Board of Investment.).

Since 2001, however, liberalization has suffered from frequent and unpredictable changes in trade and economic policies. Reversals include a rise in tariff rates and the introduction of parataríffs and specific duties (i.e. duties based on volume or quantity, rather than on value.) Sri Lanka recorded its first negative annual growth rate in 2001 (-1.4 percent).[19] With a huge budget deficit, the government had to slow liberalization while taking measures to boost revenue. One such measure was a 40 percent surcharge on imports.[20] In 2002, the surcharge was reduced to 20 percent. However, the tariff structure was complicated by new tariff bands of 2 and 20 percent. Some specific duties were also introduced. Despite all these changes, the average import duty rate[21] did not change significantly.[22] (It was more of a protectionist measure rather than revenue-enhancing one.) Trade liberalization stalled in 2002. According to the 2003 annual report of the Central Bank of Sri Lanka

> …policy direction was interrupted with the introduction of a number of tariff bands in November 2002 replacing the two-band tariff system of 10 and 25 percent, which has been in effect since February 2000. …Meanwhile, 31 items including some restrictions of tobacco and footwear are subject to either ad-valorem or specific duties, which ever is higher. Another 46 items including major agricultural products are still subject to specific duties (207).

By the end of 2003, the number of items under import controls at the 6-digit level (HS code) increased to 376 and the average import duty collection rate increased 5.3 percent (up from 4.8 percent in 2002). A Ports and Airports Development Levy (PAL) of 1 percent of CIF value for imports was introduced in May 2002.[23] (Imports for processing and re-exports were subjected to PAL at the rate of 0.75 percent of the CIF value; the rate was reduced to 0.5 percent in January 2003.) On the positive side, Sri Lanka implemented the WTO Agreement on Customs Valuation from January 2003.

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[18] The 35 percent import duty imposed in 1995 on some agricultural products continues, with some higher duties on a very limited number of items (e.g., tobacco, cigarettes, liquor).

[19] Global recession, prolonged drought, and a terrorist attack at the international airport were all contributing factors to negative growth.

[20] This was coupled with a 20 percent surcharge on corporate income tax and a one percent increase in the National Security Levy. This levy was replaced the following year by a VAT that also replaced the Goods and Services Tax.

[21] The ratio of import duty collection to total adjusted imports.

[22] Declined from 4.9 percent to 4.8 percent.

[23] In lieu of the stamp duty.

In 2004, the government reduced the number of major tariff bands but increased rates. The six-band tariff structure is now a four-band structure of 2.5, 6, 15, and 28 percent. The import surcharge continued at 10 percent, the PAL rose to 1.5 percent, and several cesses were introduced and a Social Responsibility Levy (SRL) was imposed. Some of the charges are clearly parataiffs and protect local industry. The tariff system is now very complicated. Table 6-1 presents a breakdown of the schedule's bands and number of 8-digit tariff lines as of June 2005.

Table 6-1

Tariff Bands of Sri Lanka's Tariff Schedule, June 2005

Band	Number of 8-digit Tariff Lines
Free	635
2.50%	2,170
6%	451
15%	1,625
28%	1,430
75%	4
100%	5
Ad valorem/specific	41
Specific	45
Total	6,406

SOURCE: Author's calculations based on data from Sri Lanka Customs.

How much is an imported item taxed as compared to a similar item manufactured locally? A good that costs Rs.100 CIF (e.g., delivered Colombo) is subject to a 28 percent tariff, an 18 percent VAT, a 10 percent cess (for a couple of hundred 8-digit lines only), a 1.5 percent PAL, and 0.25 percent SRL.[24] This amounts to Rs. 67.50 (Table 6-2). In this case, a domestically produced good is assessed only an 18-percent VAT—no other taxes. Thus, the difference between the imported and domestic good is significant, amounting to nearly 50 percent of the item's value.[25]

[24] Where excise duty applies, tax calculation is much more complicated. The excise duty rate goes in to the VAT base and vice versa. The SRL will also apply to the domestic good as well (e.g., cigarettes). In other words, whenever excise duty applies, SRL will apply to the locally produced good.

[25] For the imported good, the duty-like effect (tariffs plus parataiffs such as the surcharge, PAL, and cess levy) is more than 42 percent. VAT on imported goods is calculated on a loaded base that includes import duty, adding another 7.12 percentage points (25.12–18.00) to the tax burden for the imported good, as compared with the domestic good.

Table 6-2

Total Tax Incidence of a Typical Imported versus Domestically Produced Good

Imports	Duty rate (%)	Duty Value (Rs.)
CIF value	NA	100
Import duty	28	28.00
Surcharge on duty	10	2.80
PAL	1.5	1.50
Cess levy	10	10.00
VAT	18	25.12
Excise duty	0	0
SRL	0.25	0.08
Total cost	NA	167.50
Total tax	NA	67.50
Domestic Good	**Tax rate (%)**	**Tax value (Rs.)**
Ex-factory value	NA	100
VAT	18	18
Excise duty	0	0
SRL	0	0
Total cost	NA	118.00
Total tax	NA	18.00

Note: If excise duty applies to a good, SRL applies to the local good as well, not otherwise. Comparing the two total taxes should be done with caution. See text.

Trade in services (tourism and travel) accounts for about 2 percent of GDP, directly and indirectly. Employing more than 53,000 people directly and 75,000 indirectly, the sector grossed US$413 million in 2004. Industry development is led by the private sector, with the government and the Sri Lanka Tourist Board regulating and promoting tourism. At present, one third of the embarkation levy (US$5) and the one percent levy applied to all establishments approved by the Sri Lanka Tourist Board fund industry marketing and promotion.

The tourism industry aims to increase arrivals to 1 million by 2010. Sri Lanka could attempt to position itself as a regional hub for tourism through collaborative strategies. For example, it could promote packages that explore the region's diverse religious and cultural beliefs and practices (e.g., Buddhism, Hinduism, Islam). Likewise, packages focusing on one set of beliefs could be used to promote diverse regions (e.g., a Buddhist-oriented tour could treat travel to Sri Lanka, India, and Nepal as a single package).

Sri Lanka has signed a memorandum of understanding regarding tourism with Maldives and has an agreement with India on cooperation in tourism.

Investment Policy

In the late 1970s, Sri Lanka established export processing zones (EPZs) and a decade later began its privatization program. Still—and over a shorter period—Malaysia, Thailand, Vietnam, and Sri

Lanka attracted much more foreign direct investment. Sri Lanka permits 100 percent foreign ownership in all areas except the following, which are reserved for Sri Lankans:

- Money lending
- Pawn-brokering
- Retail trade investment with capital of less than US$ 1 million and retail trade in franchise or branded goods with an investment of less than US$150,000
- Personal services other than for export or tourism
- Coastal fishing
- Education of citizens under 14
- Award of local educational degrees.

More than 40 percent ownership in some enterprises requires case-by-case approval (ownership less than 40 percent is approved automatically):

- Production of goods where Sri Lanka's exports are subject to internationally determined quota restrictions
- Growing and primary processing of tea, rubber, coconut, cocoa, rice, sugar, and spices
- Mining and primary processing of nonrenewable natural resources
- Timber-based industries using local timber
- Fishing (deep-sea fishing)
- Mass communications
- Education
- Freight forwarding
- Travel agencies
- Shipping agencies.

Other investments must be approved by particular agencies or the Board of Investment (BOI), up to the percentage of foreign equity specified by BOI:

- Air transportation
- Coastal shipping
- The manufacture of arms, ammunition, explosives, military vehicles and equipment, aircraft and other military hardware, poisons, narcotics, alcohols, dangerous drugs and toxic, hazardous, or carcinogenic materials
- The manufacture of currency, coins, or security documents
- Large-scale mechanized mining of gems
- Lotteries.

Foreign investors may qualify for a wide range of incentives provided by the BOI.

Until the plantation sector was nationalized in the 1970s much of it was foreign owned. FDI was negligible until the 1980s and performance was encouraging in the 1990s. The privatization program of the mid-1990s helped attract FDI, most entering by means of wholly foreign-owned subsidiaries.

Recently, FDI in services, especially communications, has been higher than in manufacturing (apparel), with agriculture lagging in third place. From 1979–2000, Singapore had the biggest

share of cumulative FDI in Sri Lanka, followed by the United Kingdom, Japan, and South Korea (Table 6-3). In several recent years, the India–Sri Lanka Free Trade Agreement has led to India being Sri Lanka's major investment source (UNCTAD 2003).

Table 6-3

Sri Lanka's FDI Sources, Cumulative 1979–2000 (percent)

Source Country	Share in Number of Projects	Share in Total FDI
Singapore	3.9	16.5
United Kingdom	5.4	13.9
Japan	6.0	12.1
Republic of Korea	10.6	11.5
Hong Kong	6.6	10.0
British Virgin Islands	0.6	8.0
Australia	2.4	7.5

SOURCE: *BOI, 2001.*

Although Sri Lanka's ratios of FDI to GDP and to Gross Domestic Capital Formation (GDCF) have been better than the ratios of its South Asian neighbors, they have lagged far behind those of South East Asian countries (UNCTAD 2003). During 1991–1995, FDI inflows into Sri Lanka accounted, on average, for just 4.5 percent of GDCF; this increased to 5.5 percent in 1996–2002. The ratio of FDI to GDP was less than 1.2 percent in 2004. As shown in Table 6-4, 2001 was a very bad year for FDI in Sri Lanka.

In recent years a large amount of FDI flowed into telecommunications, real estate, and other service sectors thanks to liberalization. FDI in manufacturing has been channeled largely into textiles and apparel. At year end 2003, Sri Lanka had an inward FDI stock of US$2,897 million; the stock of outward FDI was much smaller, at US$102 million.

Table 6-4

Sri Lanka's FDI Inflows and Outflows, 1992–2003 (Millions of dollars)

	1992-1997 (annual average)	1998	1999	2000	2001	2002	2003
Inflows	186	150	201	175	82	197	229
Outflows	6	13	24	2	-	11	4

SOURCE: *UNCTAD.* World Investment Report 2004.

Trade and Investment Trends

Industrialized countries, especially the United States, have been the main destination for Sri Lanka's exports since 1977. In the past decade, these countries absorbed 70 to 80 percent of the country's exports. In 2004 the United States absorbed 32 percent and the UK 14 percent

(Table 6-5). India was the third largest destination, absorbing 5 percent of exports in 2003 then 7 percent in 2004. The only other SAARC country in the top 20 was Maldives (1.3 percent). SAARC countries absorbed 9 percent of exports.

Table 6-5

Sri Lanka's Top 20 Export Destinations, 2004

Country	Value (US$ million)	Country	Value (US$ million)
United States	1,865	Singapore	83
United Kingdom	776	Turkey	76
India	385	Canada	72
Germany	272	Syria	66
Belgium	196	Hong Kong	66
Japan	155	Maldives	60
Italy	153	Iran	58
Russia	151	Australia	52
U.A.E.	118	Subtotal	4,900
Netherlands	104	Total	5,757
France	100	Top 20 (% of total)	85.1
Unknown	93		

SOURCE: Calculated from Sri Lanka Customs data.

Asian countries continue to be the major origin of imports, with market share at 57 percent in 2004. SAARC countries accounted for 20 percent of imports. In 2004, India accounted for 18 percent, followed by China (and Hong Kong), and Singapore. No other SAARC member countries were among Sri Lanka's top 20 import sources for 2004 (Table 6-6).

In 2004, manufactured goods made up 21.4 percent Sri Lanka's exports. The top export was textiles and apparel (48.6 percent), followed by tea (12.9 percent). January 2005 marked the elimination of longstanding quotas on trade in textiles and apparel imposed by a number of developing countries. These quotas had long given Sri Lankan exporters access to U.S. and European markets, where quotas restricted imports from large suppliers in China and India. Nearly a year after the quotas ended, Sri Lanka's apparel exports have remained competitive in western apparel markets.

In 2004, Sri Lanka recorded its highest number of tourist arrivals—more than 566,000. The UK was the top generator (106, 645 tourists), followed closely by India (105,151). Most tourists were pleasure travelers. About 10,000 arrived from Maldives and from Pakistan. Arrivals from India and other SAARC countries increased after 2001 when Sri Lanka began issuing visas on arrival to tourists from SAARC countries. (In 2002, arrivals from India more than doubled over 2001 and it was the top tourist generating market for Sri Lanka.)

Table 6-6
Sri Lanka's Top 20 Import Sources, 2004

Country	Value (US$ million)	Country	Value (US$ million)
India	1,358	South Korea	196
Singapore	732	Indonesia	194
Hong Kong	620	Germany	175
China	461	Thailand	163
Malaysia	454	Argentina	152
Japan	412	France	136
Iran	316	Italy	124
Taiwan	314	Saudi Arabia	123
United Kingdom	291	Subtotal	6,913
U.A.E.	246	Total	8,098
Belgium	240	Top 20 (% of total)	85.4
United States	207		

SOURCE: Calculated from Sri Lanka Customs data.

Maldives

Trade Policy

Maldives' trade policy has not changed much in the past five years. The tariff schedule consists of ad valorem tariffs and a specific duty for cigarettes. There are no indirect commodity taxes, surcharges, or parataríffs. Tariffs are the only tax on imports (Table 6-7). In 2004 almost half of the tariff rate lines were at 25 percent.

Maldives has a number of tariff lines for which applied tariffs exceed tariff bindings. In fact, according to the WTO Trade Policy Review for Maldives, applied tariff rates on 149 tariff lines exceed bound rates by as much as 170 percentage points (WTO 2002). A limited number of items are prohibited or restricted for safety, security, and environmental or religious reasons (e.g., alcohol, beverages, pork, used cars, motorcycles). The export regime is relatively open. Although there are a number of islands, smuggling has not been a problem.

Imports of staple foods, mainly rice, sugar, and wheat flour are subject to quotas, but Maldives applies no standards. State trading organizations, the major importers, are allocated an import quota of 70 percent to ensure that staples are continuously available at stable and affordable prices. Retail prices of staples are controlled and capped at the imported price plus Rf 0.20 per kg in Male, and for other atolls at the Male price plus freight. In 2004, imports and exports were US$644.7 million and US$171.7 million, respectively. Maldives has deferred implementation of the Customs Valuation Agreement.

Table 6-7
Maldives' Tariff Schedule, 2004

Rate Band	Number of Tariff Lines	Percentage of Tariff Lines
0%	8	0.10
5%	431	4.61
10%	972	10.41
15%	1,734	18.57
20%	1,291	13.82
25%	4,471	47.87
35%	262	2.81
50%	15	0.16
100%	147	1.57
200%	8	0.09
Laari 30 per stick	1	0.01
Total	9,340	100.00

SOURCE: Calculated from Maldivian Customs Tariff Schedule, 2004.

Supply constraints—numerous small and dispersed islands; heavy dependence on fishing and tourism, inadequately skilled manpower, inefficient legal system—hinder trade expansion. Maldives does not have any export processing zones.

A well-regulated tourism industry has been the main force behind the country's economic growth of the past several years. Tourism accounts for more than 33 percent of GDP, generated about US$478 million in 2004, and employs about 25,000, more than half in hotels. About 40 percent of the hotel workforce is foreign. To maximize the economic impact and minimize the potential negative effects of tourism, the government began promoting lower-volume high-end tourism in lieu of mass tourism several years ago. Maldives now hosts some of the world's top resorts.

The government's National Development Plan identifies policy measures to promote tourism: facilitate local investment in the sector; diversify tourist markets and tourism products; make travel more efficient; encourage planning and management that conserves natural and cultural assets; develop a workforce that can meet high service standards; and encourage public–private sector participation in marketing, sales, planning, coordination, and research. Maldives has signed a memorandum of understanding on tourism with Sri Lanka.

Investment Policy

Maldives' FDI regime provides for 100 percent foreign ownership, in addition to foreign–local joint ventures and investment guarantees. No minimum investment levels are required, but FDI must have a capital level "acceptable to the government." Foreign investors are not excluded from or restricted in any activities. Investors' fees or royalties paid to the government are

negotiated as part of the investment agreement (e.g., garment manufacturers pay a royalty on exports that amounts to an export tax).[26]

FDI inflows have been averaging US$12 million per year for the past five years and Maldives had an investment stock of US$154 million at the end of 2003 (see Tables 6-8 and 6-9). The ratio of FDI to GDP has been hovering at 1.8 percent, and despite the relatively open regime, FDI inflows are low. Manufacturing industries with FDI include boatbuilding, distribution and water and sewerage, construction, cement packing, apparels/clothing, software, and seasonal fishing beyond 75 miles in the waters of the EEZ. FDI-based service operations include tourism, mobile and aircraft telecommunications, banking and financial services, internet, air transport, business services, medical services, spa, educational services, diving and water sports, catering, machine repair and maintenance, and property management.

Table 6-8

Maldives' FDI Inflows and Outflows, 1992–2003 (US$ millions)

	1992-1997 (annual average)	1998	1999	2000	2001	2002	2003
Inflows	8	12	12	13	12	12	12
Outflows	-	-	-	-	-	-	-

SOURCE: UNCTAD. World Investment Report 2004.

Table 6-9

Maldives' Inward and Outward Stocks of FDI, 1980–2003 (US$ millions)

	1980	1985	1990	1995	2000	2002	2003
Inward	5	3	25	61	119	142	154
Outward	-	-	-	-	-	-	-

SOURCE: UNCTAD. World Investment Report 2004.

Trade and Investment Trends

In 2004, Maldives exported US$122.8 million in goods, with US$32.6 million in goods exported to the United States (Table 6-10). The top 20 export destinations absorbed 99.9 percent of the country's exports. Among SAARC members, Sri Lanka and India (with US$0.5 million) were the only countries to import a significant amount of Maldivian goods in 2004.

Maldives imported US$641.8 million in goods in 2004 (Table 6-11). Singapore was the top source, followed by Sri Lanka, UAE, and India. The only two SAARC countries in the top 20 import sources were Sri Lanka and India. The top 20 sources accounted for 94.7 percent of Maldives' imports

[26] The garment royalty varies from country to country.

Table 6-10
Maldives' Top 20 Export Destinations, 2004

Country	Value (US$ million)	Country	Value (US$ million)
United States	32.6	Malaysia	0.7
Thailand	28.8	Netherlands	0.6
Sri Lanka	15.1	India	0.5
Japan	14.4	Switzerland	0.2
U.K	12.0	South Korea	0.2
Germany	6.0	Greece	0.1
Singapore	4.8	Saudi Arabia	0.1
France	2.8	China	0.1
Italy	2.1	South Africa	0.0
Indonesia	1.0	Top 20	99.9%
Hong Kong	0.8	Total	122.8

SOURCE: Maldives Customs.

Table 6-11
Maldives' Top 20 Import Sources, 2004

Country	Value (US$ million)	Country	Value (US$ million)
Singapore	160.8	Japan	12.1
Sri Lanka	68.5	Italy	12.0
U.A.E	66.6	Germany	10.8
India	65.8	Hong Kong	10.4
Malaysia	48.7	Canada	8.8
Bahrain	32.0	United States	8.4
Thailand	24.5	New Zealand	8.4
Australia	17.3	China	8.0
U.K	13.7	South Africa	5.7
Indonesia	12.8	Top 20	94.7%
France	12.4	Total	641.8

SOURCE: Maldives Customs.

Exports are concentrated in fish and fish products. Imports include food, fuels, and inputs for apparel manufacturing. When the global textile and apparel quota regime ended in 2005, foreign investors (e.g., from China and India) who had utilized Maldives as a production platform for entering quota-restricted U.S. and European markets left Maldives, effectively shutting down the apparel industry. This changed data on destinations, exports, and imports but had little influence

on the general economy.[27] Maldives, for example, benefited little from the EU's Everything But Arms initiative because of rules of origin.[28]

In 2004, more than 616,000 tourists visited Maldives, more than 77 percent of them European. In the last five years, on average, 21 percent of European tourists hailed from Italy, 19 percent from the United Kingdom, 12 percent from Germany, 8 percent from France, and 5 percent from Switzerland. In Asia, the second biggest market for Maldivian tourism, Japan was the largest source of tourists (7.6 percent) followed by China, India, Republic of Korea, and Sri Lanka. In January 2005, 20 of Maldives' 87 resorts closed temporarily because of the tsunami. The previous year, resorts had operated at full capacity. Authorities project that most of these resorts will reopen by mid-2005 and that occupancy rates will return to normal by the end of 2005.

Weaknesses in the Maldivian economy are aggravated by heavy dependence on fisheries and tourism. Ensuring a stable economy will require diversifying the economic base. FDI flows due to access to larger markets would widen the economic base, and here a properly structured and negotiated regional arrangement can be helpful.

The Government of Maldives is committed to greater regional integration with SAARC member countries. According to its Sixth National Development Plan, the government is aiming for Maldives to become a top-ranking middle-income country by 2020—a "hub for regional free trade" with the right "conditions for brisk commerce and economic activity" and a "more diversified economy with export oriented services trade" (viii).

TRADE COMPLEMENTARITIES AND COMPARATIVE ADVANTAGE

Most SAARC members have similar production structures and small manufacturing sectors that produce a narrow range of goods. They also tend to compete with each other in the global market on the basis of primary products. This poses an immediate dilemma for attainment of a free trade area because lack of diversity limits the pace of integration.

The region's range of potential complementarities is, however, wide. That potential can be realized by diverting trade from traditional sources to SAARC countries and by easing import restrictions on products not traded by member countries. In fact, prospects for intraregional trade are dimmed mostly by restrictive trade practices and, to a lesser extent, supply-side constraints among India's smaller partner countries in the region, rather than inherent lack of complementarity.

The fact that India, the largest market, is not purchasing enough goods from other SAARC countries could be seen as a major obstacle to the progress of integration with promised equity;

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[27] Most employees in garment factories were foreign, so most job loss among Maldivians was in indirect employment.

[28] Maldives was denied derogation from the EBA's rules of origin in the late 1980s and mid-1990s. Nepal is the only SAARC country qualified for derogation.

other SAARC countries see India's nontariff and tariff restrictions as unfairly depriving them of export opportunities. India has long maintained a restrictive trade regime that favors import-substituting industries. And despite progress in easing trade protections in recent years, even today in India there are sectors reserved for local small and medium enterprises (e.g., fountain pens). More broadly, half of the manufactured goods from SAARC countries consist of textile and leather products. They are subject to very high duties in India, where more than 76 percent of the region's population live. Many of Sri Lanka's manufacturing products have competitive or comparative advantage over India's but exports of them are thwarted high tariffs and nontariff barriers.

In addition, weaknesses among many of the SAARC countries (the "supply side") also impede trade based on comparative advantage. In general, SAARC members other than India have relatively undeveloped manufacturing sectors outside of certain niche industries, (especially apparel.) This limits competition with sheltered high-cost producers. Increased competition can only occur when industries capable of producing similar or "like" products under different cost conditions exist.

According to a study by the Pakistan Institute of Development Economics (PIDE) on revealed comparative advantage and trade complementarity in South Asia, the region is characterized by an almost identical pattern of comparative advantage in a relatively narrow range of products. The low values of trade complementarity indices indicate the lack of strong complementarities in the bilateral trade structures of South Asian countries. More specifically, exports of Bangladesh, Nepal, Pakistan, and Sri Lanka depict weak compatibility with Indian imports.

The study, however, also finds that intraregional trade can be expanded for some products. For example, economic ties could be strengthened through measures that broaden the composition of intraregional trade with a major focus on achieving vertical specialization; joint export marketing of competing regional export products; deepening of trade liberalization under SAPTA, promoting monetary cooperation, and encouraging joint industrial ventures. But promotion of regional economic cooperation is unlikely to succeed without political harmony and convergence in economic perceptions, essential prerequisites in forging an economic and trade alliance in South Asia (PIDE 2003).

REGIONAL TRADE AND TRADING ARRANGEMENTS

Sri Lanka

In 2003, Sri Lanka had a positive trade balance with least developed SAARC countries. It continues to have trade deficits with India and Pakistan. India is Sri Lanka's largest trading partner in SAARC with two-way trade of US$1321.21 million in 2003 followed by Pakistan (US$107.71). Sri Lanka does not trade much with Nepal or Bhutan (Table 6-12). Both countries are landlocked, so exports have to go through India or Bangladesh.

Table 6-12
Sri Lanka's Trade Imbalance, 2003(US$ million)

Country	Trade		Trade Balance	
	Exports	Imports	Bilateral	Global
World	4,699.1	6,671.90		(1,972.8)
Bangladesh	11.17	5.64	5.53	
Bhutan	…-	…-	…	…
India	245.05	1,076.16	(831.11)	
Maldives	55.46	22.65	32.81	
Nepal	1.66	0.00	1.66	
Pakistan	36.73	70.98	(34.25)	

SOURCE: IMF. 2004. Direction of Trade Statistics.

How do Sri Lanka's various trade agreements affect its trading patterns? In March 2000, it concluded its first bilateral agreement with India (the Indo-Lanka FTA); in June 2005 it concluded another with Pakistan. As a member of SAARC it is a party to the South Asian Preferential Trading Agreement (SAPTA) and to the framework agreement on SAFTA. Other agreements include the following:

- ***Bangkok Agreement***. Under this agreement, Sri Lanka provides concessionary rates of duty on 288 items. Only two rounds of negotiations have taken place since the agreement was signed in 1975.[29]
- ***TIFA.*** In July 2002, Sri Lanka signed a TIFA with the United States with a view to concluding an FTA in the future.
- ***Generalized System of Preferences***. Sri Lankan products received preferential treatment under the GSP schemes of Australia, Bulgaria, Canada, EU, Hungary, Japan, Korea, New Zealand, the Slovak Republic, Switzerland, and the United States.
- ***Global System of Trade Preferences***. Sri Lanka participates in the Global System of Trade Preferences among developing countries. Sri Lanka has offered preferential tariff rates for 54 tariff lines at the six-digit level.
- ***Bay of Bengal Initiative for Multi-sectoral Techno-Economic Cooperation***. BIMSTEC is a forum for facilitating and promoting trade, investment, and technical cooperation among members—Bangladesh, Bhutan, India, Myanmar, Nepal, and Thailand. The agreement came into effect in 1997. BIMSTEC hopes to expand cooperation into an FTA in the near future.
- ***Indian Ocean Rim Association for Regional Cooperation.*** This association is studying the feasibility of a preferential trading arrangement among member states.[30]

[29] Signatories are Sri Lanka, Bangladesh, China (accession in 2001), India, Republic of Korea, and Lao People's Democratic Republic.

India–Sri Lanka Free Trade Agreement

In December 1998, Sri Lanka and India signed a free trade agreement that came into force in March 2000 (Table 6-13). The agreement

- Establishes a free trade area through phased elimination of tariffs;
- Requires India to grant a three-year period of duty-free access to Sri Lankan exports and Sri Lanka to grant an eight-year year period of duty-free access to Indian exports, except items on Sri Lanka's negative list;
- Permits negative lists to protect national interests;
- Provides rules of origin criteria that ensure a minimum local value addition;
- Provides safety clauses to protect domestic and national interests; and
- Provides a review and consultation mechanism to ensure smooth operation.

Table 6-13

Summary of India–Sri Lanka Free Trade Agreement

India	Sri Lanka
Rules of Origin require 35% domestic value addition. Or 25% Sri Lankan value addition along with 10% using Pakistani imports. HS code transformation at the 4-digit level. Wholly obtained qualifies for concessions.	
100% removal of tariffs on 1,351 items upon entry into force (6-digit level)	100% removal of tariffs on 319 items upon entry into force (6-digit level)
429 items on the negative list (6-digit level)	1,180 items in the negative list (6-digit level)
Remaining 2,797 items follow phased removal of tariffs up to 100% within 3 years (6-digit level)	50% reduction in tariffs for 889 items upon entry into force with phased out tariffs: up to 70% at the end of the first year; 90% at the end of second year; and 100% at the end of third year (6-digit level)
25% tariff reduction for textiles	Removal of tariffs on remaining 2,724 items will be phased out: not less than 35% before the end of the third year; not less than 70% before the end of the sixth year; not less than 100% before the end of the eighth year (6-digit level)
50% fixed tariff concession for imports of tea from Sri Lanka on a preferential basis annual maximum quota of 15 million Kgs.	
50% fixed tariff concession for imports of garments from Sri Lanka, subject to maximum annual quota of 8 million pieces of which at least 6 million should contain Indian fabrics (no single category should exceed 1.5 million. pieces per annum)	

The agreement's rules of origin are intended to promote domestic value addition. To receive tariff concessions, a product must be wholly obtained from or go through a substantial transformation in a country if it contains material imported from a third country. The criterion is fixed at 35 percent of f.o.b. value, and falls to 25 percent if at least 10 percent of the content of the Sri Lankan export originates from Pakistan. In addition, the Harmonized System code of a final product should differ from the code of non-originating materials used to manufacture it at the 4-

[30] Members are Australia, Bangladesh, India, Indonesia, Iran, Kenya, Madagascar, Malaysia, Mauritius, Mozambique, Oman, Singapore, South Africa, Sri Lanka, Tanzania, Thailand, UAE, and Yemen.

digit level. India's Export Inspection Council and Sri Lanka's Director General of Commerce issue certificates of origin.

A Joint Committee established at the ministerial level is monitoring implementation of the agreement. The committee has nominated an apex chamber of trade and industry from each country to represent the interests of the private sector on matters relating to the agreement.

So far, Sri Lanka's exporters and importers are enjoying higher revenue due to larger trade volumes and rising demand. Joint ventures bring in raw materials, process them, and export the processed goods; FDI is flowing in and out of Sri Lanka; and trade growth is higher than ever. In 2004, trade between the countries topped US$1.8 billion. But when exports from Sri Lanka increase—as they do when duties go to zero—Indian producers pressure the government to impose quotas or ask Sri Lanka to restrain exports (e.g., of pepper, copper, vanaspati). The countries' large sensitive or negative lists cover key export commodities, and despite the agreement's assertion that the lists are to be phased out, no schedule exists for doing so. These lists protect a few producers at the expense of other producers, consumers, and the general economy.

Comprehensive Economic Partnership Agreement. In June 2002, the Prime Ministers of India and Sri Lanka agreed that the FTA should be broadened to cover services and facilitate investment flows. A Joint Study Group has recommended that the Comprehensive Economic Partnership Agreement (CEPA)

- Cover more goods and deepen market access through trade facilitation measures and removal of nontariff barriers;
- Make rules of origin more flexible and conclude mutual recognition agreements between product certifying agencies; and
- Include an agreement on trade in services, measures to promote investment in each other's countries, and other measures of economic cooperation.

CEPA negotiations will begin in early 2006.

Free Trade Agreement with Pakistan

In August 2002, Sri Lanka signed a free trade framework agreement with Pakistan. The purpose of the agreement, which came into force in mid-June 2005, is to establish a free trade area by phasing out tariffs. The salient features of the agreement are summarized in Table 6-14.

Though the India–Sri Lanka FTA is in its fifth year it merits comparison with the FTA with Pakistan. According to Sri Lanka's tariff schedule of June 2005,[31] 1,125 8-digit tariff lines are common in the negative lists of Sri Lanka under both agreements. For 2,485 common 8-digit tariff lines, import duties will phase out to zero by 2008 for Indian exports and by 2010 for Pakistani exports. Seventy common 8-digit tariff lines are already duty free for both countries. In

[31] At the 8-digit level. The agreement was signed at the 6-digit (internationally accepted) level.

addition, Pakistan can freely export to Sri Lanka 49 tariff lines at the 8-digit level that are in the negative list for India. See Table 6-15. Rules of origin under the agreement with Pakistan are less stringent.

Table 6-14

Summary of Pakistan– Sri Lanka Free Trade Agreement

Pakistan	Sri Lanka
Rules of origin require 35% domestic value addition. Or 25% Sri Lankan value addition along with 10% using Pakistani imports. HS code transformation at the 6-digit level. Wholly obtained qualifies for concessions.	
100% tariff removal for 206 tariff lines upon entry into force (6-digit level)	100% tariff removal for 102 tariff lines upon entry into force (6-digit level)
540 tariff lines on the negative list (6-digit level)	697 tariff lines on the negative list (6-digit level)
4,680 tariff lines of 5,224 at 6-digit level will become duty free over three years: 34% by the end of the first year, 64% by the second, and 100% after three years.	4,527 tariff lines of 5,224 at 6-digit level will become duty free over five years: 30% tariff reduction by the end of the first year, 40% by the second, 60% by the third, 80% by the fourth and 100% after 5 years
Special tariff rate quotas (TRQs):10,000 MT of tea free of duty per annum; 1,200 MT of betel leaf per annum at preferential margin of 35%	TRQ for 6,000 MT of Basmathi rice and 1,000 MT of potatoes free of duty per annum.
TRQ of 35% duty concession for 200,000 pieces in each of 21 categories of Sri Lankan apparel products without rules of origin on fabrics.	
20% preferential tariff margin on ceramic tiles and tableware (No complete tariff elimination).	

Table 6-15

Comparison of Sri Lanka's FTAs with India and Pakistan, June 2005

No. of Tariff Lines	India–Sri Lanka	Pakistan–Sri Lanka
49	Negative	100%, immediately
657	Negative	Residual list
1,125	Negative	Negative
4	Negative	Residual list
36	100%, immediately	100%, immediately
1,009	100%, immediately	Residual list
34	100%, in 3 years	100%, immediately
346	100%, in 3 years	Residual list
641	Residual list	100%, immediately
2,485	Residual list	Residual list
20	Residual list	Negative
Total 6,406		

SOURCE: Author's calculations.

Agreements to which Sri Lanka is a party and which were in force as of mid-June 2005 are summarized in Table 6-16. The negative list, duty free list, and positive list of each agreement is given out by 8-digit tariff lines in Sri Lanka's tariff schedule of June 2005. (There are 6,406 8-digit tariff lines.)

Table 6-16

Summary of Agreements, June 2005 (8-digit level)

Agreement	Negative List	Duty-free List	Positive List
India–Sri Lanka FTA	1,831	2,034	2,541
Pakistan–Sri Lanka FTA	1,145	763	4,498
SAPTA (for developing countries)		7	194
Bangladesh		0	25
Sri Lanka–SAPTA LDC		6	155
Sri Lanka - SAARC		0	5
Generalized System of Trade Preferences		2	86
Bangkok Agreement		11	297

SOURCE: Author's calculations.

Maldives

Maldives does not have a natural resource or raw material base and depends heavily on imports, especially from developed countries. As shown in Table 6-17, Maldives has a trade deficit with almost all SAARC countries (except Pakistan where imports and exports are almost equal in 2003). The country's biggest trading partner in South Asia is Sri Lanka, followed by India. It does not trade with Bangladesh, Bhutan, or Nepal.

Table 6-17

Maldives' Trade Imbalances, 2003

Country	Trade (US$ Million)		Trade Balance (US$ Million)	
	Exports	Imports	Bilateral	Global
World	112.36	470.67	NA	(358.31)
Bangladesh	0.00	0.00	0.00	NA
Bhutan	-	-	-	NA
India	0.35	47.75	(47.40)	NA
Nepal	0.00	0.00	0.00	NA
Pakistan	1.78	1.74	0.04	NA
Sri Lanka	28.29	64.49	(36.20)	NA

SOURCE: IMF. 2004. Direction of Trade Statistics.

Maldives' one bilateral agreement, which is with India, became effective on March 31, 1981. Basically a most-favored nation type of agreement, it requires both countries to accord commerce

of the other treatment no less favorable than that accorded third countries. It does not prohibit either from granting or continuing

- Privileges that facilitate frontier trade;
- Advantages and privileges to any neighboring countries;
- Advantages resulting from a customs union, a free trade area, or similar arrangements already concluded or to be concluded; and
- Advantages or preferences accorded under any scheme to expand trade and economic cooperation among developing countries open to all developing countries.

Maldives is also eligible for the General System of Preferences in most industrialized countries, except the United States, its main export market. Canned fish exports to the EU benefit the most from GSP treatment.[32] Once Maldives is no longer an LDC, it could lose GSP benefits.

As a member of SAARC, Maldives is a party to SAPTA. Like Bangladesh, Bhutan, and Nepal, it is an LDC entitled to special and more favorable treatment.

SAFTA AGREEMENT

The Framework Agreement on South Asian Free Trade Area (SAFTA) was signed in January 2004 during the SAARC Summit in Islamabad. In January 2006 members will begin implementing the agreement by phasing out tariffs over 10 years. The salient features of the agreement are summarized in the Introduction chapter of this compendium. 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 Maldives) having a longer period to phase in the lower rates. Under Article 7.1-c, 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.

Implementation Issues

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 nontariff barriers. Note also that India's size and geographic reach greatly influence trade arrangements in SAARC. India shares borders with all SAARC countries, except Maldives and Sri Lanka—but is closer to both than are 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 subregional groupings that include other SAARC members, accounts for a large share of intraregional trade, and is the major trading partner for most SAARC members. Thus, most trade-related issues involve India.

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[32] This is because of rules of origin criteria and product exclusions.

Sensitive Lists

Sensitive lists will cover so many items (about 20 percent for developing countries and 30 percent for LDCs), that concessions will likely be granted only for items that are not traded and on agricultural products and raw materials for which import duties are already low or nonexistent. Product-by-product negotiation will exacerbate this situation. The lists could very well be a collection of mutually exclusive negative lists derived from member countries' bilateral agreements. And having one negative list for developing countries and another for LDCs will create problems. The framework agreement does not mention phasing out the lists.

Infrastructure and Transport

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

Other Trade Agreements

Bilateral and other regional agreements could undermine the SAFTA process. The sensitive lists of bilateral agreements may be smaller and domestic content requirements could be less stringent. If this is the case, trade between parties to the bilateral or other regional agreement would naturally take place on the most advantageous terms—rendering SAFTA largely irrelevant.

On the positive side, subregional or bilateral agreements could work to SAFTA's advantage. Such agreements may encourage coproduction on a bilateral or subregional basis. This in turn could help producers meet rule of origin requirements under SAFTA. This, however, depends on the particular rules of origin that apply to SAFTA-qualifying trade. If SAFTA permits "regional cumulation" (whereby the local content of goods produced in the region is measured on a regional, rather than solely national basis), such terms will work to the advantage of smaller countries who would not otherwise meet the rule-of-origin requirements. For small countries, particularly those lacking any significant resource or industrial base, such as Maldives, rules of origin will be difficult to meet in the absence of regional cumulation.

Trade Facilitation

The lack of automated electronic interchange for such items as cargo declarations, licenses and permits, duty payments, and cargo releases, makes trade transactions in the region difficult. Sri Lanka and Maldives, which have both simplified their customs procedures, have already put in place the ASYCUDA++ system and now need to harmonize HS codes. Sri Lanka has also automated its cargo clearance systems and implemented the WTO/GATT Valuation Agreement. Maldives' electronic data interchange system permits registered users submit import and export documents electronically.

Article 8 of the SAFTA Framework Agreement addresses trade facilitation. Facilitation can be improved considerably within the existing framework and without incurring heavy capital investments by

- Synchronizing business timings at borders,
- Simplifying and standardizing customs procedures,
- Standardizing trade documents,
- Establishing joint customs operations, and
- Simplifying transit trade.

Parataiffs and Nontariff Barriers

In the past ten years, many countries in South Asia have independently cut tariffs. Meanwhile, many products are increasingly subject to nontariff barriers and parataiffs, such as infrastructure development fees, surcharges, and special fees on imports. These barriers nullify the benefits of tariff liberalization, and ensure that informal trade persists despite lower tariffs. Parataiffs in Sri Lanka, for example, are eroding the margin of concessions granted to exporters who are eligible for concessions under trading arrangements.

New nontariff barriers include customs valuation, subjectivity, and discretionary interpretation of SAPTA origin certification; restricted ports of entry; and countervailing duties, etc. Some of these barriers can be eliminated by harmonizing standards, requiring mutual recognition of procedures, and establishing common labeling. Others can be eliminated by improving border infrastructure—cross-border corridors, border logistics, testing facilities, and customs facilities, procedures, and documentation.

The SAFTA agreement lacks a definite and binding timeframe for eliminating nontariff barriers. Tariff concessions are meaningless in this context and will be of little benefit.

Other Issues

Measures such as revenue compensation, not a feature of any other regional agreement, will merely nullify the gains of concessions. Sri Lanka, for example, is already having problems with revenue collection due to other recent trade and tariff reforms. And it is not economically resilient enough to be compensating another country for revenue losses equivalent to concessions granted.

Moreover, complicated and high percentage domestic value-addition criteria could prevent countries from meeting local content requirements of rules of origin or from granting tariff preferences otherwise possible under the agreement.

RECOMMENDATIONS

Sri Lanka has long sought greater access to regional markets. Now that it has greater access through bilateral agreements with India and Pakistan, its interest in SAFTA is waning. Possible “burdens” of SAFTA, viewed from Sri Lanka’s perspective (e.g., a revenue compensation mechanism for LDCs) further dampen the country’s enthusiasm. Such a measure would cancel the value of concessions because all SAARC members other than India and Pakistan are LDCs. If Sri Lanka is to benefit from the SAFTA agreement, the SAFTA process will have to go beyond the bilateral agreements.

Maldives will benefit from the SAFTA agreement as its main markets, India and Sri Lanka, accelerate tariff reductions. Since Maldives’ tariff rates are relatively low and it has no industry or

agriculture to protect, the impact on agriculture and industry from additional trade liberalization would be minimal. The economy could benefit very much from inflows of capital that could result from investors seeking toeholds to the region's largest markets. Maldives, however, needs to compensate for likely revenue losses, perhaps by introducing a tax on goods and services, and to minimize rules of origin because it has no raw materials.

Both Sri Lanka and Maldives, as resource-constrained economies with limited industrial capacity, stand to gain from an agreement that can widen the production base to bring resources or intermediate goods in. Both also stand to benefit from a regional approach to attracting tourists, should SAFTA be broadened to cover services.

To help ensure that the SAFTA agreement is beneficial, the following steps are recommended in finalizing it:

- Minimize negative lists and provide a schedule for phasing them out. This will satisfy the WTO's "substantial trade" requirement of Article XXIV, the provision governing the establishment of WTO-compatible regional trade arrangements. Major export items from one country should not be listed on the sensitive list of another country. For Sri Lanka, major export items are apparel and tea; for Maldives, fish and fish products.
- Simplify rules of origin so they are transparent and at least equivalent to the rules of bilateral agreements. Among existing bilateral agreements, the "best" rules will need to be agreed for SAFTA. For example, rules under the Pakistan–Sri Lanka free trade agreement are a better model than those under the India–Sri Lanka agreement.
- India must take the lead in making significant tariff cuts. India's dominance in the region cannot be overstated, and market access commitments by India will largely determine how significant SAFTA's potential is for the smaller economies in the region.
- Provide for a trade facilitation process that harmonizes standards, streamlines customs procedures, expedites banking procedures, and deals with other procedural or administrative barriers to regional commerce. Trade facilitation measures will help cut transaction costs, especially for small and medium enterprises and the poor.
- Remove constraints on the movement of capital to encourage regional and global investment.
- Make available technical cooperation and assistance for LDCs to enhance infrastructure, technology, and human capacity. Given proper commitments from developing countries, a country such as Maldives will benefit from such assistance.
- Encourage countries that stand to lose revenue to undertake fiscal reforms and examine other forms of taxation, such as direct or consumption taxes, to compensate for possible revenue losses.
- Discourage antidumping and countervailing actions, which impede trade and undercut the benefits of free trade.
- Minimize visa restrictions to permit free movement of people in the region. Maldives and Sri Lanka already provide visas on arrival to tourists from SAARC countries.

- Address cooperation in the services sector to facilitate trade and investment flows in the region.

If the SAFTA agreement is to succeed, all these issues must be addressed with firm commitment and measures implemented according to some sort of schedule. In addition, unilateral liberalization in trade in goods and services should be encouraged to minimize negative effects such as trade diversion.

CONCLUSIONS

When the heads of seven SAARC member countries signed the SAFTA framework agreement in January 2004, they signaled their determination to achieve regional economic integration. Frustrated by the lack of progress since then, however, some countries are exploring alternatives. For its part, in June 2005 Sri Lanka and Pakistan began implementing a free trade agreement, the first of its kind for Pakistan.

Does SAFTA make economic sense for Sri Lanka? Yes, if doing so leads to deeper trade and investment liberalization and sound trade facilitation measures. But for Maldives, with almost no raw materials or natural resources, few human resources, and a very narrow tax base, SAFTA will not be of much help, especially if rules of origin are cumbersome and inflexible and no technical assistance is provided. Maldives also needs to address revenue needs internally because financial compensation for revenues lost as a result of tariff reductions under SAFTA is unlikely.

If SAFTA is to succeed, trade liberalization and facilitation must occur in tandem, covering depth of tariff cuts, rules of origin, nontariff barriers, parataiffs, and harmonization of standards, customs procedures, and banking procedures. In addition, issues involving facilities for every mode of transport—air, sea or land—and the needs of landlocked countries for transit facilities should be addressed. Moreover, sensitive lists need to be smaller and phased out according to a schedule and rules of origin need to be simple and minimal.

At the same time, all countries must carry out fiscal, monetary and trade reforms to facilitate regional integration. Regional agreements such as the SAFTA agreement can benefit member countries so long as the countries undertake trade reforms to avoid trade diversion. Maldives, for example, will benefit when its two biggest trading partners reduce barriers. Sri Lanka will benefit to the extent that SAFTA holds more promise than existing bilateral agreements with India and Pakistan. Regional cooperation holds great promise for tourism in particular, an industry important to both Sri Lanka and Maldives.

In sum, regional economic cooperation in South Asia is likely to be complex and gradual, requiring the commitment and perseverance of all SAARC member countries.

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7. Pakistan

Shahid Javed Burki with Mohammed Akbar

Of all the economies in South Asia, Pakistan will feel the impact of the successful launch of the South Asian Free Trade Area (SAFTA) most strongly. The country will gain in several ways. The share of trade in its gross domestic product (GDP) will increase, foreign direct investment will increase, the structure of the economy will change, long-term growth prospects will improve, the incidence of poverty will decline, and the quality of the legal system will improve.

"Successful launch" means that the member countries of the South Asia Association of Regional Cooperation (SAARC) will approach the regional trading arrangement with the understanding that the agreement is meant to improve the welfare of all the states of South Asia. No country will attempt to gain for itself advantage over others by denying others the benefits of being part of a large South Asian market. A successful launch also means that SAFTA will develop into areas that are not currently in its scope—that is, it will allow the entry of countries on the region's periphery. It should be possible to bring Afghanistan into the fold relatively quickly; this will benefit not only Afghanistan, but India and Pakistan as well.

We reach the main finding of this study—that SAFTA will have a decidedly positive impact on Pakistan—after reviewing how the country's economic and trade systems have developed over time. We provide a brief overview of the model of economic growth that South Asian countries followed for several decades after achieving independence; analyze the composition of Pakistan's exports and imports as well as the direction of exports and the origin of imports; examine the openness of Pakistan's economy and how it is viewed by the world outside; review the impact of Pakistan's trade policies on the country's trade regime; and examine some of Pakistan's bilateral and multilateral trading arrangements, and how trade relations are developing between Pakistan and India. Finally, we analyze the possible impact of SAFTA on Pakistan's trade and the structure of its economy and enumerate the study's main conclusions.

INTEGRATED SOUTH ASIAN ECONOMY UNDER BRITISH RULE

Before 1947, the British governed most of the South Asian mainland from New Delhi. The areas that now constitute the independent states of Bangladesh, India, and Pakistan were parts of a single, integrated economy linked by an elaborate network of roads and railways. Although Nepal and Bhutan were not part of the British Indian empire, they were bound with it through treaties that gave the British various kinds of oversight over the affairs of the two semiautonomous states. There was considerable trade among these areas. Intercountry trade continued even after the

partition of British India. Surpluses in food grains, jute, raw cotton, spices, dried fruit, and condiments were important exports from what was then Pakistan to what had become India. India exported raw materials such as iron and coal to Pakistan as well as a large variety of finished consumer products. For Pakistan in the late 1940s, more than 40 percent of exports were to India and 20 percent of imports were from India.

For a few years after partition, India continued to use Pakistan's road and railway network for its exports and imports. Some of India's international trade—in particular surplus commodities from Punjab and Rajasthan—continued to use the Karachi port. Indian trade with Afghanistan also flowed through Pakistan. But in 1949 India and Pakistan became hostile neighbors.

This happened quickly when Pakistan refused to follow other members of the Sterling Area[1] in devaluing their currencies with respect to the U.S. dollar. Proclaiming that India would not pay 144 of its rupees in exchange for 100 Pakistani rupees, Delhi launched a trade war with its neighbor. The result was both catastrophic (in the short term) and fortuitous (in the long term) for Pakistan. The extreme shortage of basic consumer goods in Pakistan caused by the trade war pushed the country to develop an industrial base of its own. Government provided generous incentives to the private sector to invest in industry. Pakistan's industrialization was helped by the Korean War (1951–1954), which produced a boom for several commodities—raw cotton, raw wool, raw leather, and raw jute—in which Pakistan had large export surpluses. The windfall gains in export earnings produced by the commodity boom gave Pakistan the foreign exchange it needed to import capital goods for the industrialization drive the government had launched.

The 1949 trade war with India had consequences unexpected by Delhi or Karachi (then the capital of Pakistan). It provoked Pakistan to respond energetically to the Indian move. The Indian action quickened the pace of industrialization in Pakistan; shifted the attention of the government from agriculture, by far the largest sector of the economy, toward manufacturing; brought the fledgling private sector to the forefront of the economy; and severed economic links with India.

What would have happened to the structure of the Pakistani economy if India had not launched the trade war of 1949? This question is important because the easing of tensions between the two rivals may once again propel Pakistan toward the realization of its real economic potential. At the time of its founding, Pakistan had two distinct economic advantages over its neighbor—a well-endowed agricultural sector and a more developed transport infrastructure. Both were the result of the British administration's preoccupation with the threat of famine in its Indian domain. Recurrent food shortages not only had taken a heavy toll in terms of lives lost, but also presented the British a security challenge. There was growing resentment against the inability of the government to produce enough food to feed the entire population. The government reacted to the political threat posed by recurrent famines by irrigating large tracts of virgin land in the northwestern provinces of Punjab and Sindh with water from the Indus River system. An elaborate system of roads and railways carried the large grain surpluses produced by these

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[1] The Sterling Area referred to the countries Britain had once ruled. For several years after India gained independence and India and Pakistan emerged as independent states they continued to remain in the Sterling Area.

investments to the food-deficit areas in the country's northeast. The port of Karachi was also developed for bulk commodities such as wheat and rice to be ferried to Kolkata, the main port in the food-deficit areas of British India.

Partition in 1947 and the hostility that developed between India and Pakistan disrupted this economic system. Pakistan neglected its agricultural sector while pursuing rapid industrialization, and India turned toward other countries with food grain surpluses to import wheat and rice. The government's indifference to agriculture turned Pakistan into a food-deficit area within a decade of independence. This was an extraordinary development for what was once called the granary of British India. The Pakistani state also neglected the long-distance transport of bulk goods. The railway system, once the pride of British India, fell into disrepair and decay. For a variety of reasons, some of them political, Pakistan developed a relatively efficient, privately managed trucking system that gradually took long-haul business away from the government-owned and -managed railway.

Could this direction be reversed and could Pakistan once again use its large agricultural potential to provide food grains, industrial raw material, and high value-added crops to India? Could Pakistan once again develop its communication and transport infrastructure to become the hub of the economies of northern South Asia and southern Central Asia? The answer to these questions will depend in part on how India and Pakistan open their economies to one another, either within the context of SAFTA or without it. First, though, a discussion of the process of economic openness that began in South Asia in the early 1990s will be useful.

SOUTH ASIAN PREFERENCE FOR IMPORT-SUBSTITUTION

Although India and Pakistan (including what is now Bangladesh) followed different paths to industrialization—India using the public sector to dominate a number of industries while Pakistan encouraged private entrepreneurship—both used the state to protect industries. The import-substitution policies pursued by the two countries erected high walls of protection around all sectors of the economy. This meant not only high tariffs but also the use of various forms of licensing to control entry into industries. The resulting license *raj* in both countries created inefficiencies, promoted public sector corruption, and constrained the rate of economic growth.

This bias against trade as an engine of growth began to change as a result of internal and external developments. The external reason was the model of growth followed by the countries of East Asia. These so-called miracle economies had used an approach that had at least four components, three of which were related to the role of the state. First, the state played an economic role not by creating an industrial base to be managed by the public sector but by persuading private entrepreneurs to invest in the sectors the government regarded with favor. As Japan had done during its industrialization drive, East Asian states selected the "winners" for investment by the private sector. Second, the state facilitated private investment by allowing industrialists to access the banking system for low-priced loans. Third, the state invested heavily in developing the human resource and in creating capacity to do research and development to support industrialization. The fourth element of this strategy was the aggressive pursuit of markets for

domestic products. The industrialization effort itself was in the hands of the private sector but it took full advantage of the incentives provided by the state.[2]

Trade played a decisive role in accelerating growth and reducing poverty in the miracle economies of East Asia. "So far the Far East generally was characterized by a virtuous interaction among beneficial policies: outward orientation, high literacy, and emphasis on higher education. But the primary role must be assigned to outward orientation that set up the system for high and productive investments," observes Jagdish Bhagwati, the Indian economist, in his recent book on globalization (2004, 63–64).

The 1991 foreign exchange crisis in India persuaded the country's political and economic managers to opt for greater economic openness and begin the long process of aligning the country's economy with those of East Asia. Some of the controls the state had imposed on the economy were lifted and some adjustments were made to lower the tariffs that had protected domestic industry. The result was acceleration in the rate of economic growth, increase in exports, and some foreign interest in investing in the country. The Indian experience served as a model for other South Asian economies. Pakistan instituted its own economic reforms at about the same time, and Bangladesh followed. Openness had finally arrived in South Asia. Nevertheless, the South Asian economies remain more protective than those in East Asia, and bureaucratic controls, although considerably eased, still inhibit intercountry trade.

According to a recent report prepared by the Confederation of Indian Industry, the average tariff in India, at 22 percent, is the second-highest for a major developing country, after Nigeria. A typical international trade deal for India involves up to 30 parties, 257 signatures, and 118 copies of the same document. Imports sit in Mumbai for an average of three weeks, compared with less than 24 hours for other major ports in the world (World Bank 2005).

Given the import-substitution bias of the South Asian economies for almost four-and-a-half decades, trade was used not to promote growth but to find an outlet for excess commodities and goods with relatively low added value. International trade also provided capital equipment that could not be produced by domestic industries. Taxes on trade were also an important source for government revenue in all South Asian countries. Most of them had poorly developed tax systems and continued to depend on easy-to-collect taxes on trade to feed government coffers.

PAKISTAN: COMPOSITION AND DIRECTION OF TRADE

South Asian countries' trade policies resulted in the concentration of trade in terms of both composition and destination. Pakistan's trade involves a few goods and commodities and is directed at only a handful of countries. Only recently has greater economic openness provided new opportunities for finding new destinations for exports as well as new sources of supply for imports.

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[2] See *The East Asian Miracle: Economic Growth and Public Policy* (World Bank 1993), for an analysis of the determinant of the East Asian miracle.

Composition and Destination of Exports

As Table 7-1 shows, the composition of trade has changed in the past decade and a half. In 1990/91, commodities accounted for nearly one-fifth of total export earnings. Raw cotton, rice, and unprocessed leather were the principal export items in this category. Semimanufactures accounted for another quarter of the value of exports. Cotton yarn was the main item in this category. Manufactured goods made up the rest. Even in this category, cotton products—mostly "grey cloth" and low value-added products—were prominent. Over the next decade and a half, the share of primary commodities and semimanufactures declined significantly, with each category accounting for slightly more than one-tenth of the total while manufactures increased to nearly four-fifths.

Table 7-1

Composition of Pakistan's Exports, 1990–2004 (Percentage Share)

Year	Primary Commodities	Semi-manufactures	Manufactured Goods	Total
1990/91	19	24	57	100
1992/93	15	21	64	100
1994/95	11	25	64	100
1996/97	11	21	68	100
1998/99	12	18	70	100
1999/2000	12	15	73	100
2000/01	13	15	72	100
2001/02	11	14	75	100
2002/03	11	11	78	100
2003/04[a]	10	12	78	100

[a]*Provisional.*

SOURCE: *Pakistan Economic Survey 2003-04, Table 9.6*

If the composition of exports is viewed in terms of broad product groups such as cotton and cotton-based items, a different picture emerges from the one suggested in Table 7-1. As Table 7-2 shows, the concentration of commodities changed little over the years. Almost two-thirds of the value of exports is accounted for by raw cotton, cotton yarn, and cotton fabrics. Rice accounts for about 5 percent of the total. Leather is the only item for which exports have declined as a share of the total, from 9 percent in 1990/91 to 5 percent in 2003/04. This was the result of the growth of leather-based industries.

Table 7-2

Pakistan's Major Exports, 1990–2004 (Percentage Share)

Commodity	90/91	92/93	94/95	96/97	98/99	99/00	00/01	01/02	02/03	03/04[a]
Cotton	61.0	59.8	58.7	61.3	59.1	61.0	58.9	59.4	63.3	62.5
Leather	9.1	9.3	8.0	7.7	6.9	6.3	7.5	6.8	6.2	5.3
Rice	5.6	4.7	5.6	5.6	6.9	6.3	5.7	4.9	5.0	5.2
Synthetic textiles	5.7	7.4	7.1	6.1	5.1	5.3	5.9	4.5	5.1	4.2
Sports goods	2.2	1.9	3.2	3.7	3.3	3.3	2.9	3.3	3.0	2.6
Subtotal	83.6	83.1	82.6	84.4	81.3	82.2	80.9	78.9	82.6	79.8
Others	16.4	16.9	17.4	15.6	18.7	17.8	19.1	–21.1	17.4	20.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] *July–March*

SOURCE: Pakistan Economic Survey 2003-2004, Table 9.4

The structural change noted in Table 7-1 was the result of the changes in the composition of cotton-based products. As Table 7-3 shows, while the share of cotton yarn declined significantly, that of cotton knitwear and linens increased. In the past decade and a half, the textile industry in the country has begun to move in the direction of finished products. Unlike Bangladesh and Sri Lanka, Pakistan made little attempt to develop a garment and apparel industry, but concentrated on home and industrial fabrics. Consequently, the shares of knitwear and bed-wear in total exports increased from one-fourth to one-third of the total in the past five years. It is because of this change that the share of manufactures in total exports increased by 20 percentage points, from 57 percent in 1990/91 to 78 percent in 2003/04 (as noted in Table 7-1).

Table 7-3

Pakistan's Exports of Textile Manufactures, 1998–2004 (percentage share)

Item	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04[a]
Cotton yarn	19.0	19.2	18.7	16.1	12.9	14.8
Cotton cloth	22.4	19.6	17.9	19.6	18.6	20.9
Knitwear	14.9	15.9	15.8	14.6	15.9	17.3
Bed wear	12.3	12.7	12.9	15.9	18.4	17.4
Towels	3.6	3.5	4.2	4.6	5.2	4.8
Tents, canvas, and tarpaulin	0.8	0.9	0.9	0.9	1.0	0.9
Readymade garments	13.1	13.8	14.4	15.1	15.1	12.6
Synthetic textiles	8.0	8.2	9.5	7.1	7.9	6.1
Made-up articles	5.1	5.5	5.7	6.1	5.0	5.2
Others	0.8	0.7	-	-	-	-
Total	100.0	100.0	100.0	100.0	100.0	100.0

[a] *July-April*

SOURCE: Pakistan Economic Survey 2003-04, Table 9.5

The concentration of export commodities is matched by geographic concentration. As shown in Table 7-4, some 45 percent of total exports are directed toward half a dozen countries. In more recent years, the United States has been the single largest market for Pakistan's exports, taking in 24 percent of the total. The U.S. share has more than doubled since 1990, while Japan and Germany have receded in importance. For other importers of Pakistani products, the shares in the total have remained virtually unchanged.

Table 7-4 shows a steady increase in Dubai's share in Pakistan's total exports. This is due largely to the redirection of goods and commodities to and from India—the so-called third-country phenomenon—that has become increasingly important for trade between these two countries. Because direct trade with India is limited to a few items, and even for these, both exporters and importers must observe expensive and time-consuming regulatory controls, trade through third countries, which bypasses these regulatory requirements, has increased. As discussed later, one of the important consequences of removing barriers to India–Pakistan trade will be the elimination of these back-door channels.

Table 7-4

Pakistan's Major Export Markets, 1990–2004 (Percentage Share)

Country	90/91	92/93	94/95	96/97	98/99	99/00	00/01	01/02	02/03	03/04[a]
United States	10.8	13.9	16.2	17.7	21.8	24.8	24.4	24.7	23.5	23.6
Germany	8.9	7.8	7.0	7.5	6.6	6.0	5.3	4.9	5.2	5.0
Japan	8.3	6.8	6.7	5.7	3.5	3.1	2.1	1.8	1.3	1.1
United Kingdom	7.3	7.1	7.1	7.2	6.6	6.8	6.3	7.2	7.1	7.5
Hong Kong	6.0	6.6	6.6	9.4	7.1	6.1	5.5	4.8	4.6	4.9
Dubai	2.8	5.9	4.0	4.6	5.4	5.7	5.3	7.9	9.0	7.7
Saudi Arabia	3.6	4.7	2.7	2.6	2.4	2.5	2.9	3.6	4.3	3.0
Subtotal	47.7	52.8	50.3	54.7	53.4	55.0	51.8	54.9	55.0	52.8
Other countries	52.3	47.2	49.7	45.3	46.6	45.0	48.2	45.1	45.0	47.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] *July–March*

SOURCE: Pakistan Economic Survey, 2003-04, Table 9.7

Composition and Origin of Imports

The composition of Pakistan's imports has not changed significantly in the past decade and a half. Two changes are worth nothing, however. First, Pakistan's imports of consumer goods as a share of the total have declined, while imports of raw materials for use in manufacturing goods have increased. This reflects the development of indigenous manufacturing capacity (see Table 7-5). Second, Pakistan's imports of fertilizer have dropped as the development of indigenous production capacity relieved the need for imports. Pakistan is an oil-importing country, with nearly one-fifth of the value of imports accounted for by various crude and refined products. This proportion has not changed over time (see Table 7-6).

Table 7-5

Composition of Pakistan's Imports, 1990–2004 (Percentage Share)

Year	Capital Goods	Raw Material for		Consumer Goods	Total
		Capital Goods	Consumer Goods		
1990/91	33	7	44	16	100
1992/93	42	6	38	14	100
1994/95	35	5	46	14	100
1996/97	37	5	43	15	100
1998/99	31	6	47	16	100
1999/2000	26	6	54	14	100
2000/01	25	6	55	14	100
2001/02	28	6	55	11	100
2002/03	31	6	53	10	100
JULY–MARCH					
2002/03	29	6	55	10	100
2003/04 [a]	32	7	51	10	100

[a] *Provisional*

Source: Pakistan Federal Bureau of Statistics

Table 7-6

Pakistan's Major Imports, 1990–2004 (Percentage Share)

Commodities	90/91	92/93	94/95	96/97	98/99	99/00	00/01	01/02	02/03	03/04 [a]
Machinery [b]	20.5	24.3	22.8	23.1	17.9	13.9	19.3	17.1	18.5	18.2
Petroleum and products	22.2	15.5	15.3	19.0	15.5	27.2	31.3	27.1	25.1	20.1
Chemicals [c]	12.8	12.5	14.0	13.4	16.6	17.5	20.0	15.9	15.1	16.6
Transport equipments	6.7	12.5	5.9	4.7	5.7	5.5	4.0	4.8	5.6	5.6
Edible oil	5.3	5.9	9.6	5.1	8.7	4.0	3.1	3.8	4.8	4.7
Iron and steel	3.3	3.2	3.6	3.9	3.1	3.0	2.6	3.3	3.3	3.4
Fertilizer	3.5	2.5	1.2	3.2	2.8	1.9	1.6	1.7	2.1	1.7
Tea	2.2	2.1	1.8	1.1	2.4	2.0	1.9	1.5	1.4	1.4
Subtotal	76.5	78.5	74.2	73.5	72.7	75.0	83.8	75.2	75.9	71.7
Others	23.5	21.5	25.8	26.5	27.3	25.0	16.2	24.8	24.1	28.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] *July–March*

[b] *Excluding transport equipment*

[c] *Excluding fertilizer*

SOURCE: Pakistan Ministry of Commerce, unpublished memoranda

While the commodity composition of imports stayed more or less the same, there were some shifts in their origin (see Table 7-7). The share of the United States and Japan declined by almost

one-half, from nearly a quarter of the total in the early 1990s to one-eighth in more recent years. The shares of large European countries also declined, whereas those of the Middle East—in particular Saudi Arabia and Kuwait—increased significantly. Saudi Arabia is now the single largest source of imports into Pakistan. The country has provided Pakistan an oil import facility that allows Islamabad to defer payments for oil imports and protects Pakistan from wide fluctuations in the price of oil in the international market.

Table 7-7

Major Sources of Pakistan's Imports (Percentage Share)

Country	90/91	92/93	94/95	96/97	98/99	99/00	00/01	01/02	02/03	03/04[a]
United States	11.8	9.4	9.4	12.0	7.7	6.3	5.3	6.7	6.0	6.3
Japan	13.0	15.9	9.6	8.6	8.3	6.3	5.3	5.0	6.6	6.4
Kuwait	0.7	3.3	5.8	6.9	5.9	12.0	8.9	7.1	6.6	6.7
Saudi Arabia	6.2	5.4	4.9	6.0	6.8	9.0	11.7	11.6	10.7	11.5
Germany	7.3	7.4	6.8	5.6	4.1	4.1	3.5	4.3	4.6	4.0
United Kingdom	4.9	5.2	5.1	5.0	4.3	3.4	3.2	3.4	2.9	3.1
Malaysia	4.0	5.1	8.8	4.7	6.7	4.3	3.9	4.4	4.6	4.2
Subtotal	47.9	51.7	50.4	48.8	43.8	45.4	41.8	42.5	42.0	42.2
Other countries	52.1	48.3	49.6	51.2	56.2	54.6	58.2	57.5	58.0	57.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[a] *July–March*

SOURCE: *Pakistan Ministry of Commerce, unpublished memoranda*

As will be discussed later, both the composition of exports and imports as well as the destination of exports and the origin of imports will change significantly if a free trade area in South Asia comes into being. This will be the case in particular as trade develops with India and possibly with Afghanistan.

PERCEPTIONS OF PAKISTAN'S OPENNESS IN A "FLAT" WORLD

Although Pakistan's economy is more open than the economies of most South Asian countries—certainly compared to India's economy—the overall impression is different. Perceptions are important, particularly in an increasingly globalized economy, in which, as Thomas Friedman puts in his recent book, the world is becoming flat (Friedman 2005). Pakistan's GDP increased 8.4 percent in 2004/05 (third in Asia, behind China and Singapore); to sustain this growth, it will need large flows of external capital to augment its low domestic savings. Foreign interest in Pakistan is contingent on the country's ability to improve its image—to one of economic openness and receptiveness to foreigners and foreign ideas.

Economic Freedom

The fact is, that is not the impression that Pakistan gives, and this is reflected in indices such as those developed and published by *The Wall Street Journal* and Heritage Foundation (see Tables 7-8 and 7-9).

Table 7-8

Index of Economic Freedom

Countries	Ranking
Sri Lanka	80
India	119
Nepal	127
Pakistan	134
Bangladesh	141

SOURCE: Gwartney and Lawson, 2004

Table 7-9

Indices of Economic Openness in South Asia

Index	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Government consumption as share of total	10.0	6.9	8.2	7.9	8.6
Transfer and subsidies as share of GDP[b]	9.3	8.6	-	9.9	8.9
Government enterprises and investment as share of total investment	4.0	6.0	2.0	4.0	4.0
Judiciary independence [a]	3.2	7.0	-	3.0	3.7
Protection of intellectual property[a]	1.8	4.2	-	2.5	3.5
Mean tariff rate[a]	5.7	3.8	7.1	5.9	8.0
Hidden import barriers	4.8	5.5	-	6.0	5.0
Costs of importing	7.3	7.4	-	7.9	6.9
Actual vs. expected size of trade sector[b]	3.6	5.6	3.8	3.9	5.8
Interest and capital market controls	4.4	4.3	1.8	4.6	4.1
Summary index					
Index	5.9	6.3	5.6	5.7	6.0
Rent	83.0	68.0	94.0	90.0	78.0

[a] *Scale of 1-10, with 10 indicating the best.*

[b] *On a scale of 1-10, with 1 indicating full potential realized and 10 entire potential to be realized.*

SOURCE: Gwartney and Lawson, 2004

The 2004 Index of Economic Freedom rates Pakistan at 134, considerably below Sri Lanka, and somewhat lower than India and Nepal. Almost all East Asian countries are ranked as free, with

scores between 1 and 1.99 on a scale of 1 to 5, but all South Asian countries are categorized as mostly unfree, with scores between 3 and 3.99.

According to a more comprehensive index of economic freedom by the same source, Pakistan receives a score of 5.7 on a scale of 1 to 10, with Bangladesh at 5.9, Sri Lanka at 6.0, and India at 6.3. Only Nepal ranks lower than Pakistan, at 5.6. Pakistan ranks 90 of 123 countries evaluated. India ranks the highest at 68, followed by Sri Lanka at 78, and Bangladesh at 83. Hong Kong scores the highest, while Myanmar gets the lowest rank.

Pakistan also performs poorly on this index because of Islamic extremism:

> Where Islam is embedded in authoritarian societies, it tends to become the vehicle of angry protest—Egypt, Syria, Saudi Arabia, Pakistan. But where Islam is embedded in a pluralistic society—Turkey or India, for instance—those with a more progressive outlook have a chance for a better hearing of their interpretation and a democratic forum where they can fight for their ideas on a more equal footing (Friedman 2005, 457).

Potential for Trade Compared to Performance

How is Pakistan's potential in international trade viewed? One group of researchers has measured the deviation of a country's trade sector from its expected size. Because countries of differing demographic and geographic sizes, in different regions, would naturally trade more or less according to these differences, the researchers used a regression model to estimate the size of the trade sector given the size and location of a country. If a nation trades much more than the model predicted, the policy regime must be favorable to trade; if a nation trades much less than expected, there must be significant barriers to trade in place. The model included working-age population, geographic size, length of coastline, absence of coastline, a linear trend variable, and a measure of each country's proximity to world concentrations of demand as variables for determining the potential size of the trading sector.

The results of the exercise suggest that the larger an economy (in terms of either population or geography), the smaller the trade sector. This result accords with economic theory, which suggests that larger population centers such as China and India have greater opportunities to pursue internal comparative advantages and economies of scale; and larger geographic economies such as Brazil, South Africa, Russia, and the United States, have larger reserves of natural resources, reducing the need to import inputs for domestic production. Also, large countries must transport goods and commodities over longer distances to trade with other nations. The model also predicts that countries that are close to areas of demand, such as the United States, Europe, and Japan, will have larger trade sectors.

According to the model, most countries in East Asia—China, Malaysia, Hong Kong, and Singapore—with scores of 10 have achieved their full potential, while the countries of South Asia, with scores ranging between 3.6 for Bangladesh and 5.8 for Sri Lanka, have a long way to go. Pakistan, at 3.9, is near the lowest score in South Asia, while India, at 5.6, is close to the top. These results imply that pro-trade policies and greater openness to the outside world will have greater significance for Pakistan than for India. The same is true for Bangladesh. These two

countries, sitting on the borders of the large and rapidly growing Indian economy—on the periphery of a center of demand—would stand to benefit from the removal of impediments that inhibit regional trade. They will also benefit by becoming more progressive and modern in outlook. What is needed is not merely a change in trade and economic policies but a more effective mechanism to implement these policies in letter and spirit.

CURRENT TRADE POLICY AND TRADE REGIME

An important feature of world trade in the past three decades has been the growing participation of developing countries. Between 1970 and 2000 their merchandise exports grew at an average annual growth rate of 12 percent, compared to 10 percent for the world as a whole. Growth in the world economy slowed sharply in 2001; performance was weak in all three leading economic regions in the developed world, and the spillover effects on developing countries were much stronger than in downturns in the 1990s. As a result, for the first time since the oil price hike at the end of the 1970s, all regions of the world experienced a simultaneous economic slowdown, and a sustained global upswing is not yet in sight.

International trade played a major role in transmitting the slowdown in the developed world to developing countries. All major developing regions were affected, but the impact was most marked in East and South Asia. In South Asia, Pakistan was the most affected country, especially after the September 11, 2001, attacks on the United States and the subsequent war in Afghanistan (e.g., war-risk premium, travel advisories, cancellation of export orders, and perception of foreigners). As the frontline state against terrorism, and facing escalating tension with India, Pakistan's foreign trade suffered one of the most difficult times in the country's history.

There were several unhappy developments on the home front. For the past several years, Pakistan's economy has faced serious difficulties, mainly because of the persistent failure of structural reforms. The imposition of economic sanctions in May 1998, following tests of nuclear bombs in the desert of Balochistan, exposed Pakistan's underlying vulnerability and precipitated a balance-of-payment crisis. After October 1999, an attempt was made to arrest the downward slide. Some signs indicate that not only has the downward slide been arrested, but the economy has turned around and may be poised for a takeoff. GDP growth has increased steadily, from 5.1 percent in 2002/03, to 6.4 percent in 2003/04 and to 8.4 percent in 2004/05.

Pakistan has come a long way since 1998/99, when the country was on the brink of default and international reserves were almost exhausted, economic growth was anemic, debt ratios were alarmingly high, investors' confidence was at its lowest ebb, and credibility among international financial institutions had eroded. In a critical and fragile regional and domestic environment, with constant threats to security (as a result of being a frontline state in the war against terrorism), a prolonged and severe drought, and high oil prices, Pakistan has made an impressive economic turnaround in a short five years.

A broad-based economic recovery, continued strengthening of macroeconomic stability, and the near-elimination of external account vulnerability are among the major successes of the past five years. A sharp increase in growth was accompanied by low inflation, a highly conducive interest rate environment, better revenue collection, fiscal deficit reduction, significant increases in

exports and imports as well as in remittances, some appreciation in the value of the rupee, a decline in both internal and external debt, a substantial increase in foreign direct investment, and an improvement in the credit rating in international capital markets.

Reforms in the Import Regime

Historically, Pakistan has followed a mix of both import-substitution industrialization and export-promotion strategies. Arguments for developing infant industries often took a predominant role in policy formulation. This was reflected in the prevalence of very high import tariffs (averaging 65 percent) until the early 1990s. Even high tariffs, however, could not generate the needed revenues, as Pakistan's restrictive tariff policies were undermined by the use of discretionary powers in the form of user and/or product-specific statutory regulatory orders.[3] As a result, the high tariffs, along with the often misused discretionary powers, created an anti-import bias in the production process and thereby hampered the country's export competitiveness.

During structural reforms, the tariff regime was simplified and rationalized. This was achieved through a reduction in tariff rates and bands (called "slabs" in Pakistan and India) and less reliance on statutory regulatory orders that had overprotected some industries and underprotected others. The maximum tariff rate was reduced from 45 percent in 1997 to 35 percent in April 1999, then to 30 percent in July 2001 and 25 percent in 2002. The number of main tariff bands was reduced to four.[4] However, efforts to rationalize the tariff regime were hampered by exogenous factors, including the terrorist attacks of September 11, 2001, war in Afghanistan, an uncertain situation in Iraq, a military buildup on the Pakistan–India border, and a surge in terrorist activities within Pakistan. These factors kept both investors and buyers away from Pakistan. Nonetheless, the government's deep commitment to continuing the structural reforms, including comprehensive tariff reforms, reinforced investment, which in turn stimulated growth to some extent. The effects of the exogenous factors were minimized.

Generally, Pakistan's applied tariffs are below WTO bound commitments, and the weighted average applied tariff is 14.0 percent, down from 56 percent in 1994. In November 2000, Pakistan reached an agreement with the WTO Balance of Payments Committee to phase out quantitative restrictions on textile imports. The government removed all textile products from its negative list, including woven cotton fabrics, woven synthetic fabrics, bed linens, curtains, certain knitted fabrics and apparel items, tents, carpets, and textile floor coverings. Many of these items are key Pakistani export products. All textile products can now be imported into Pakistan, although the tariff on certain synthetic fibers (scheduled to expire in 2008) remains relatively high.

Pakistan's trade policy in 2004 continued to ban the import of 30 items, mostly on religious, environmental, security, or health grounds. Effective July 1, 2004, Pakistan reduced duties on imported automobiles to between 50 percent and 100 percent from the previous range of

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[3] Statutory regulatory orders were issued by the Central Board Revenue, often influenced by vested industry groups.

[4] The bands are set at (1) 5 percent for most raw materials, (2) 10 percent for most intermediate goods, (3) 25 percent for most consumer goods, and (4) more than 25 percent for luxury items.

75 percent to 150 percent. The government exempted all domestically produced pharmaceutical inputs from its general sales tax through a statutory regulatory order issued in April 2002. Imported pharmaceutical inputs subject to a 10 percent customs duty rate are also exempt from general sales tax. This includes most (but not all) imported pharmaceutical inputs. In fiscal 2002, the government reduced duties on instant print film and instant print cameras to 10 percent from the 30 percent to 200 percent range to eliminate the incentive to smuggle these products.

Significant headway has been made in simplifying, consolidating, and rationalizing statutory regulatory orders to improve the transparency and nondiscriminatory nature of the tariff regime. The total number of tariff-related, user-specific statutory regulatory orders declined to 28 from more than 70 in 1998/99. The government reserves the power, however, to grant sector-specific duty exemptions, concessions, and protections under statutory regulatory orders. In recent years, the use of statutory regulatory orders has decreased. These orders and other trade policy and regulatory documents are published on the Central Board of Revenue's website.

Nontariff Barriers

Pakistan used import licensing and other nontariff barriers widely during its early import-substitution period, but they were never as pervasive or as multilayered as in India. They began to be removed during the 1980s, with progress continuing steadily into the 1990s so that by 1998 the proportion of product lines subject to traditional quantitative restrictions was only 2.7 percent, slightly lower than the proportion in Sri Lanka in the same year. The removal of quantitative restrictions up to this point was undertaken behind declining but still high tariff barriers, however, and in 1998 some industries protected by the remaining quantitative restrictions and by government or government-controlled import monopolies were very large, including, for example, most of agriculture and the fertilizer industry. But starting in 1997/98, Pakistan embarked on a radical trade liberalization program. By 2003, it had eliminated nearly all traditional quantitative restrictions and parastatal import monopolies and drastically reduced the level and simplified the structure of import tariffs. The most sweeping reforms occurred in the agricultural sector, where government trading monopolies were abolished and other government interventions greatly reduced.

An exception to the general removal of quantitative restrictions is the continuation of a longstanding ban on imports from India of products not on a limited positive list of 771 items (corresponding to about 1,500 eight-digit tariff lines). Given the considerable potential of this trade, this practice (together with equivalent informal restrictions by India, which appear to severely constrain Indian imports from Pakistan) is a major qualification to Pakistan's otherwise quantitative restriction-free trade policies.

Another major exception is the continuation of local-content programs in the auto industry. In December 2003, Pakistan requested WTO approval for a second three-year phaseout extension of this program, until December 2006. Pakistan's local-content programs started in 1988, but the Uruguay Round Agreement on Trade-related Investment Measures (TRIMS) required developing countries to remove them in five years—by 2000. Pakistan obtained a three-year extension from WTO and phased out all its programs except the auto programs between July 2001 and December 2003. Pressure from other WTO members was crucial for bringing about this change of policy,

but the change was also facilitated by reductions in tariffs on intermediate materials and components. These reductions made the local-content programs less attractive to local firms because the incentive is to obtain tariff exemptions or reductions for some imported intermediate goods and components in return for commitments to produce or buy other materials and components domestically.

As in India, apart from these exceptions, the main potential source of protective nontariff restrictions arises through the use of technical regulations and regulations based on health and safety. Many of these are being used in Pakistan, including restrictions on imports of second-hand products. Protection of local industries is clearly the dominant motive for the latter (e.g., the bans on the import of secondhand consumer durables such as air conditioners and refrigerators, vehicles, and various types of industrial machinery and equipment).

Customs Valuation

In January 2000, the government began implementing a transactional valuation system pursuant to which 99 percent of import valuation is based on invoice value, in accordance with the WTO's Customs Valuation Agreement. Currently, about 90 percent of imports are assessed duties pursuant to the transactional valuation system. Nevertheless, some traders in food and nonfood consumer products report irregularities and deviations in the application of that system.

Standards and Quality Control

The Pakistan Standards and Quality Control Authority is the national standards body. As of June 30, 2003, it had established more than 21,000 standards for agriculture, food, chemicals, civil and mechanical engineering, electronics, weights and measures, and textile products, including 15,500 ISO standards—1,000 new ISO standards since 2003. No new standards were approved in 2004, however. Testing facilities for agricultural goods are inadequate and standards are inconsistently applied, which industry contends has resulted in occasional discrimination against imports of farm products. Generally, however, importers have not reported the restrictive application of sanitary, phytosanitary or environmental standards. Pakistan accepts most international standards.

Government Procurement

Pakistan has not signed the WTO Agreement on Government Procurement and has not made a commitment to accept its disciplines.[5] Work to be performed for government agencies, including the purchase of imported equipment and services, is often awarded through tenders that are publicly announced or issued to registered suppliers. The government established the Public Procurement Regulatory Authority in May 2002 to strengthen procurement practices. International tenders now are publicly advertised and sole-source contracting using company-specific specifications has been eliminated. There are no buy-national policies.

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[5] This WTO agreement is plurilateral and members may elect to sign it. As of September 2005, 13 members have signed the Agreement on Government Procurement; an additional 9 members are negotiating accession to this agreement.

Political influence on procurement decisions, charges of official corruption, and long delays in bureaucratic decision making have been common in the past. Investors have reported instances when the government used the lowest bid as a basis for further negotiations, rather than accepting the lowest bid under its tender rules. Occasionally, the government reportedly has disqualified experienced and technically proficient bidders otherwise qualified under tender specifications. The government does not invite private tenders for the transportation of crude oil, and requires all transport of crude oil to be conducted by the state-owned Pakistan National Shipping Corporation.

Export Promotion

Pakistan promotes the export of Pakistani goods with measures such as tariff concessions on imported inputs and income and sales tax concessions. Subsidies in fiscal 2004 were confined mostly to wheat and, according to the government sources, totaled roughly $76 million. The government also provides freight subsidies to some products, and these subsidies totaled close to $17 million in fiscal 2004. On January 5, 2005, the government announced that its Export Development Fund would provide a 25 percent air and sea freight subsidy for leather garment exports for calendar year 2005.

Pakistan established its first export processing zone (EPZ) in Karachi in 1989, with special fiscal and institutional incentives to promote exclusively export-oriented industries. The government subsequently established additional EPZs in Risalpur, Gujranwala, and Sialkot in Punjab Province and Saindak and Duddar in Balochistan Province. In 2004, the government went a step further and announced the decision to establish a free trade zone in Gwadar patterned on one across the sea in Dubai. Principal government incentives for EPZ investors include an exemption from all federal, provincial, and municipal taxes for production dedicated to exports, exemption from all taxes and duties on equipment, machinery, and materials (including components, spare parts, and packing material), indefinite loss carry-forward, and access to export processing zone authority “one window” services, including facilitated issuance of import permits and export authorizations.

Export Duties

Use of export duty instruments has declined considerably in the past decade or so. Before that, 25 product groups, mainly agricultural items, were subject to ad valorem rates ranging from 10 percent to 45 percent, specific or compound duties, to collect revenue or discourage exports of raw materials. Despite the elimination of export duties, including tax on cotton, and minimum prices in July 1999, regulatory duties on exports of crushed bones (10 percent), uncrushed bones (5 percent), and raw and wet blue hides and skins (20 percent) are still in force. Minimum price requirements now affect cotton yarn only and are set by the All Pakistan Textile Association. Such restraints on exports tend to reduce the prices of the goods covered and therefore are an implicit subsidy to domestic users of these goods.

Taxation Structure in Pakistan

Taxation structures among member countries of a regional trade arrangement can be a stumbling block to greater integration if they differ greatly. Fiscal harmonization, therefore, must be given top priority as countries move toward economic integration. This is a difficult area, as Europe's experience demonstrates. The June 2005 summit of European countries collapsed over the issue of fiscal harmonization. Pakistan's fiscal system shares many features of those of other large countries of South Asia. And, as with India and to a lesser extent Bangladesh, this structure has been reformed to bring it in line with those in more advanced developing countries. Fiscal reforms have helped to open the economy.

Federal taxes in Pakistan, as elsewhere, are classified into two broad categories: direct and indirect taxes. Direct taxes primarily comprise the income tax, along with the supplementary wealth tax. For the purposes of computing total income and charging tax, income is classified under the following heads:

- Salaries
- Interest on securities
- Income from property
- Income from business or professions
- Capital gains
- Income from other sources.

All individuals, unregistered firms, associations of persons, etc., are liable to tax, at rates ranging from 10 to 35 percent. All public companies (other than banking companies) incorporated in Pakistan are assessed a corporate tax rate of 39 percent. The effective rate is likely to differ, though, on account of allowances and exemptions related to industry, location, and exports.

Tax on dividends received is 5 percent, and when dividends are received from a foreign company, 15 percent. Intercorporation dividends declared or distributed by power generation companies are subject to a reduced rate of 7.5 percent. Other companies are taxed at 20 percent. Dividends paid to all non-company shareholders by the companies are subject to withholding tax of 10 percent, which is treated as a full and final discharge of tax liability in respect of this source of income.

Treatment of Dividend Income

Dividend income received by nonresidents from the state enterprises mutual fund set up by the Investment Corporation of Pakistan, or dividends received from a domestic company out of income earned abroad provided the company is engaged abroad exclusively in rendering technical services in accordance with an agreement approved by the Central Board of Revenue, are not taxed, provided the total amount received is below Rs. 10,000.

A person resident in Pakistan is entitled to a tax relief on any income earned abroad, if such income has already been taxed outside Pakistan. Proportionate relief is allowed on such income at an average rate of tax in Pakistan or abroad, whichever is lower.

The government of Pakistan has so far signed agreements to avoid double taxation with 39 countries, including almost all the developed countries of the world. These agreements lay down

the ceilings on tax rates applicable to different types of income arising in Pakistan. They also lay down some basic principles of taxation that cannot be modified unilaterally.[6]

Customs Revenue

Goods imported to and exported from Pakistan are liable to rates of customs duties as prescribed in the Pakistan Customs Tariff. Customs duties in the form of import duties and export duties constitute about 37 percent of total tax receipts. The rate structure of customs duty is determined by a large number of socioeconomic factors. However, the general scheme envisages higher rates on luxury items as well as on goods classified as "non-essential." The import tariff has been given an industrial bias by keeping the duties on industrial plants and machinery and raw material lower than those on consumer goods.

Central Excise

Central excise duties are applicable on a limited number of goods produced or manufactured in Pakistan as well as on services provided or rendered in Pakistan. For most items, central excise duty is charged on the basis of value or retail price. Some items, however, are charged on the basis of weight or quantity. Goods are classified in accordance with the Harmonized Commodity Description and Coding system, which is used throughout the world. Exports are exempt from central excise duty.

Sales Tax

Sales tax of 15 percent is levied on all goods imported into Pakistan and on all supplies made in Pakistan by a registered person in the course of furtherance of any business carried on by that person. Input tax adjustment is built into the system, and a registered person can adjust the tax payable by him on his supplies according to the tax paid at earlier stages of production. Thus, the tax paid at any stage of production does not exceed 15 percent of the total sales price of the supplies.

Tax Reforms

Since the early 1990s, successive governments have attempted to reform the tax system. These attempts, however, have yielded limited results, and the tax-to-GDP ratio has remained in a narrow band, 11 to 13 percent, since the 1990s.

According to the Organization of Economic Cooperation and Development, tax revenue as a percentage of GDP in developed countries ranges between 30 and 50 percent, with an average of 38 percent, while the average in developing countries is 18 percent. Pakistan's tax-to-GDP ratio, at 12.9 percent, is well below the average for developing countries, and it is comparable to that in other countries in the region (see Table 7-10).

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[6] Pakistan has concluded tax treaties with the following countries: Austria, Germany, Lebanon, Sri Lanka, Bangladesh, Greece, Libya, Sweden Belgium, India, Malta, Switzerland Canada, Indonesia, Mauritius, Thailand, China, Iran, Poland, Tunisia, Denmark, Ireland, Romania, Turkey, Egypt, Italy, Saudi Arabia, Turkmenistan, Finland, Japan, Singapore, United Arab Emirates, France, Kazakhstan, South Korea, United Kingdom, and United States.

Pakistan's low tax-to-GDP ratio is due primarily to inherent weaknesses in the tax system, including inefficient tax administration, a narrow tax base, skewed tax structure, complex and nontransparent tax system, and corruption and evasion.

Historically, Pakistan has depended heavily on indirect taxes (such as sales taxes) to meet its fiscal needs. Although efforts to reduce this dependence have been somewhat successful, indirect taxation still constitutes nearly 67 percent of government's total tax revenue (Table 7-11). In developing countries such as Pakistan, it is easier to generate revenue by taxing consumption and usage of commodities than the wealth and income of the rich. This mechanism, however, raises the cost of living of lower-income groups. Despite its successful implementation of structural reforms and liberalization, the government has not made much progress in this area and still relies on a regressive taxation structure, which disproportionately affects the poor.

Table 7-10

Tax-to-GDP Ratio, Selected Asian Countries

Country	Tax-to-GDP Ratio
Pakistan	12.9
India	14.4
Sri Lanka	14.5
Bangladesh	12.6
Nepal	9.6
China	16.8
Thailand	13.8
Singapore	15.4
Philippines	12.3
Indonesia	13.1
Iran	8.6

Source: World Bank, World Development Indicators

In undertaking structural reform and liberalization, the government has shifted its focus away from customs duty and taxing international trade as a main source of revenue generation to domestic production and consumption in the form of sales tax. During the past five years the share of customs duty has declined and that of sales tax has increased.

Table 7-11

Share of Various Taxes in Pakistan's Total Tax Revenue

Year	Direct Taxes	Custom Duty	Sales Tax	Excise Duty
1999/00	29.2	15.5	30.2	16.9
2000/01	29.5	11.9	36.1	15.4
2001/02	31.0	10.6	36.2	10.4
2002/03	28.6	8.5	36.7	12.9
2003/04	28.6	7.8	37.8	15.5

Source: Central Board of Revenue Year Book 2003/04

Tax reforms have attempted to widen the tax base, strengthen tax administration, promote self-assessment, eliminate whitener[7] schemes, reduce the multiplicity of taxes, and tackle the culture of tax evasion and corruption. An income tax ordinance introduced in 2001 allows for universal self-assessment, uniform tax rates, removal of nonadjustable withholding taxes, elimination of exemptions, and detailed audit. Moreover, the tax survey and documentation drive in 1999/2000 allowed the Central Board of Revenue to net additional income taxpayers and sales taxpayers. It has also profiled 600,000 taxpayers, which will make tax assessment more effective and detect tax evasion and underreporting.

REGIONAL AND BILATERAL TRADE AGREEMENTS

Regional trade arrangements usually take the form of free trade areas, customs unions, or agreements leading to one or the other. They differ considerably in scope. In their simplest form, they provide for the exchange of preferences on a limited range of products between two or more countries. At the other extreme, they may substantially liberalize all trade and contain disciplines that go beyond eliminating tariffs to addressing standards, services, intellectual property, and competition. Although some regional trade arrangements on goods are fully functional and have resulted in high levels of integration, others have been less successful—such as the South Asian Preferential Trading Arrangement (SAPTA).

The increase in regional trade arrangements, coupled with the preference for bilateral free trade agreements, has produced the phenomenon of overlapping membership. Jagdish Bhagwati has called this “the spaghetti bowl” approach to international trade. Because each arrangement tends to develop its own miniature trade regime, a single country frequently has different rules applying to different trading partners. Traders’ costs in meeting multiple sets of trade rules can hamper trade flows.

A quick look at the geographical spread of regional trade arrangements shows that historically, the Euro-Mediterranean region has been the area of the greatest concentration, accounting for more than 50 percent of all such arrangements in force. Although it appears likely that regional trade arrangements will continue to proliferate in the Euro-Mediterranean region, almost as many regional trade arrangements are under negotiation in the Americas. This reflects not only the relative maturity and the dynamism of the process in the two regions but also the importance of regional trade arrangements in improving the economies and the lives of the peoples involved. Even the WTO, the advocate of global integration, realizing the importance of the matter, has given regional trade arrangements a legal status in Article 24 of the General Agreement on Tariffs and Trade (GATT) and Article 5 of the (General Agreement on Trade in Services) GATS. These articles allow regional economic integration agreements in goods and services, provided that the agreements help trade flow more freely among the countries in the group without raising barriers to trade with the rest of the world. Regional trade arrangements and multilateral integration initiatives are supposed to complement each other in the pursuit of more open trade.

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[7] Tax amnesty.

South Asia in general and Pakistan in particular have lagged behind in this trade diplomacy. Intraregional trade in South Asia, although increasing rapidly, is less than 5 percent of total trade. Reasons for the poor economic integration of South Asia include a low level of trust, ethnic and religious conflicts, a multitude of bilateral disputes, and a long tradition of import substitution. As a consequence, the countries of the region end up trading more with the rest of the world than among themselves. Political rhetoric impeding mutually advantageous intraregional trade and myriad import restrictions have prompted smuggling (unofficial intraregional trade is estimated to be two to four times the official trade). The only bilateral free trade agreement in force in the region is between India and Sri Lanka. Sri Lanka and Pakistan also signed a free trade agreement. SAPTA, the other plurilateral regional trade arrangement in South Asia, has failed to gain any significance even after more than 20 years. Very little hope could have been attached to its success, anyway, given the nature of the relationship between the two large nations of the regional trade arrangement—India and Pakistan.

Only recently has Pakistan changed its stance on trade agreements with other countries, both in the region and outside it. Pakistan initiated discussions on a free trade agreement with Sri Lanka in 2002, but the agreement has not come into force, as negotiations on the modalities have not been concluded after three years.[8] Pakistan has also signed a limited trade pact with China, known as Early Harvest. Under this agreement, Pakistan will offer preferential treatment to a limited number of goods imported from China and vice-versa.

Pakistan has signed a trade and investment framework agreement with the United States, which may lead eventually to a free trade agreement between the two countries. The agreement establishes principles for the two nations' trade and investment relationship and provides a forum for the United States and Pakistan to examine ways to expand bilateral trade and investment. A joint council has been created to consider a wide range of commercial issues. The council will establish a permanent dialogue about expanding trade and investment between Pakistan and the United States.

Besides lobbying to join ASEAN, Pakistan has initiated negotiation for free trade agreements with Malaysia, China, and Bangladesh. Some progress has also been made in normalizing trade relations with India.

PROMOTION OF INDIA–PAKISTAN TRADE

Expansion of trade between India and Pakistan may not have to wait for the launch of the South Asian Free Trade Area (SAFTA). The Islamabad Declaration—issued on January 6, 2004, following a meeting between the president of Pakistan and the prime minister of India—promised better relations between the two countries. The meeting was held on the sidelines of the twelfth summit of the South Asian Association for Regional Cooperation (SAARC), at which the seven members of the association agreed to launch the SAFTA on January 1, 2006.

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[8] In March 2005, the two parties were still negotiating the sensitive list, phaseout list, and immediate zero-duty list.

At the India–Pakistan summit of April 19, 2005, the two governments put trade relations at the center of a new approach to easing tensions. A number of initiatives were taken to ensure that trade would increase between the two countries. According to the statement issued at the conclusion of the Delhi summit,

> [B]oth leaders agreed that enhanced economic and commercial cooperation would contribute to the well-being of the people of the two countries and bring a higher level of prosperity to the region. The two leading economies of South Asia should work together for greater prosperity of the region. The leaders decided to reactivate the Joint Economic Commission as early as possible. They also agreed that the Joint Business Council should meet soon.

The Indian private sector's reception to the summit's pronouncement was positive. The Indo–Pakistan Joint Business Council's statement of April 19 suggested exploring possibilities "for setting up joint ventures and provide legal framework for furthering closer links between both nations in ... cotton industry, engineering products, educational institutes, services, information exchange and tourism." According to the council's Mahendra K. Sanghi, bilateral trade between India and Pakistan could reach $10 billion by 2010, from $3 billion at present. The estimate of the current value of trade between the two countries included the exchange of goods and commodities involving third countries, in particular the United Arab Emirates (Dubai). "Indian commodities were generally noted for their cheap prices whereas Pakistani goods were qualitatively better. If bilateral trade was increased, producers in both countries could look for price efficiencies by providing lower cost inputs to each other," said Mr. Sanghi (*The Hindu* 2005).

Business people in both countries were confident that bilateral trade could increase quickly if the governments took steps such as easing visa restrictions, improving land and air communication, and facilitating cross-border investment. They pointed out that such measures had resulted in increasing India-China bilateral trade from $1 billion in 1994/95 to $13.6 billion in 2004/05.

Pakistani businessmen echoed the view of their counterparts in India and urged the two governments to dismantle the nontariff barriers that inhibit trade between the two countries. In a survey conducted by the Progress, Harmony and Development Chamber of Commerce, an industry body, three-fourths of the 300 business people polled responded that with relaxed visa norms, South Asia could not only see a sharp increase in intraregional trade, it will also be able to attract a significant share of the $1.3 trillion available for investment from oil-rich Arab countries. About 80 percent of those polled were of the view that even with the granting of most-favored nation (MFN) status by India, Pakistan's trade surplus with its neighbor had decreased sharply in recent years because of India's trade restrictions.

During 2004/05, exports from India to Pakistan are expected to reach $440 million, while India's imports from Pakistan will be only $60 million. Pakistanis believe that the large trade balance in favor of India is the consequence of India's trade barriers, such as certification requirements for molasses and textiles, and India's insistence on using its laboratories for the required seal of approval. However, the Indian government indicated that it was prepared to remove these barriers. "We will remove any perceived nontrade barriers to imports from Pakistan," said

Commerce and Industry Minister Kamal Nath in an interview with an Indian newspaper (Ramachandran 2005).

Although the Islamabad and Delhi summit initiated a process that resulted in a number of small steps to ease tension between the two South Asian rivals, nothing specific was done to increase the flow of trade. Nevertheless, bilateral trade did increase. Pakistan continued to resist Indian pressure to grant it MFN status, but allowed an increase in the number of items that could be imported from India from 687 to 770. This resulted in an increase in bilateral trade from $245 million in 2000/01 to an estimated $600 million in 2004/05. These estimates are for the exchange of goods and commodities through official channels; they do not include the large amount of trade through third countries or the value of smuggled commodities and merchandise.

On May 5, 2005, less than three weeks after President Musharraf's visit to India and the signing of the Joint Statement in New Delhi, Islamabad decided to allow duty-free import of five items from India by land route: meat, live animals, potatoes, tomatoes, onions, and garlic. It is expected that one million tons of meat and live animals will come into Pakistan from India. In announcing this decision, the Pakistani cabinet noted the difference in prices for these commodities in the two countries. In other words, policymakers in Islamabad had begun to factor in the macroeconomic impact of free trade in their decision making. This was a significant departure from earlier thinking, in which international trade was viewed through the prism of protection, particularly for industries that were viewed as infant.

Prospects for easing restrictions on the movement of agricultural products across the border are good. The agricultural sector still accounts for about a quarter of gross national incomes of both countries. Pakistan's occasional wheat deficits could be satisfied by India, which has a large surplus of wheat and has accumulated a vast reserve that it exports at highly subsidized prices to distant markets. Pakistan has the potential to become a major supplier of such high value-added crops as fruits, vegetables, and flowers to the large urban centers in north India, including the capital, Delhi. The two countries could collaborate in exporting such specialty products as basmati rice, highly valued in the Middle East and by the large Indian and Pakistani diasporas in Britain and North America.

The energy sector is likely to lead to the development of trade relations between India and Pakistan. Both countries—especially India—face serious energy shortages, especially if their economies continue to grow at the current rate of 6 to 7 percent a year. Negotiations are ongoing between Islamabad and Delhi on the construction of a pipeline that will bring natural gas from Iran to India through Pakistan. This project is estimated to cost $4 billion and will provide Pakistan with transit fees amounting to an estimated $500 million a year. Pakistan could also tap into the pipeline to satisfy its own rapidly increasing demand for natural gas. There are also plans for bringing gas from Turkmenistan through Afghanistan and Pakistan to India and from Qatar, once again through Pakistan to India. Building the second project is estimated to cost $3.3 billion.

In spite of close political relations between Islamabad and Delhi on the one side and Washington on the other, the United States' objection to the Iran–Pakistan–India pipeline has not deterred the two countries from moving ahead with the project. In a discussion with the Indian press after his

meeting with Prime Minister Singh, President Musharraf said that trade between the two countries would be conducted to aid the prospects of India and Pakistan and not to satisfy extraregional strategic concerns.

Some in India have advanced the possibility of cooperation in the energy sector beyond the construction of pipelines. There has been talk of using Pakistan's large storage capacity for diesel and heavy fuel to aid India's strategic reserves. Reliance Industries, the largest Indian private sector corporation, which has extensive interests in the energy sector, was reportedly hoping to begin gas exploration in Pakistan.

The northern states of India could use the Karachi and Gwadar ports to cut the distance between points of consumption and port of entry. Trade could also become the instrument for resolving the longstanding Kashmir dispute. One of the authors of this study has suggested such an approach in a strategy paper prepared for the United States Institute of Peace (Akbar and Suleman 2005).

IMPACT OF SAFTA ON PAKISTAN

How would the successful implementation of SAFTA affect Pakistan's international trade and the structure of its economy? Would improving the design of SAFTA increase its positive impact? We attempt to provide answers to these questions in this section on the basis mostly of projections, taking into consideration the situation that prevailed six decades ago when the British, as they prepared to leave, began dividing South Asia into a number of independent states.

The most significant impact of SAFTA on Pakistan will be a sharp increase in international trade as a proportion of GDP. In 2004/05, the trade-to-GDP ratio was on the order of 30 percent, with trade defined as including trade through informal channels and GDP measured according to updated 2001 national income accounts. With SAFTA successfully implemented and with trade with Afghanistan conducted mostly through formal channels, total trade could increase at a rate of 10 to12 percent per year in the next 10 years. Total trade in real dollars (2004/05 dollars) could increase from the present $33.5 billion to $90 billion.[9] With the economy more open and with trade with India allowed free of the positive test of permitted exports and imports, India–Pakistan trade is likely to increase tenfold, from the current $2 billion (including informal trade) to $20 billion.[10] In other words, of the $58 billion increase in total trade projected for this period, $18 billion—or almost 31 percent of the increase—could come from increased exports to and imports from India (see Table 7-12).[11]

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[9] According to the government of Pakistan's Medium Term Development Framework exports will increase by 12 percent per year on average while imports will increase at 10 percent. GDP is expected to increase by 7 percent per year.

[10] Studies in both Pakistan and India show that the present level of trade between the two countries is only 10 to 12 percent of potential trade. See, for example, Eugenia Baroncelli, "Pakistan-India Trade Study: Economic Gains and the 'Peace Dividend' from SAFTA,"a study for the Pakistan-India trade project; commissioned by the World Bank at the request of the Government of Pakistan.

[11] A recent World Bank study, *South Asia Free Trade Area: Promise and Pitfalls of Preferential Trade Arrangements*, using the Gravity Model estimated that trade between India and Pakistan has the potential to

Table 7-12

Projected Value of Pakistan's Formal and Informal Trade in 2004/15 ($ billion)

Type	2004/05				2014/15			
	Exports	Imports	Total	% of GDP	Exports	Imports	Total	% of GDP
Formal	14	18.0	32.0		43.0	47.0	90.0	
Informal	0.5	1.0	1.5		--	--		
Total	14.5	19.0	33.5	30	43.0	47.0	90.0	42.0

SOURCE: Author's projections.

A significant reduction in tariffs as envisaged in SAFTA will not be the main contributor to the smart increase in India–Pakistan trade. Instead, trade will increase mostly because of the elimination of nontariff barriers and measures to facilitate trade adopted by the two countries. An open trading system would mean the use of short sensitive lists to regulate trade initially, with the understanding that these lists will be dispensed with over time. In addition, Pakistan will need to grant MFN status to India, and India will need to eliminate nontariff barriers that keep out of its markets the many items of interest to Pakistani exporters (Akbar and Suleman).

Both sides will need to restore and develop transport and communication links, connect their electric power grids and natural gas pipelines, and open to each other the use of their airports and ports. For all this to happen SAFTA will need not only to be more aggressively implemented, but also to incorporate sectors not currently in its scope. A sharp increase in the quantum of India–Pakistan trade will require regulatory changes in the two banking systems for trade financing to be available to all traders without restriction.

Greater openness on the part of Pakistan will also affect trade with Afghanistan. Formal trade between Afghanistan and Pakistan has increased sharply since the fall of the Taliban in December 2001. Counting in the value of current trade an estimate of informal trade, Afghanistan is now the third-most-important destination (and to a lesser extent, source) of trade for Pakistan. This is likely to grow four-fold, increasing the value of total trade from the current $1.9 billion to an estimated $8.3 billion, equivalent to growth of 15 percent per year. With this anticipated increase, Afghanistan is likely to become Pakistan's third-most-important trading partner, approaching the United States in importance, but still considerably behind India (see Table 7-13).

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increase more than 40-fold. However, we have taken a much more conservative estimate, keeping in mind various policy-related constraints that trade may face even with normalized MFN trade relations between the two countries.

Table 7-13
Projected Direction of Pakistan's Trade—Imports and Exports (Percentage Share of Total)

Country	2004/05	2014/15
United States	19	12
India	5	22
Afghanistan	5	9
Dubai	6	-
United Kingdom	4	3
Saudi Arabia	10	12
Subtotal	49	58

SOURCE: Author's projections

With the successful implementation of SAFTA, the structure, destination, and origin of Pakistan's international trade will change profoundly. Agricultural and light engineering products will become important export items while industrial raw material and capital equipment will become important import items. With Pakistan able to meet a significant proportion of its energy needs by tapping the gas pipelines from Iran, Central Asia, and the Middle East to India, the share of fuel imports in total trade should decline. And, with Pakistan able to earn large transit fees from the use of its territory for gas pipelines to India, the share of the service sector in export earnings should increase significantly.

New trading opportunities with the countries in the region will change the structure of the Pakistani economy. Agriculture should regain some of the importance it had at the time of independence from Britain. But Pakistan will not become the granary for the rest of South Asia as it was then. Its agricultural system, with its year-round supply of water, should be able to provide high value-added output to the growing Indian and Middle Eastern markets. With transit trade earning more foreign exchange, the transport sector should feel the impact, through the modernization of trucking, processing, repackaging, and warehousing industries. The banking sector will also have to develop new product lines to provide financing for new lines of export to India as well as for service transit trade. And Pakistan could see a major expansion in tourism as Indians begin to visit holy sites in Pakistan that have been inaccessible to them as well as other sites in the country's picturesque northern areas. Lahore is already preparing for the arrival of Indian tourists. According to one British newspaper account "the city is sprucing itself up for a growing flow of visitors from Delhi—many of whom have memories or relatives there—with a fancy new airport, refurbished colonial buildings, and ambitious hotel projects" (Burnett 2005, W20). An increase in tourism will result in rapid expansion of the hotel, restaurant, and entertainment industries.

The envisaged structural change in the Pakistani economy will need large amounts of investment, some of which could be provided by Indian companies. For that to happen, however, India and Pakistan will need to agree on a policy framework for regulating cross-border flow of capital. Such an agreement will be politically easier to conclude within the SAFTA framework. This is

one of the several areas in which the SAARC countries will need to begin deliberation in order to increase the reach and scope of the proposed SAFTA.

CONCLUSIONS

This study reaches a number of important conclusions. First, it lends further credence to the conclusion arrived at in the overview paper on SAFTA prepared to launch this project that a regional trade arrangement would benefit to all countries in the region. A well-designed SAFTA is likely to be more successful than some other regional trade arrangements in the developing world because regional arrangements anchored in large economies have a greater chance of success than those that are made up of countries of similar size. Mercosur in Latin America's southern cone, with Brazil as its large anchor economy, has been more successful than the Andean Pact or the Central American Free Trade Area. SADC, in Southern Africa, has also been a successful regional trade arrangement, anchored as it is by South Africa. India will have to play a significant role in making SAFTA a success. For SAFTA to succeed, it is critical that India does not adopt a mercantilist approach as it negotiates the SAFTA framework.

Second, SAFTA will provide a framework within which Pakistan–India trade could develop. The value of this trade could increase two-and-a-half times in the five years after the launch of SAFTA, from the current $2 billion[12] to $5 billion. It will increase four-fold again, to $20 billion, in the following five years. Initial growth will come from redirecting trade through third countries through direct channels. With SAFTA in place, India should replace the United States as the main market for Pakistan's exports. In 2011, five years after the launch of the free trade area, India should account for one-fourth of Pakistan's total export earnings. India should also replace Saudi Arabia as the single largest source of imports for Pakistan.

Third, the growth of intraregional trade will bring about a significant change in the structure of the Pakistani economy. The country will once again begin to focus on its large agricultural potential, supplying the large and rapidly growing Indian market with a variety of high value-added agricultural products that Pakistan is well equipped to produce. The share of agriculture in Pakistan's GDP will most likely increase. Pakistan's agricultural processing industry will also grow rapidly to meet India's demand for high value-added products.

Fourth, the growth of Pakistan–India trade will reduce the incidence of poverty in the country because the products that will have markets in India will have a larger labor content than the products that currently dominate Pakistan's exports. This will certainly be the case for the type of agricultural output that will figure prominently in goods exported to India as well as fashion garments for which there is a large and growing Indian market.

Fifth, although services are not included at this time in the SAFTA framework, greater economic exchanges between India and Pakistan are likely to have some impact on some service areas. Given recent advances in Pakistan's banking industry, it is likely that Pakistani banks will

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[12] Includes informal trade.

penetrate the Indian market while the Indian information technology sector will find opportunities in the Pakistani market.

Sixth—and another indirect consequence of the launch of SAFTA—will be the development of Pakistan as an energy hub linking India with rich sources of energy in Central Asia and the Middle East. Similarly, Pakistan could benefit greatly by offering transit facilities to India for its trade with Afghanistan, Central Asia, and the western provinces of China. India–China trade has increased significantly in the past several years; some of this could transit through Pakistan, saving transportation costs for Asia's two giant economies while providing revenues to Pakistan.

Seventh, growth of trade with India and the offer of transit facilities to that country will have a significant impact on the development of transport infrastructure in Pakistan. Pakistan's large investments in building a modern road network and modern airports in Karachi and Lahore (and soon in Islamabad) and in port development will begin to pay off. The network of motorways in Pakistan, which is under expansion, will get additional traffic from India. Gwadar port in the west of the country could also become an important port for India's trade with the Middle East, helping to relieve the pressure on ports on India's west coast, particularly Mumbai. Similarly, Lahore's modern airport will provide an outlet for passenger and goods traffic for the states of Punjab and Haryana in India.

Eighth, another area not covered at present in the SAFTA agreement will see some significant developments. Serious skill shortages in Pakistan could be met by India, while workers from Pakistan could provide the labor needed by the agricultural sector in the Indian states of Punjab and Haryana.

Ninth, tourism, another area excluded from SAFTA, will see investments by India's experienced hoteliers as tourism—initially religious and eventually general—brings large numbers of people from India to Pakistan. There is some talk of providing the Sikh community in northern India special access to religious sites in the Pakistani province of Punjab.

Tenth, as happened in Europe, better economic cooperation between India and Pakistan would reduce the possibility of open conflict between the two countries. Greater trade and movement of people between India and Pakistan may "soften" the borders and provide a framework within which the enduring problem of Kashmir could be resolved. President Musharraf of Pakistan has begun to talk about the emergence of "soft" borders between India and Pakistan, while Prime Minister Singh of India has repeatedly talked about trade and a relatively free movement of people as a way to produce peace and harmony in South Asia.

For Pakistan, the initial impact of SAFTA will be better economic relations with India. Over time, a successful SAFTA could draw in other countries. This is particularly the case with Afghanistan, whose isolation will be considerably reduced by opening borders with India through a transit facility granted by Pakistan. The landlocked states of Central Asia could also find outlets to the sea and to large Indian markets through Pakistan. In other words, policymakers in South Asia, as they prepare to launch SAFTA, should look at it from a dynamic rather than a static perspective. They must design the free trade area in a way that it can readily expand in geographic scope as well as in the scope of areas for cooperation.

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8. Afghanistan

Kathleen Trask

Emerging from more than two decades of war and isolation, Afghanistan is transforming its economy to a market-based system in which the private sector is the engine of growth. The Government of Afghanistan's target for per capita income is $500 by 2015, an ambitious goal that will require an annual average per capita growth rate of more than 8 percent for the next 10 years. Underlying this goal is a strategy to facilitate development of a competitive, export-oriented private sector, in part by reintegrating Afghanistan into global and regional markets. Historically, Afghanistan's ties with trading partners in Central and South Asia have been an important part of its economy, and revitalizing these ties will be important to the country's reconstruction. How could membership in the South Asian Free Trade Area (SAFTA) contribute to these goals?

Participation in SAFTA could offer many benefits for Afghanistan, the most significant being freer trade with two of its largest trading partners—India and Pakistan. Deeper regional integration also presents an opportunity for expanding trade with other countries by providing for significantly greater market access for exports. Afghanistan's tariffs are low, but SAFTA would open the country's domestic market even more, particularly with improved trade facilitation and transit between SAFTA members. More open markets can lower prices for consumers, boost competition, and increase investment. Finally, membership in SAARC—a presumed precursor to SAFTA membership—provides for deeper regional integration on a wide range of issues.

Concerns about Afghanistan's membership in SAFTA include the effect on government revenues. Tariffs are the most significant source of government revenue and as Afghanistan seeks to develop a sustainable budget in the absence of donor support, revenue will be a primary concern. Other concerns include the impact on the development of domestic industry and the balance of payments as Afghanistan tries to address a growing trade deficit. Concerns about trade diversion caused by SAFTA membership are mitigated by Afghanistan's relatively moderate tariff regime.

In the rest of this section we analyze these issues, weighing the potential costs and benefits of Afghanistan's participation in SAFTA and providing a starting place for discussions in Afghanistan and among SAARC members. We first present overviews of Afghanistan's economy and trade regime, and of SAARC and the SAFTA agreement as the context for the analysis.

OVERVIEW OF THE ECONOMY

With an official per capita gross domestic product (GDP) of only US$207 and 70 percent of its population living in poverty (defined as an income of less than $2 per day), Afghanistan is one of the world's poorest countries. Its recent history has been dominated by struggles against the effects of 20 years of isolation and civil war; in fact, nominal per capita income has increased by less than 1 percent per year on average over the past 27 years (Table 8-1).

Table 8-1

Afghanistan Economic Indicators[1]

Indicator	1975	2002	2003
Official GDP (US$ billion)	2.4	4.0	4.6
Official Annual Growth	3.0	29	16
Population (million)	14.0	21.8	22.8
Official GDP per capita	169	186	207
2004 Human Development Index rank	173rd of 178		

SOURCES: *World Bank. 2004.* Afghanistan: Country Economic Report*; UNDP. 2004.* Afghanistan: National Human Development Report.

Since 2001, Afghanistan has worked to establish civil stability and is committed to prudent macroeconomic management and market-oriented reforms that will improve the economic environment and economic performance. Achieving Millennium Development Goals and a per capita income of US$500 by 2015 will require per capita growth rates of more than 8 percent annually through 2015.[2] While growth has been strong since 2001, much of it has been fueled by donor-financed reconstruction and a boom in agriculture due to the end of a protracted drought. In the coming years Afghanistan must look to the private sector to fuel sustainable growth. The next sections provide an overview of the current structure of the economy, a discussion of reforms of the enabling environment, and a discussion of the structure of trade in Afghanistan.

Structure of the Economy

Agriculture accounted for 52 percent of Afghanistan's GDP in 2002 (Table 8-2). With nearly 57 percent of the population employed in agriculture—estimates go as high as 70 percent when the opium sector is included—the revitalization of the agricultural sector is central to the government's efforts to reduce rural poverty and eradicate poppy production. Historically, leading commodities have included cereals, cotton, fruit and nuts, livestock and milk, and karakul. Productivity in all sectors, however, has declined significantly in the past decades.

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[1] The economic figures in Table 6-1 and throughout the entire discussion of Afghanistan include only official GDP unless otherwise specified. When the illegal opium sector is included in estimates, per capita GDP is US$310.

[2] The UNDP estimates a population growth rate of 2.5 percent, which implies that GDP must grow at a rate of 13 percent annually to achieve this target.

Table 8-2
Structure of Afghanistan's Economy

Sector	Level (current US$ million)		GDP Structure (% of Total)	
	1975	2002	1975	2002
Agriculture	1,196	2,105	51	52
Industry	373	976	16	24
Services	798	967	34	24
Total	2,367	4,048		

SOURCE: World Bank. 2004. Securing Afghanistan's Future: Technical Annex 1 to Chapter 1.

Afghanistan was once a net exporter of cereal, but cereal production has suffered serious declines as a result of conflict and prolonged drought. In the 1960s, cereal yields in Afghanistan were among the highest in the region–30 percent higher than in Iran and 17 percent higher than in Pakistan. By 2001, yields had dropped by 13 percent and Afghanistan now lags behind Pakistan by nearly 60 percent. Cotton, once a growing segment in the 1970s, has now all but disappeared. Output of fruit and nuts, both fresh and dried, has traditionally been substantial; at one time, Afghanistan was the world's leading exporter of dried fruits. Significant capital improvements will be required to restore this segment's prominence because it has suffered from neglect in the shift to subsistence production. Karakul skins were also once an important export commodity but the sector has suffered a similar decline.

The agricultural sector has rebounded strongly since 2001, with production increasing by 80 percent in 2002 alone. The rise in cereal production has been aided by rainfall and improved irrigation. A number of projects are working to rehabilitate the traditional export sectors, including fruit and nuts, whose exports have tripled since 2001. Combined with continued favorable precipitation, capital and technology improvements and irrigation investment will help revitalize the agricultural sector.

Manufacturing, power, oil, and mining account for 75 percent of industrial production in Afghanistan; construction fueled by reconstruction initiatives accounts for the remaining 25 percent. In the late 1970s, the bulk of manufacturing involved state-owned processing of primary goods, including cotton textiles, agroprocessing, fertilizer, construction materials, and small-scale production of handicrafts. Over the next 20 years, the deterioration of the agricultural sector and basic infrastructure diminished output. As security and infrastructure improve, particularly transport and electricity, investments in these sectors will spur industrial growth.

Afghanistan has reserves of iron, chrome, copper, silver, gold, barite, sulfur, talc, magnesium, mica, marble, lapis lazuli, asbestos, nickel, mercury, lead, zinc, bauxite, lithium, and rubies. These reserves are not being exploited, primarily because of legal and regulatory difficulties with the private development of state-owned resources. Recently, however, a new mining law was passed to provide a framework for private investment in the redevelopment of these resources. World Bank estimates indicate that rising demand for construction materials could fuel growth in this sector (WB 2004). Exploitation of oil and natural gas reserves is also promising. The

production of natural gas, once exported to the Soviet states, declined following the withdrawal of the Soviet Union.

The service sector has also grown rapidly since 2001, particularly services related to public administration and trade. This growth is likely to continue, with more opportunities for investment in financial services, telecommunications, and transportation arising. The services sector has garnered the most investment since 2001; investments in the telecommunications sector are well above US$300 million. Hotel investments, estimated at nearly $75 million, include construction of the Hyatt Regency, the five-star Serena Hotel financed by the Aga Khan Fund for Economic Development, and renovation of the Intercontinental Hotel.

Economic Reforms

While the response of the private sector has been encouraging, achieving sustainable market-driven growth will require overcoming obstacles arising not only from the effects of the civil conflict but also from two decades of state control of the economy. In addition to massive efforts over the past three years to improve security and rehabilitate basic infrastructure, the government has focused on creating an environment adequate for private sector growth. Significant accomplishments include the following:

- ***Macroeconomic Policy Reforms.*** Afghanistan has introduced a new currency, instituted sweeping reforms in the central bank, and maintained a stable exchange rate accompanied by moderate inflation.
- ***Financial Sector Reforms.*** In addition to reform of the central banking system, the passage and implementation of modern banking legislation in 2004 has opened the financial sector to more private sector participation. The deepening of financial markets—particularly for credit, insurance, and leasing—are high priorities in the government's private sector development strategy.
- ***Institutional Reforms.*** The government has embarked on a large-scale program of civil service reform to rationalize the size of government and raise institutional efficiency and capacity.
- ***Business Procedure and Trade Administration Reforms.*** In 2004, business licensing procedures were simplified, reducing to 48 hours a process that once required up to 3 months and 72 signatures. Modern investment legislation and establishment of the Afghan Investment Support Agency (AISA), a one-stop shop, streamlined investment procedures. Finally, extensive reforms and modernization are making import and export procedures simpler and more transparent.
- ***Establishment of Industrial Parks.*** Industrial parks will be important in attracting investment to Afghanistan because they facilitate rapid utility servicing of a large number of investors in a discrete area. Investors will not have to wait for general municipal infrastructure rehabilitation that might or might not extend to suitable industrial land. Creating industrial parks throughout the country will provide investors with land, energy, water, and road access in a timely and transparent manner. Three sites are now being developed.

The results of the initial reforms are evidenced in robust growth rates and rising investment. In 2004, AISA facilitated more than US$760 million in planned investment in Afghanistan. While progress has been substantial, much has yet to be done, and the government remains committed to revitalizing traditional sectors, facilitating expansion into new sectors, and formalizing the economy.

Structure of Trade

To facilitate development of the private sector, the Government of Afghanistan has made integrating the country's markets with global and regional economies a high priority. The 2003 ratio of trade in goods to GDP for Afghanistan was roughly 55 percent, compared to the 63 percent average for SAFTA countries. The nominal value of exports declined by nearly two-thirds between 1978 and 2002, but export growth is increasing rapidly, rising 44 percent in 2003 alone. Imports more than quadrupled during the same period, contributing to a substantial trade deficit. Although a significant portion of the deficit reflects donor-financed reconstruction initiatives, policymakers are concerned about the sustainability of the deficit. Table 8-3 presents trends in Afghanistan's trade flows and provides data on the external balance.

Table 8-3

Structure of Afghanistan's Foreign Trade

Structural Element	1978	2002	2003
Exports (US$ million)	269.2	100.0	144
Imports (US$ million)	450.5	2,452.0	2,101
Balance (US$ million)	(181.4)	(2,352.0)	(1,957)
Trade in goods (% of GDP)		64	55

SOURCES: *World Bank. 2004. Securing Afghanistan's Future: Technical Annex 1 to Chapter 1; Government of Afghanistan, Central Statistics Office.* Afghanistan Trade Statistical Yearbook 2003-2004.

Exports

Pakistan and India absorbed 53 percent of Afghanistan's exports in 2002 and 77 percent in 2003. No exports to other SAARC member states are recorded in Afghanistan's statistics. Taking in 6 percent of Afghanistan's exports in 2003, Russia is the country's next most significant market (Table 8-4).

The export base is narrow, with three commodity groupings—carpets, dried fruits, and animal skins—making up two-thirds of exports. Medical seeds, mostly licorice, make up roughly 9 percent of exports. While fresh fruits make up only 5 percent of exports, this sector grew 165 percent in 2003. Growth in fresh grape exports has been particularly strong. Table 8-5 presents the commodity composition of exports by country.

Table 8-4

Value of Afghanistan's Exports by Destination

Destination	2002	2003	
	Value (US$ million)	Value (US$ million)	Percent of Total
Pakistan	26	99	69
India	27	11	8
Russia	3	8	6
United Kingdom	0	3	2
Finland	9	1	1
Germany	6	2	1
Belgium	3	-	0
United States	4	-	0
United Arab Emirates	5	-	0
Other	16	20	14
Exports	100	144	

SOURCE: *Government of Afghanistan, Central Statistics Office.* Afghanistan Trade Statistical Yearbook 2003-2004.

Table 8-5

Composition of Afghanistan's Exports by Commodity Grouping and Destination, 2003

Commodity	Total		Pakistan		India	
	Value (US$ million)	Percent of Exports	Value (US$ million)	Percent of Exports	Value (US$ million)	Percent of Exports
Dry fruits	58.7	40.8	40.7	69.4	4.2	7.1
Animal skins and fur	30.8	21.4	27.5	89.4	-	-
Carpets	16.2	11.3	13.2	81.8	0.2	0.9
Medical seeds	12.6	8.8	4.2	33.4	5.7	45.2
Fresh fruits	7.1	4.9	5.9	82.7	0.2	2.8
Wool and animal hair	4.4	3.1	2.0	45.3	-	0.0
Oil seeds	3.7	2.6	-	0.0	-	0.0
Cotton	3.4	2.4	3.4	99.4	-	0.0
Other	6.8	4.8	2.1	31.1	0.5	7.2
Total	143.7		99.1	68.9	10.7	7.5

SOURCE: *Government of Afghanistan, Central Statistics Office.* Afghanistan Trade Statistical Yearbook 2003-2004.

Goods destined for Pakistan and India dominate the Afghan export sector. Most carpets and fresh and dried fruits, as well as nearly 90 percent of animal skins—mostly cow hides—are destined for Pakistan. Afghanistan once dominated India's imports of dried fruits and nuts, but now imports from California have a substantial share of the market. India, however, recently granted preferential access for Afghan dried fruits and nuts, significantly increasing exports for this sector and boosting the share of Afghan products in that market.

Afghanistan can expect to continue expanding exports of traditional agricultural products to regional markets. Exports to developed country markets could also expand as exporters develop their capacity to compete in international markets and meet international standards. The carpet industry is striving to capitalize on the unique characteristics of Afghanistan's traditional carpets to expand market opportunities, and is aiming to develop cutting and washing facilities to increase value-added production. At present, Afghan carpets are sent to Pakistan for cutting and washing, then re-exported to their final markets. The redevelopment of Afghanistan's mining resources, particularly marble, gemstones, and lapis lazuli, will also create a source of export growth in the short to medium term.

As it improves Afghanistan's environment for investment and private sector development, the government also seeks to facilitate the emergence of new competitive sectors, including a rehabilitated industrial and manufacturing sector. With a liberal trade and investment regime in place, Afghanistan could attract investors seeking to produce for the regional market.

Imports

The origins of Afghanistan's imports are far more diverse than the destinations for its exports (Table 8-6). Pakistan and India, the dominant origins of imports in SAARC, accounted for only 15 percent of Afghanistan's imports in 2003. Afghanistan also imports from Bangladesh and Sri Lanka, mostly black tea and some consumer items, but together these countries accounted for only 0.3 percent of 2003 imports. Passenger cars, tires, and vehicle spare parts made up a large share of imports from Japan, particularly in 2002. This share is declining, and preliminary 2004 statistics indicate that Japan's share has declined to less than 6 percent of imports.[3] Imports of black tea account for approximately 2 percent of imports, with Kenya supplying nearly 55 percent of the market. Bangladesh and India supply only 4 percent of this market.

Imports consist primarily of inputs and consumer goods. India and Pakistan are significant sources for clothes and food products; Pakistan supplies nearly 89 percent of Afghanistan's imported flour. In 2003, India accounted for 56 percent of garment imports and more than a fifth of medical imports.

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[3] Data for March 2004–March 2005 are preliminary. For consistency, this section relies largely on 2003 data. Implementation of new customs procedures in 2004 signals a break in Afghan trade statistics. Previously, valuation certificates issued by the Afghan Chamber of Commerce and Industry, a state-controlled organization that had once had wide-ranging regulatory powers, were the basis for import and export data. The new procedures eliminated the chamber's role, so trade data are now generated from customs data.

Table 8-6
Afghanistan's Imports by Country of Origin

Country	2002		2003	
	Value (US$ million)	% of Total	Value (US$ million)	% of Total
China	20	1	382	18
Japan	999	41	299	14
Pakistan	207	8	181	9
India	37	2	122	6
Germany	49	2	84	4
Kenya	57	2	55	3
Korea	113	5	22	1
Turkmenistan	50	2	14	1
Kazakhstan	22	1	7	0
Singapore	1	0	1	0
Unspecified	898	37	934	44
Total	2,452		2,101	

SOURCE: *Government of Afghanistan, Central Statistics Office.* Afghanistan Trade Statistical Yearbook 2003–2004.

The composition and origin of Afghanistan's imports have shifted in the past three years. Preliminary customs data for 2004 indicate that Pakistan is now the leading source of imports, claiming nearly 22 percent of the Afghan market. The same data also show that Pakistan's market share of construction materials rose to nearly 55 percent.[4] Japan's share of the import market has declined to 5.5 percent, indicating a shift from imports of vehicles and parts likely due to the initial demands of reconstruction. The 2004 data also indicate that India's share in the Afghan import market had dropped to 2.8 percent. The booming demand for construction materials is likely to continue with reconstruction, but over time the composition of imports is likely to continue shifting to consumer goods. The rising productivity of Afghanistan's agricultural sector and the development of an agroprocessing industry could weaken the strong demand for cereal and food imports. Table 8-7 presents the composition of imports by country grouping.

TRADE REGIME

Before 2001, the trade regime of Afghanistan was designed to meet the goals of a state-controlled economy and was characterized by elaborate import and export procedures. In the past three years, the government has made reforming the trade regime a high priority to reestablish trade ties that have historically been a source of prosperity.

[4] The next-largest suppliers of imported construction materials are China and Iran, with 22 and 6 percent of the import market, respectively.

Table 8-7
Afghanistan's Imports by Commodity Grouping and Origin, 2003

Commodity	Total		Pakistan		India	
	Value (US$ million)	% of Imports	Value (US$ million)	% of Imports	Value (US$ million)	% of Imports
Fabrics	421.7	20.1	1.7	0.4	13.5	3.2
Spare parts of mech. V.M.	346.0	16.5	3.0	0.9	2.5	0.7
Tires and tubes	151.1	7.2	0.0	0.0	35.0	23.2
Metal production	104.9	5.0	17.4	16.6	0.8	0.8
Flour and wheat flour	82.9	3.9	73.6	88.8	0.0	0.0
Tea	76.3	3.6	0.0	0.0	2.6	3.4
Vegetable oil	69.0	3.3	15.8	22.9	0.0	0.0
Cement	58.6	2.8	6.2	10.6	0.0	0.0
Medicines	41.2	2.0	0.7	1.7	9.3	22.6
Televisions	32.6	1.6	0.0	0.0	0.0	0.0
Petroleum, oil, etc.	32.1	1.5	0.0	0.0	0.0	0.0
Soaps	30.7	1.5	1.1	3.6	0.2	0.7
Footwear	20.7	1.0	1.2	5.8	0.1	0.5
Sugar	18.8	0.9	7.1	37.8	2.8	14.9
Threads	18.0	0.9	0.9	5.0	0.2	1.1
Clothes	15.9	0.8	0.8	5.0	8.9	56.0
Cigarettes	7.5	0.4	0.4	5.3	1.2	16.0
Chemical	6.9	0.3	0.3	4.3	0.0	0.0
Fertilizer	6.7	0.3	0.0	0.0	0.0	0.0
Bicycles	6.4	0.3	0.1	1.6	0.4	6.3
Stationery	2.5	0.1	0.1	4.0	0.2	8.0
Unspecified	551.0	26.2	50.9	9.2	45.0	8.2
Total	2,101.5		181.3	8.6	122.7	5.8

SOURCE: *Government of Afghanistan, Central Statistics Office.* Afghanistan Trade Statistical Yearbook 2003–2004.

Tariffs

In 2004, Afghanistan instituted reforms in its tariff regime and customs administration. The previous tariff schedule had 26 rates ranging to a maximum of 150 percent and a simple average tariff of 35 percent. The schedule was further complicated by the use of arbitrary exchange rates to calculate import values. Customs administration has been substantially rationalized since 2001. In 2004, Afghanistan began implementing the AYSCUDA system and passed customs legislation developed in coordination with the World Customs Organization and in full compliance with international standards and best practices. The new tariff schedule introduced the Harmonized System (HS) of Classification (HS2002), simplified and rationalized systems for import valuation, and reduced the number of tariff bands to six. Table 8-8 presents an overview of the new schedule.

Table 8-8
Afghanistan's Tariff Schedule, 2005

Duty Rate	No. of Tariff Lines	Percent of Tariff Lines	No. of Imports	Percent of SAARC
2.5%	2,599	49	49.3	74.8
4%	324	6	1.6	1.5
5%	1,924	37	28.4	17.3
8%	4	0	-	-
10%	219	4	3.6	1.4
16%	149	3	14.7	2.7
Prohibited	37	1	2.4	2.2
Total	5,256			
Simple average		4.2%		
Trade-weighted average			5.4%	3.3%

Note: *The trade data are from the Customs Department and so reflect actual revenue collections. Recorded imports of prohibited goods include "unspecified items" and some allowable exemptions.*

As indicated in Table 8-8, there is no zero tariff rate for imports. Although categories are not precisely defined, the new schedule is similar to a cascading tariff system with rates corresponding to "essential items," "raw materials and capital goods," "petroleum," "luxury," and "non-priority items." The 8 percent rate is reserved for petroleum products. The new schedule has reduced the simple average tariff to 4.2 percent.

As indicated in Table 8-9, Afghanistan has the lowest tariff regime in the region. The approximate trade-weighted tariff is 5.4 percent for all imports and 3.3 percent for imports from SAARC. Customs data were used in calculating the trade-weighted tariffs in Table 8-8; the calculations assume that all items are dutiable but actual applied trade-weighted tariffs are undoubtedly lower. Duty exemptions cover significant portions of trade (e.g., imports by aid organizations). Calculations are based only on officially recorded trade. Actual trade flows are estimated to be higher for a variety of reasons, including smuggling and incomplete coverage by customs. For example, Table 8-8 records no imports in the category for the 8 percent tariff rate reserved exclusively for petroleum, a significant import commodity.

Table 8-9
Summary of Tariff Structures in South Asia

Country	Simple Average Tariff
India	22.2
Pakistan	17.3
Bangladesh	16.3
Sri Lanka	11.3
Nepal	13.7
Afghanistan	4.2

SOURCE: Nathan Associates Inc. 2005. Promoting Intraregional Trade in South Asia: The South Asian Free Trade Area and its Potential for the Region.

The tariff code bans certain types of import commodities: all swine products in HS Chapters 1, 2, 15, and 16 constituting 19 tariff lines; all alcohol products from Chapter 22 constituting 15 tariff lines; opium imports constituting a single tariff line in Chapter 13; and a single tariff line in Chapter 53 for seed cotton. The restrictions on swine products, alcohol, and opium are motivated by public safety and morals in the Islamic Republic of Afghanistan and would not be an issue for SAFTA membership.[5] The restriction on seed cotton is reportedly motivated by a desire to maintain the quality of Afghanistan's stock. Imports of prohibited items recorded in Table 8-8 represent allowable exemptions and include "unspecified items."

Nontariff Barriers

Afghanistan's tariff regime is quite liberal. Except for the prohibited items listed above, quantitative restrictions on trade are few. Imports of charcoal and salt are largely prohibited to protect domestic potential; exports of scrap metal are also barred by presidential decree to control the export of aging state-owned military equipment; and no sectors are subsidized or supported. Nontariff barriers, such as paratariff charges, administrative barriers, and difficulties with transit and trade facilitation, in part counteract this liberality.

Paratariff Charges

Imports and exports are subject to several sets of miscellaneous charges, some formal and some informal.

- ***Red Crescent Fee.*** All imports and exports are charged a 2.5 percent fee for support of the Red Crescent organization.
- ***Indirect Income Tax.*** Importers are charged a fee of approximately 3 percent at the border. This fee is relatively new and coverage uncertain. It presumably eliminates the need for traders to file income tax returns under the new Income Tax Law passed earlier this year. In case of overpayment, traders should be able to file for a refund at the end of the tax year.
- ***Miscellaneous Charges.*** Depending on the point of entry, other fees include small taxes levied by municipalities at the borders. These include fees charged at Herat for veterans and monuments.
- ***Municipal Taxes.*** Imports may be subject to municipal taxes depending on their destination. Recently, a fertilizer shipment traveling from the Torkham border to Kandahar paid small municipal fees at Jalalabad, Kabul, Wardak, and Kandahar. These fees are variously reported as user fees, road taxes, or municipal taxes.
- ***State-owned Enterprises.*** The Government of Afghanistan is committed to a program of privatization of state-owned enterprises, many now defunct. In certain cases the government retains regulatory authority. The Petroleum and Natural Gas Enterprise and

[5] Article 14, paragraph b of the SAFTA agreement allows contracting states to impose measures necessary to protect "public morals; human, animal or plant life and health; and articles of artistic, historic and archaeological value."

the Afghan Fertilizer Corporation both extract 2 percent in-kind payments on petroleum and fertilizer imports, respectively.

- ***Other.*** Imports of cars produced between 1975 and 1986 are subject to a fine of 40 percent. Most other charges reported in documentation of Afghanistan's trade regime were eliminated by customs reforms. Most commonly mentioned are the valuation charges once required by the state-run Chamber of Commerce, which has been eliminated.
- ***Exports.*** Although no specific tax is levied on exports, major export commodities are still associated with state-run guilds (e.g., carpets, raisins, medical herbs, animal products). The process for obtaining export permissions is often lengthy and involves a variety of nuisance taxes. In addition, exports of animal skins are charged small taxes at the border.

These miscellaneous taxes and charges add significantly to tariff barriers on trade. The Red Crescent fee alone increases the tax barrier on SAARC imports by more than 75 percent. Fertilizer is subject to only a 2.5 percent tariff, but the "municipal" taxes levied on the fertilizer shipment mentioned above amounted to an additional charge of nearly 13 percent.

Afghanistan is committed to establishing an open and transparent trade regime and has been rapidly clarifying processes in cooperation with the private sector. Reforms of the customs administration have already greatly improved the trade environment. In addition, Afghanistan has applied for WTO membership and hopes to move through the accession process quickly. Accession will require addressing each parataiff charge listed above. These charges violate the SAFTA agreement and GATT Article VIII, which requires that border charges be tied to actual services. Except for the indirect income tax, these parataiffs do not contribute to central government revenue because each fee is retained by the charging organization (i.e., municipalities, Red Crescent, the state-owned enterprise).

Administrative Barriers

Most administrative barriers to trade are the legacy of a state-run economy that instituted an elaborate system of import and export controls. The scope of administrative barriers to trade has been curtailed in the past three years, yet substantial obstacles remain: [6]

- ***Limited Access to Legal Information and Significant Regulatory Uncertainty.*** Difficulties in addressing administrative barriers are compounded by legislation languishing on the books. In fact, identifying the legal basis for many procedures is the most difficult part of changing them. Initiatives to improve the enabling environment involve developing systems to identify and address legal barriers.
- ***Limited Access to Process Information.*** Basic information on import and export procedures and charges, including the customs tariff schedule, is not widely available. Because some procedures involve more than one ministry, it is difficult to find a single source that describes the entire process.

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[6] Discussion is drawn in part from Miller (2003).

- ***Over-reliance on Paperwork***. Many agencies write letters or complete forms granting permission for a step in the export process or acknowledging that another agency has signed off on a step, permitting the trader to undertake the next step in another agency. For example, after a raisin exporter pays his export duties at the bank, the bank writes a letter to the Ministry of Commerce confirming payment. Upon receiving this letter, the ministry writes a letter for the exporter to give to Customs, confirming that the bank has told the ministry that duties are paid.
- ***Import Licenses.*** Traders must have a business license but blanket requirements for import licenses on each shipment have been reduced. Certain imports, however, still have extra procedures (e.g., all vehicle imports require a letter from the Ministry of Commerce).

While progress in these areas has been substantial, customs difficulties, inefficiencies in ports and import procedures, and licensing and other regulatory requirements impose costs that can far exceed tariff barriers. Removal of these administrative, legal, and systemic barriers is a critical complement to effective trade policies.

Transit and Trade Facilitation

A landlocked country, Afghanistan needs efficient, low-cost transit routes and trade facilitation systems to help exporters take advantage of market access arising from trade agreements such as SAFTA. Once these systems are developed, Afghanistan will be able to capitalize on its strategic position as a landbridge in Central and South Asia.

Afghanistan has transit agreements or understandings with Pakistan, India, Iran, and Uzbekistan and is a signatory of the International Transit Convention (Transports Internationaux Routiers). It also participates in the Central and South Asia Transport and Trade Forum's (CSATTF) Corridor Development Plan. Afghanistan's transit relations with Pakistan are governed by the Afghan Trade and Transit Agreement ratified in 1965.[7] The treaty requires that freight be moved from the railways in Karachi to railheads at Chaman and Peshawar. Vehicles registered in both Pakistan and Afghanistan are allowed to carry freight across the border. The agreement is no longer able to accommodate developments in transit trade that have since occurred. In 1965, Pakistan had only one port, railways were the main mode of transport, and containerization was relatively new. The agreement needs to be updated to reflect developments in transit and transport infrastructure because transit via Pakistan will be critical for trade with SAARC member states.

Difficulties caused largely by the re-export of goods in transit into the Pakistan market have plagued Afghanistan's trading relationship with Pakistan. At present, six items are on the "negative list" of commodities that do not qualify for transit status: cigarettes, cooking oil, tires and tubes, televisions, auto parts, and telephones. If Afghanistan were to join SAFTA, the reduction in tariff differences between the two countries would curb incentives for smuggling and ease problems with the current transit arrangement. Other issues include the taxation of goods in

[7] For details on the status of the agreement see UNCTAD (2005a and 2005b).

transit to Afghanistan by municipal authorities and the nearly 100 percent inspection rate that causes long delays at borders.

Significantly absent in transit arrangements is an accord between Pakistan and India that would allow India transit rights through Pakistan. Such an accord would boost the competitiveness of goods on the Afghan market. Meanwhile, Afghanistan's cooperation with India on transit is being developed under the terms of a Memorandum of Understanding from the "Trilateral Meeting on the Development and Construction of Transit and Transport Infrastructures" on the Chabahar–Milak–Zaranj–Delaram route between the Islamic Republic of Iran, Government of India, and the Transitional Islamic State of Afghanistan. The agreement will promote and develop transit and transport affairs, eliminate transit and transport barriers and constraints, and provide safe, smooth, rapid, and low-cost transportation. The full development of this system would allow for the reconstruction of the Chabahar port and connecting freeways, potentially reducing the route from Iran to India by 700 km.

Though the SAFTA agreement does not address transit issues explicitly, better transit relations between Afghanistan and Pakistan and with the rest of SAARC could be one of the most significant benefits of joining SAFTA. Without these provisions, benefits for Afghanistan will be limited.

Trade infrastructure and facilitation must also be addressed. Delays, cumbersome procedures, and lack of facilities at borders drive up costs and seriously undermine the competitiveness of Afghanistan's exports. Deteriorated border port facilities used for transshipment and warehousing cannot meet the needs of modern transit and transportation. The government is planning to strengthen border facilities, particularly at Hairatan. These facilities are currently state run, but future cooperation with the private sector is likely.

The government is also working with the private sector to reduce trade costs by harmonizing and rationalizing trade, transport, and transit documents and procedures; promoting better cross-border operations, investments, and transport logistics facilities, including inland container depots and freight centers; and eliminating transshipment requirements at the border. SAFTA provisions for cooperation in trade facilitation among member states could be of substantial benefit to Afghanistan.

Trade Agreements

Integrating Afghanistan's markets with global and regional economies will be critical in achieving the development goals of the Government of Afghanistan. In working toward these goals, Afghanistan has pursued opportunities for reestablishing and expanding the scope of its international trade agreements. Participation in SAFTA will not exclude Afghanistan from pursuing other opportunities for integration or affect the terms of current agreements.

Regional Trading Agreements

Regional integration is among Afghanistan's highest priorities for trade policy and it has been pursuing trade agreements throughout the region. Agreements with SAARC member states are limited to agreements with Pakistan and India. In addition to the Afghan Trade and Transit

Agreement discussed earlier, both Pakistan and Afghanistan are members of the Economic Cooperation Organization (ECO), which promotes regional trade liberalization and integration. Members include Azerbaijan, Iran, Kazakhstan, the Kyrgyz Republic, Pakistan, Turkey, Turkmenistan, and Uzbekistan. In early 2005, Afghanistan signed the ECO Trade Agreement that will reduce intra-ECO tariffs to a maximum of 10 percent over the next 15 years. The agreement also provides for cooperation on the reduction of nontarrif barriers and parataríffs. Under the ECO framework, Afghanistan is preparing to become a signatory of the Transit Transport Framework Agreement, which will allow transportation by foreign carriers and eliminate the need for transshipment of goods at the border.

Under a preferential trade agreement, India has granted 50–100 percent tariff concessions for Afghan exports of dried fruits, fresh fruits, seeds, medicinal herbs, and precious stones. Afghanistan has granted a 100 percent margin of preference on eight products including black tea, certain categories of medicines, refined sugar, cement clinkers, and white cement. As a result, the market share of Afghan products in the Indian market has increased substantially, demonstrating how Afghanistan could benefit from freer trade with SAARC member states. In 2003, more than 76 percent of Afghan exports to India were covered by the tariff preferences.

Afghanistan has also been engaged in bilateral negotiations for cooperation on a range of trade issues with Iran, India, Pakistan, Tajikistan, Turkey, Russia, and Uzbekistan. Afghanistan already participates in CSATTF and is investigating joining the Central Asian Regional Economic Cooperation (CAREC) program, whose members include Azerbaijan, China, Kazakhstan, the Kyrgyz Republic, Mongolia, Tajikistan, and Uzbekistan. CAREC seeks to promote coordination in customs, energy, trade facilitation, and trade policy.

World Trade Organization

Having received observer status to the WTO in December 2004, Afghanistan is committed to moving quickly through the WTO accession process in the next four years. Accession will allow Afghanistan to become a full member of the global economic community and send a strong signal to international investors and traders about the nature and stability of its trade regime. The SAFTA agreement complements WTO participation as it incorporates the major principles of the GATT agreements. The only potential concern is the scope of freer trade under SAFTA. As is explained in the next section, SAFTA member states may exclude certain items from the arrangement through “sensitive lists.” This issue is still under negotiation but WTO standards stipulate that preferential trading agreements must free “essentially all trade,” which is usually interpreted as 85 percent of intra-SAFTA trade flows.

Other Preferential Agreements

Afghanistan is eligible for preferential import duties through several agreements. The European Union’s Everything but Arms Initiative allows duty-free and quota-free access for all goods originating in Afghanistan. The United States’ Generalized System of Preferences grants Afghanistan duty-free access to U.S. markets for a wide range of products, including handwoven carpets and textiles. Afghanistan also signed a Trade and Investment Framework Agreement with the United States in 2004. A Memorandum of Understanding between Canada and Afghanistan under Canada’s Least Developed Countries Initiative provides preferential access to Canadian

textile and apparel markets. And Japan's Generalized Preferences Treatment grants duty- and quota-free access to the Japanese market for a range of Afghan products.

The challenge for Afghanistan is to develop its capacity to take advantage of opportunities arising from these arrangements. Exporters have enjoyed some success in exporting carpets to the United States and dried fruits and nuts to the UK, but trade figures reveal that they are not fully exploiting export potential. In part, this is due to a lack of expertise among exporters who have been isolated from developed country markets for many years. Exporters could benefit from programs that build capacity in design and market preference and help them meet strict international standards, especially for agricultural products.

THE SAFTA AGREEMENT

The South Asian Association for Regional Cooperation (SAARC) was established in 1985 by the People's Republic of Bangladesh, the Kingdom of Bhutan, the Republic of India, the Republic of Maldives, the Kingdom of Nepal, the Islamic Republic of Pakistan, and the Democratic Socialist Republic of Sri Lanka to promote economic growth, social progress, and cultural development in the region. Cooperation among member states encompasses initiatives that cover everything from the environment and forestry to biotechnology. Increasing economic cooperation, regional integration, and particularly intra-SAARC trade flows is a central goal of member states, whose long-term objective is creation of a South Asian Economic Union (SAEU). As a first step, member states implemented the SAARC Preferential Trade Agreement (SAPTA) in 1993.

In proceeding to the next stage—elimination of trade barriers within SAARC—member states signed an agreement forming SAFTA in January 2004. The agreement calls for eliminating barriers to trade and facilitating the cross-border movement of goods between contracting states; promoting conditions for fair competition; and establishing a framework for further regional cooperation. Governed by the principles of the WTO, reciprocity, and an awareness of the needs of least-developed SAFTA countries (Bangladesh, Nepal, Bhutan, Maldives), the agreement targets the elimination of tariffs, parataiffs, and nontariff barriers.[8] In January 2006 member states will begin implementing SAFTA by phasing down tariff and nontariff barriers over ten years. Reductions will proceed at a slower pace for least developed members (LDM) and non-least developed members (NLDM).[9]

IMPLICATIONS OF SAFTA FOR AFGHANISTAN

Because Afghanistan would have the lowest per capita income in SAFTA, it would likely be classified as an LDM and thus be eligible for the longer implementation period and special and differential treatment. Afghanistan would therefore benefit from improved access to SAARC markets and the greater opening of Afghan markets to SAARC members. Membership also has implications for revenue, something of serious concern to policymakers. Other areas of beneficial

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[8] Parataiffs are border charges levied exclusively on imports and which do not correspond to specific services. Such charges violate WTO provisions.

[9] The introduction to this book provides details on the provisions of the SAFTA agreement.

cooperation, while not explicitly covered in the SAFTA agreement, could be facilitated by Afghanistan's participation in SAARC and greater integration with the South Asian region.

Improved Access to SAARC Markets

Tariff-free or nearly free access to large markets in India and Pakistan is one of the most appealing features of SAFTA membership for Afghanistan's exporters. Under the terms of the agreement, Afghanistan's exports to India and Pakistan would face a maximum tariff of 5 percent by 2009. How much could greater access mean to Afghanistan?

The markets of SAARC member states are significant destinations for Afghanistan's exports. The success of Afghan fruit and nut exports to India under the recent bilateral agreement shows that preferential access to the South Asian market could significantly expand trade for Afghanistan. SAARC markets, however, are relatively protected, particularly in agricultural sectors that are the basis of Afghanistan's comparative advantage. Although Afghanistan does not currently export to other SAARC member states, trade liberalization could lead to export opportunities in previously unexploited sectors. To quantify these issues, a rough estimate of the amount of liberalization that would occur on the basis of current exports is presented in Table 8-10. Afghan exports face an estimated trade-weighted average tariff of 16.6 percent in Pakistan and India.[10] Dried fruits, the most significant export to Pakistan, face an estimated tariff of 22 percent. Carpets and animal skins also face substantial tariffs there. Greater market access for carpets in Pakistan could serve several objectives as Afghanistan seeks to increase value-added processing and encourage carpetmakers to return from Pakistan.

Significant exports to India face an average 28 percent trade-weighted tariff.[11] Even dried fruits under the preferential agreement face a tariff of 23 percent. Reductions of tariffs to between zero and 5 percent will likely boost exports in these categories significantly.

Afghanistan has no recorded exports to other SAFTA member states, but given its strong advantage in specialty agricultural products, such as dried fruits and nuts, preferential access to large and growing markets in Bangladesh, Sri Lanka, and Nepal could provide a significant opportunity for Afghan exporters. In addition, the development of mineral resources in Afghanistan could lead to more exports to SAARC member states. But if gains in market access under SAFTA are to be meaningful, several issues must be addressed:

- ***Sensitive Lists.*** The size and composition of sensitive lists have yet to be decided, but if these lists were to exclude agricultural commodities, benefits to Afghanistan would be severely curtailed.

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[10] No exports to SAARC members other than India and Pakistan are recorded in the Afghan data.

[11] According to India's trade statistics, imports from Afghanistan totaled US$40.48 million in 2003—more than four times the level recorded in the Afghan statistics. Using India's data, the trade-weighted tariff faced by Afghan goods in the Indian market was 19.93 percent.

Table 8-10

Afghanistan's Exports to SAARC and Average Trade-weighted Tariff

Export	Pakistan			India		
	Value	Percent	Tariff	Value	Percent	Tariff
Dry fruits	40.7	41.1	22.0	4.2	38.9	23.0
Animal skins and fur	27.5	27.8	7.0	-	-	-
Carpets	13.2	13.3	25.0	0.2	1.9	15.0
Medical seeds	4.2	4.3	10.0	5.7	52.8	33.3
Fresh fruits	5.9	5.9	22.0	0.2	1.9	22.0
Wool and animal hair	2.0	2.0	5.0	-	-	
Oil seeds	-	-	10.0	-	-	100.0
Cotton	3.4	3.4	5.0	-	-	
Karakul skins	2.1	2.2	12.6	0.5	4.5	22.2
Other	40.7	41.1	22.0	4.2	38.9	23.0
Total	99.1			10.8		
Trade-weighted tariff			16.6			28.2

Notes: Detailed trade data on exports provided by Customs is incomplete and record only a fraction of total exports. The trade-weighted tariffs calculated in Table 6-11 use figures from the Central Statistics Office and are an estimate for the commodity categories. For unclassified, the average tariff for the commodity groupings was used. The trade-weighted tariffs calculated are consistent with estimates from Customs (23.6 percent for India and 15 percent for Pakistan).

India tariffs reflect the preferential agreement with Afghanistan..

SOURCES**:** *Government of Afghanistan, Central Statistics Office.* Afghanistan Trade Statistical Yearbook 2003-2004; *Tariff codes for India and Pakistan.*

- ***Rules of Origin.*** Like the sensitive lists, rules of origin have yet to be decided. They might not affect the agricultural commodities that Afghanistan now exports, but if they exclude from preferences light manufacturing exports likely to be developed in Afghanistan over the medium term they could erode benefits.
- ***Transit and Trade Facilitation.*** Implementing Afghanistan's transit rights across Pakistan to India has been difficult, and problems with trade facilitation abound in the region. For example, many countries require that goods at the border be transferred onto domestic freight carriers. In addition, a lack of facilities at the borders poses a significant obstacle for exporters of fresh produce, most recently hindering attempts to increase exports of fresh grapes to India. At the India–Pakistan border, fresh produce traders have to hand carry crates across the border, resulting in a high spoilage rate.

The SAFTA agreement discusses transit and trade facilitation, but specifies no mechanisms. If Afghanistan were to join SAFTA, such mechanisms would be a high priority; without them the value of tariff reductions would be significantly reduced.

Opening Markets to SAARC Members

While tariff-free access to SAARC markets is appealing, the greatest potential concern for Afghanistan is allowing SAFTA member states, particularly Pakistan and India, tariff-free access to its own markets. A common fear is that Afghanistan will be flooded by imports from Pakistan

but not be able to export anything. Putting aside the flawed mercantilist argument underlying this fear, it should be stressed that opening markets to SAFTA imports will reduce prices, provide developing sectors easier and cheaper access to imported inputs, and boost competition, which, in turn, will spur domestic development.

How much would Afghanistan be opening its markets? Its markets are already open as measured by tariff barriers (see Table 8-8). SAARC member states face a 4.2 percent simple average tariff and a 3.3 percent trade-weighted average based on existing imports. Furthermore, 92 percent of Afghanistan's tariff lines are already 5 percent or less and thus already meet the SAFTA standard. As an LDM, Afghanistan would in theory have 10 years to reduce rates on 8 percent of its tariff lines. In short, Afghanistan is already open to SAFTA imports, which should alleviate fears about the effect of SAFTA on domestic industry.

Dwelling on analysis of tariff barriers, however, misses the point of furthering regional integration. To benefit from a more open domestic market, Afghanistan should be seeking to increase trade—and in relation to SAFTA, transit and trade facilitation are the most significant obstacles. If SAFTA were to provide a forum for improving transit relations—such as allowing for duty-free transit of Indian exports to Afghanistan—the greater competitiveness of goods in the domestic market could be a significant benefit for Afghanistan.

Revenue Implications

The possible effect of SAFTA membership on government revenues is a major concern. Tariff revenues are the biggest source of revenue for the Government of Afghanistan, and the need to develop a sound budget in the absence of donor support makes revenue sources a top priority. While SAFTA does provide for a revenue compensation mechanism for LDMs, compensation is unlikely to be financial.

At present, domestic revenues account for roughly half of the government's revenue, with the rest financed through donors (Table 8-11). Although the tax base is expanding, roughly 60 percent of domestic revenue comes from customs duties. Other sources include a 20 percent corporate tax, personal income tax ranging from 10–20 percent, a 20 percent rental tax, and a 2 percent tax on business receipts. Implementation of the Income Tax Law passed in early 2005 is expected to begin later this year. Income taxes are then expected to account for a rising share of revenues, diminishing the importance of customs duties. SAFTA membership, however, would eliminate customs revenue from trade with India and Pakistan—and policymakers are likely to raise objections on this point.

Because collections data are not available, the analysis calculates approximate customs revenue on the basis of existing tariffs and trade data. For several reasons this exercise is more likely to overestimate losses from SAFTA membership. Only India and Pakistan are included in the estimates. Though imports from Bangladesh and Sri Lanka are recorded in the Afghan trade data, they account for less than one half of one percent of imports.

Table 8-11

Afghanistan Government Revenues, 2003

Source	Amount (US$ million)	Percent of Total
Domestic revenue	333	49.1
Afghanistan Reconstruction Trust Fund	280	41.3
Law and Order Trust Fund	65	9.6
Total domestic revenue	678	

SOURCE: Government of Afghanistan.

Using 2004 customs trade data on imports, Table 8-12 notes the percentage of SAARC imports in each tariff category. As noted, nearly three-quarters of imports from SAARC are in the 0–5 percent tariff range. An estimate of revenue collections at current tariff rates is compared to a scenario in which all tariffs above 5 percent are reduced to 5 percent as required by SAFTA. According to this calculation, tariff revenue from SAARC members would fall by approximately 11 percent.

Table 8-12

Estimating Afghanistan's Potential Revenue Losses on SAFTA Imports

Tariff (%)		SAARC Imports		Customs Revenue (US$)	
Current	SAFTA	Value (US$)	Percent of Imports	Current	SAFTA
0.0	0.0	11,580,908	2.2	-	-
2.5	2.5	394,340,271	74.8	9,858,507	9,858,506.8
4.0	4.0	7,914,056	1.5	316,562	316,562.3
5.0	5.0	91,202,387	17.3	4,560,119	4,560,119.3
8.0	5.0	-	-	-	-
10.0	5.0	7,643,137	1.4	764,314	382,156.9
16.0	5.0	14,484,980	2.7	2,317,597	724,249.0
Total		527,165,740		17,817,099	15,841,594
% Change					-11.1

Note: The zero percent tariff category represents imports that were exempted from prohibitions and unspecified goods.

SOURCE: Government of Afghanistan. Customs Statistics, 2004.

Table 8-13 presents an estimate of the loss in customs duties. According to the calculation, revenues based on existing trade and tariff data are an estimated US$116 million. Imports from SAARC countries account for approximately one-quarter of imports in the customs data and 15 percent of potential customs collections. Using the change in tariff revenue on SAARC imports estimated in Table 8-12, this calculation estimates a 1.71 percent reduction in customs duties. Duties account for roughly 60 percent of domestic revenue, so the decline in revenues is likely to be minimal. The paratariff barriers discussed earlier are not included in the estimates for two reasons. First, most collections from parataríffs are not included in central government revenues.

Second, as Afghanistan progresses toward WTO membership, most paratariffs will have to be eliminated and thus do not represent an opportunity cost of SAFTA membership.

Table 8-13

Estimating Loss to Afghanistan's Customs Collections from SAFTA Membership

Current (%)	Value (US$)	Percent of Imports	Revenue (US$)
0.0	51,002,273	2.4	-
2.5	1,049,977,792	49.3	26,249,445
4.0	34,438,075	1.6	1,377,523
5.0	606,002,764	28.4	30,300,138
8.0	0	-	-
10.0	77,278,113	3.6	7,727,811
16.0	312,798,231	14.7	50,047,717
Total	2,131,497,248		115,702,634
Revenue with SAFTA			113,727,130
Percent change in Customs collections			(1.71)

Note: The zero percent tariff category represents imports that were exempted from prohibitions and unspecified goods.

SOURCE: Government of Afghanistan. Customs Statistics, 2004.

Not only do the revenue implications seem moderate, but these calculations almost certainly overestimate potential losses in customs revenue for several reasons. The customs revenue collections calculated in Tables 8-12 and 8-13 are overestimates because they assume that all imports are dutiable. Customs collections in 2003 were only US$81.9 million. Next, they assume existing trade flows even though Afghanistan's trade is likely to increase not only with SAFTA members but also with non-SAFTA members as a result of a better trade environment. Third, improved trade and transit facilitation could be one of the most significant benefits of SAFTA membership. Improved border control can reduce illegal trading and boost revenue. Finally, the calculations almost certainly overestimate the percentage reductions in future government revenues as Afghanistan begins to develop more efficient tax bases that diminish the importance of customs revenue (e.g., income tax or a VAT). Over the course of SAFTA's 10-year implementation period, concerns about tariff revenues will also diminish.

Other Issues

While the commitment to tariff reductions is the most explicit commitment in the SAFTA agreement, member states view the agreement as a platform for negotiations on other issues, including transit and trade facilitation, nontarrif barriers, and standards. As a participant in SAARC and SAFTA, Afghanistan would be able to influence negotiations. In addition, the SAFTA agreement calls for negotiations on subjects that complement the government's current initiatives. Potential mechanisms for addressing nontarrif barriers and cooperation on regional standards dovetail with Afghanistan's policy objectives as it moves toward WTO accession. Cooperation in standards development could be very helpful, as standards development is still in its infancy in Afghanistan. Many exporters from developing countries are barred from developed

country markets not by tariff barriers but by an inability—financial and technical—to meet stringent standards. Developing regional solutions for export standards through SAFTA could help member states maximize scarce resources.

Moreover, by facilitating investors' ability to capitalize on Afghanistan's status as a landbridge between Central and South Asia, regional integration will make the country a more attractive investment destination. This is a benefit not only for Afghanistan but also for member states who will be able to take advantage of increasingly efficient transit routes through Afghanistan to Central Asia and the markets of Eastern and Western Europe. For example, Afghanistan is ideally situated for low-cost delivery of energy resources from Central Asia to the rapidly growing energy markets of South Asia. A Memorandum of Understanding signed in 2002 started negotiations for a natural gas pipeline to run from Turkmenistan through Afghanistan—tracing the ring road from Herat to Kandahar—to Pakistan. Constructing the pipeline will require an estimated US$2 billion and will take approximately three years. It will transport 15–30 billion cubic meters of natural gas and create about 10,000 jobs for Afghanistan. It will also raise US$100–300 million annually from transit fees for Afghanistan, nearly doubling current domestic revenue.

Energy demands in India are expected to double by 2020, and the pipeline may be extended to serve this market. Negotiations on the extension involve concerns about security in Afghanistan, financing, and fees. Given the size of the market for energy in South Asia, the pipeline could be expected to complement recent negotiations for a 2,600 km pipeline from Iran to Pakistan to India. Afghanistan's participation in SAFTA will promote this initiative and could focus negotiations on solidifying transit regimes in the region.

Afghanistan also stands to benefit from any future SAFTA negotiations on services. The country's services sector is one of its fastest growing, with many opportunities for regional investors. The country's liberal investment regime and regulatory and legal reforms have opened the way for private investors across a wide range of sectors. The recently passed Mining Law, for example, provides encouragement for private investment in rehabilitation of the mining sector. Additional legislation to allow for greater private participation in previously state-controlled sectors is likely to follow. Investors from SAARC member states, including India and Pakistan, are already taking advantage of opportunities in banking and transportation. The Bangladesh Rural Advancement Committee is establishing facilities for microfinancing and credit provision throughout Afghanistan.

CONCLUSIONS

The reintegration of Afghanistan into global and regional markets is a central component of the government's strategy to enable private sector-led growth. Historically, Afghanistan's ties with its trading partners in Central and South Asia have been an important part of its economy, and SAFTA membership could be very helpful in revitalizing these ties.

Under SAFTA's tariff liberalization program, tariffs will be reduced to 5 percent, greatly increasing opportunities for expanding Afghan exports in the South Asian market. At present, Afghanistan's exports are subject to high tariffs in SAFTA markets—a 16 percent trade-weighted

average tariff in Pakistan and 28 percent in India. Other member states also impose high tariffs in the agricultural sectors that are the base of Afghanistan's comparative advantage. Afghanistan's own tariffs are comparatively low; its simple average tariff is only 4.2 percent and its trade-weighted tariff on imports from SAARC is 3.3 percent. Nearly all of its tariff lines already meet the 0–5 percent rate set by the SAFTA agreement. Thus, joining SAFTA will have little effect on tariff-based revenue.

Rendering gains in market access under SAFTA meaningful, however, will require careful negotiation of rules of origin, transit and trade facilitation mechanisms, and the size and composition of sensitive lists. The potential benefits of SAFTA membership for Afghanistan are substantial. As a member of SAARC and SAFTA, Afghanistan can promote progress on these issues to ensure that benefits are realized.

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Appendix. Trade, Investment, and Economic Cooperation Agreements

To Which SAFTA Members are Parties

Agreement	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	Includes	Coverage
Bangkok Agreement	√		√				√	China, S. Korea, Laos	Goods
Bay of Bengal Initiative for Multisectoral Technical and Economic Cooperation (BIMSTEC)			√				√	Myanmar, Thailand (Bangladesh, Bhutan and Nepal belong to the BIMSTEC Forum but are not signatories to the FTA)	Goods
Bilateral Investment Treaties (BITS)—Bangladesh	√							16 separate treaties with Belgium, France, Germany, Netherlands, Japan, United Kingdom, United States, Italy, Indonesia, South Korea, Thailand, Switzerland, Philippines, Iran, Uzbekistan	Investment
BITS—India			√				√	22 separate treaties with Egypt, France, Germany, Ghana, Switzerland, Indonesia, Italy, Korea, Netherlands, Kazakhstan, Oman, Portugal Spain, Sweden, Thailand, United Kingdom, Czech Republic, Australia, Austria, Belgium, Croatia, Denmark	Investment
BITS—Nepal					√			4 separate treaties with Mauritius, United Kingdom, France, Germany	Investment
BITS—Pakistan						√	√	Separate treaties with 33 countries	
BITS—Sri Lanka			√			√	√	Individual treaties with India and Pakistan; additional treaties with 22 countries	
Economic Cooperation Organization (Preferential Agreement)						√		Afghanistan, Azerbaijan, Iran, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan	Goods
EU–India Agreement on Sugarcane			√					European Union	Sugar quotas and guaranteed prices
EU–India Cooperation Agreement			√					EU	Broad commitments to MFN, maintenance of GSP preferences, reciprocity and non-discrimination in investment, "cooperation" in industrial, agricultural, and services sectors.
General System of Trade Preferences among Developing Countries	√		√			√	√	40 other countries	Goods
India–Afghanistan Preferential Trade Agreement			√					Afghanistan	Goods

Agreement	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka	Includes	Coverage
India–ASEAN Framework Agreement on Comprehensive Economic Cooperation			√						Framework for negotiations for an agreement to include goods, services, investment, and standards. "Early harvest scheme" provides for tariff reductions on goods while negotiations continue.
India–Chile Framework Agreement			√					Chile	Creates negotiating mechanism for preferential trade agreement; commits countries to "cooperate" in areas of trade in goods, trade in services, investment, and standards
India–GCC Framework Agreement			√					Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and United Arab Emirates	Broad mandate for economic cooperation and formal commitment to explore feasibility of an India–GCC FTA.
India–MERCOSUR Preferential Trade Agreement			√					Brazil, Argentina, Uruguay, Paraguay	Goods
India–SACU Framework Agreement			√					South Africa, Lesotho, Swaziland, Namibia, Botswana	Provides for negotiations towards a preferential or free trade agreement
India–Singapore Comprehensive Economic Cooperation Agreement			√					Singapore	Goods, services (including movement of natural persons), investment, standards
India–Sri Lanka Free Trade Agreement			√				√		Goods
India–Thailand FTA Framework Agreement			√					Thailand	Framework for negotiations for an agreement to include goods, services, investment, and standards. "Early harvest scheme" provides for tariff reductions on goods while negotiations continue.
Pakistan–Malaysia Early Harvest Program						√		Malaysia	Goods (precursor to planned Pakistan-Malaysia Free Trade Agreement)
Protocol relating to Trade Negotiations among Developing Countries (PTN)	√					√		Brazil, Chile, Egypt, Israel, Mexico, Paraguay, Peru, Philippines, Republic of Korea, Romania, Tunisia, Turkey, Uruguay, Yugoslavia (1971 borders)	Goods
Sri Lanka–Pakistan FTA						√	√		Goods
Tripartite Agreement			√					Egypt, [former] Yugoslavia (1968 borders)	Goods (Agreement dormant since early 1990s)
United States–Pakistan Trade and Investment Framework Agreement						√			Sets out "basic principles" of US-Pakistan trade and investment relationship
United States–Sri Lanka Trade and Investment Framework Agreement							√		Affirmations of shared interest in (1) liberalizing and expanding trade and investment, (2) upholding IPR laws, and (3) respecting core labor standards

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