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Regional Trading Arrangements of India
Conceptual and Policy Issues

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I. Introduction

I.1 The Context

The global trends in economic growth across countries have traversed different economic regimes over the past decades. In the more recent decades, the globalization process has entailed decisive policy changes, the world over. It has entailed trade openness, greater emphasis on foreign direct investment, stabilization policies, redefining the role of the state, among others. Observations reveal that there have been positive growth outcomes in both the developing and developed worlds. However, it has also been noticed that while the developing world has been unable to reap the full benefits in terms of economic growth across countries, the developed world has also shown signs of growth-sluggishness in country-specific contexts.

Another major global trend has been in the realms of trade interactions among countries. Along with the advent of WTO, in contrast to previous decades, the last decade has witnessed a growth of regional trading arrangements (RTAs) at an unprecedented pace (Chart 1). By January 2005, around 312 RTAs were notified to GATT/WTO (Crawford and Fiorentino, 2005). As of 15 June 2006, about 197 RTAs were in force (WTO, 2006). It is important to highlight that a major increase in the number of RTAs took place between now and 1995. A rather well known fact is that around two-thirds of global trade is conducted on a preferential basis than the MFN basis.

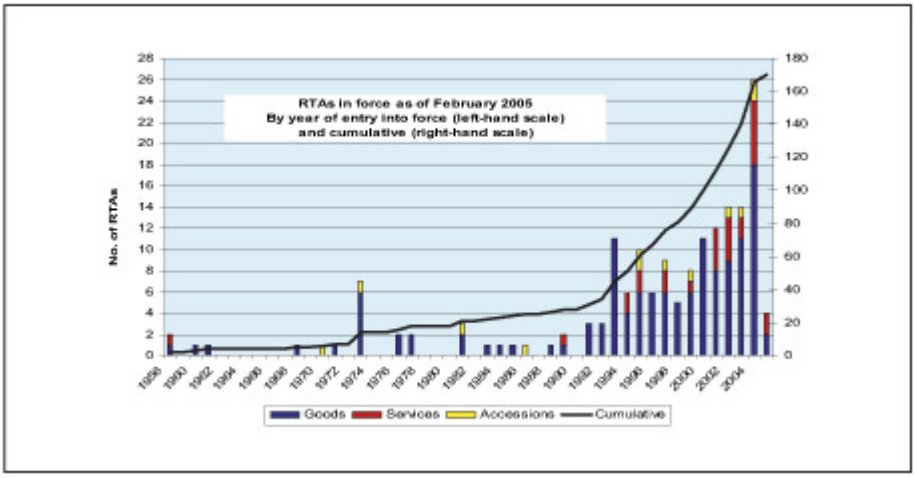
A scenario such as above throws up the question the increasing regionalism that the world has been witnessing has any concrete relationship with the growth convergence/divergence outcomes? An answer to this question would have important implications for the recent trend of its increased emphasis on regional trading arrangements (RTAs) in the case of India.

Against this background, an attempt has been made to analyse the conceptual and empirical basis of India's RTAs.

I.2 Structure of the Paper

Section II lays down the conceptual basis of RTAs, however, along with highlighting the positive effects of the RTAs the paper puts forth the imperatives of putting in place adequate safeguards. Thus, in Section III liberalization and the need for safeguard mechanisms are analyzed. Against this backdrop, India's recent regional economic engagements are put together in Section IV. Towards, the end, in Section V some empirical evidence of the relationship between growth convergence and regional integration are presented along side some estimates of trade gains in South Asia in static and dynamic scenarios. The paper is summed up in Section IV.

Chart 1: Notified RTAs to the GATT/WTO (1948-2005) by entry into force



Source: (Crawford and Fiorentino, 2005)

II. The Conceptual Basis

II.1 Regionalism and Multilateralism

This has been a much-debated aspect in the present era of economic policy making. It has been contented that while absolute protectionism is reduced as a result of the economic integration process the relative protectionism against the rest of the world increases and thus the processes of regionalism and multilateralism should not be considered as complementary (Elena et. al; 1999).

In our view, this finding needs a different explanation. As absolute protectionism is reduced in a regional framework, *ceteris paribus* the overall protectionism in the entire world (including the region under consideration) would have got reduced. Therefore, reduction in protection in a particular region would contribute to the globalisation and multilateral liberalisation process. To argue about the effects of regional liberalisation on multilateral liberalisation, by excluding the region and comparing it with the rest of the world could be misleading.

Moreover, regional economic integration could pave way for its members to participate more effectively in the multilateral process of economic change, by providing them with opportunities to experiment with the economic change at a smaller scale and magnitude within the region. This could contribute to their preparedness to the multilateral liberalisation process at the larger scale by contributing to their efficiency and competitiveness profiles through cooperation. Hence, it is a myth that regional economic integration is not complementary to the globalisation process. Thus, the recent attempts of regional integration by India need to be viewed against this understanding that RTAs are building blocks to the multilateral trading system.

II.2 Adjustment Cost vs. Efficiency Concerns

In the India-specific context, there was a stage of development when trade liberalization was considered crucial for enhancing efficiency-levels through import-competition. However, this posed the risk of a deindustrialization process in the country, as the domestic stakeholders needed some time for adjustment for withstanding import-competition. The RTAs in India provide for an avenue to balance these seemingly conflicting objectives of addressing efficiency-concerns and phase of transition and adjustment. This is possible due to the very nature of RTAs. The import liberalisation is calibrated in terms of the choice of a country (or countries), sectors and timeframe. It does not open up all sectors to all the countries at the same time. Moreover, import liberalisation is done with reciprocity, so our exports also get market access.

II.3 Trade-Development Relationship

II.3.1 Two-way Causality

India's RTAs also need to be viewed as those trying to strengthen the two-way trade and development relationship. While trade can initiate achieving developmental objectives through employment generation, the development process itself enhances trade capabilities.

II.3.2 Trade Creation and Diversion

One of the arguments against regional groupings since the work of Viner (1950) and subsequently Meade (1955) and Lipsey (1970) has been that they may not necessarily bring about welfare gains, especially in the short run, due to their trade diverting effects. Trade diversion occurs when the participating countries in a regional grouping are not low cost producers. In this sense, the grouping may be an efficiency-reducing arrangement. Due to regional trade liberalisation the member countries acquire an advantage over the extra-regional countries in terms of lower product prices. A member country thus switches its imports from the more efficient rest of the world producers to the lesser efficient and higher cost partner member country. This results in resource misallocation and amounts to trade diversion.

However, for instance, within the South Asian region there are several lower unit value export items already present and are not being imported by the South Asian countries from within the region. They are actually being imported from outside the region. By not importing those by other South Asian countries results in welfare loss. Thus, the *costs of non-cooperation* have been estimated to be substantial for different South Asian countries.

In this context, one may refer to the analytical and empirical work summarized in the Cecchini Report (1988) in arguing a case in favour of the EU.

Quite ironically and contrary to received trade theories the South Asian region has been thus characterized by some sort of *reverse trade diversion*. Cognizance is taken of this aspect in the overall framework of India's strategy of RTAs.

Trade Diversion not necessarily Bad

It is often missed out from the analytical debate on the subject that trade diversion in some products could itself lead to trade creation in other products over a period of time. Illustratively, if an intermediate product is cheaper in a member country and it is imported by a partner member country on preferential terms, it becomes further cheaper in the importing country. This makes the final product highly competitive in the importing country for the production of which the imported input is used. The possibilities of trade creation in the final product increase, generating the forward linkage effect. Similarly, backward linkage effect in the country producing the intermediate product could also be present. Thus, through their backward and forward linkage effects, trade diversion could lead to trade creation in a dynamic setting (Das, 2006).

II.3.3 Rules of Origin

It is not difficult to explain as to how important rules of origin are, especially in the context of India's RTAs. It is a set of instruments, a lack of consensus on which, has delayed the implementation of the Draft Framework Agreement on India-Thailand FTA and the SAFTA Treaty. It was with many difficulties that India and Sri Lanka agreed upon it during the negotiations for their bilateral FTA, a few years back. Absence of provisions relating to origin-

rules under the India-Nepal FTA raised concerns about imports from Nepal into India having adverse implications in some Indian domestic sectors. The problem was tackled by setting in place these rules during subsequent negotiations.

The obvious question is why rules of origin are so important that they have such a strong bearing on the outcome of international economic relations' negotiations? The answer lies perhaps in the conceptual ambiguity which envelopes this trade policy instrument in developing countries.

Whether or not a product has originated in a particular country is decided if the product has undergone substantial transformation. There are three prime ways of determining this. Firstly, the change-in- tariff-heading test implying that the tariff heading of the final product is different from the tariff headings of its inputs. Second, a percentage test is applied according to which a minimum percentage of total value addition should be achieved with the help of domestic inputs. Finally, specified process tests require a product to undergo certain stipulated processes.

However, agreement on the implementation of these tests is often difficult. For instance, the extent of 'substantial transformation' for different products would depend on the level of disaggregation (i. e. HS 4- or 6-digit level) on which tariff-shift is envisaged. Similarly, fixing of percentages of minimum value addition varies from product to product, depending on the prevailing labour costs and the product-specific import dependence of the country in terms of intermediates. These policy-conflicts can be resolved if the role of origin-rules are understood with clarity.

One of the prime functions of these rules is to prevent trade deflection in trading arrangements. In any FTA, members set their own external tariffs but give preferential tariff treatment to each other. The divergence between external tariffs of the members and the preferential tariffs becomes a potential source of trade deflection. In the absence of any rules of origin within the FTA, the country with lowest external tariffs is likely to serve as an entry point into the partner's market for the goods of the non-member countries. In this sense, rules of origin are important tools for checking trade deflection from one member country to another member country of third country goods.

The three modalities of determining origin of a product aim at substantial transformation in inputs. They together facilitate value-addition in the country of manufacturing and play a developmental role. Such requirements, checking the import content of value addition, have the potential for generating backward and forward linkages in a country adhering to the rules. Thus, a member country is prevented from becoming a mere trading country as these requirements act as a deterrent to assembly kind of production activities. However, rules of origin should be designed in a manner that is not trade- restricting. They should not become trade barriers due to their complex methods of implementation.

Developed countries use the rules of origin for developmental purposes, though in some cases they do act as NTBs. NAFTA is a case in

point wherein for the automotive sector different percentages of the regional value content are laid down for various phases, for instance 56 per cent between 1998 and 2002 and 62.5 per cent thereafter for some categories of motor vehicles. In the case of textiles and apparel, there is a "triple-transformation test" that requires fabrics or clothing items to be spun from yarns or fibres produced in North America as well as to be cut and sewn within the FTA. Cutting does not determine the country of origin as the new rules are based on processing or assembly operations.

It is clear from above that rules of origin, if designed adequately could not only prevent trade deflection possibilities but also act as a catalyst to value-addition efforts in members of an FTA (Das, 2004 and Panchamukhi and Das, 2001). Their implementation should, however, not swing to the other side of spectrum where its effects are akin to NTBs. This remains as a policy challenge, especially in FTA negotiations in the developing world.

II.4 Trade-Investment Linkages

It is further acknowledged in India's RTAs that the strengthening of trade-investment linkages is a pre-requisite for achieving economic successes because of the fact that trade deficits between bigger and smaller countries need to be compensated by capital account surpluses wherein outward-FDI from bigger to smaller countries takes place. This kind of linkage helps in improving export supply capabilities of the smaller countries and in the second round there are favourable trade effects.

The real gains from an FTA result from efficiency-seeking industrial restructuring, which also builds productive capacities in relatively lesser-developed economies. Therefore, most of the new age free trade arrangements of India are trying to combine trade in goods and services with investment liberalisation.

The trade-investment linkages also run in both the directions. While a free trade agreement can spur investment flows in terms of efficiency-seeking regional restructuring, it is the trade-creating joint ventures that ultimately have a decisive impact on regional trade flows. The trade-creating joint ventures are in a position to take advantage of the regional freer trade agreement. In this context, in a dynamic scenario, vertical integration and horizontal specialization could be focused upon with the help of cross-country investment flows that strengthen trade-investment linkages. This may essentially mean distribution of different stages of production in a particular industry regionally in an integrated manner viz. the vertical integration and specialization in the same stage of production with the help of product differentiation across the region viz. the horizontal specialization (Das, 2004). This is the basis of argument highlighting the imperatives of moving beyond SAFTA to bring in investment cooperation within the ambit of the South Asian economic integration process.

II.5 Static and Dynamic Gains

In the literature on regional trading arrangements, the effects of removal of trade barriers in terms of export growth are analyzed in the context of static and dynamic gains. For instance, reduction in tariffs means greater market access to member countries, which manifests itself in export growth in a static setting. The scenario of a dynamic framework is different in which due to economies of scale – arising on account of enhanced market access - ultimately the manufacturing processes experience gains in terms of cost reductions and improved product competitiveness. Short run static trade diversion effects, if any, are likely to be outweighed by the long run positive dynamic effects of regional integration in terms of increased competition, economies of scale and benefits of intra-industry trade.

What is more, in a dynamic setting trade-investment linkages get strengthened whereby, trade deficits between bigger and smaller countries of an FTA, get compensated by capital account surpluses, wherein outward-FDI from bigger to smaller countries takes place. This kind of linkage helps in improving export supply capabilities of the smaller countries and in the second round there are favourable trade effects.

II.6 Need for Safeguards

The preceding analysis present a brief overview of the conceptual basis for India' regional economic engagements. However, such RTAs are not bereft of certain deleterious implications for the domestic stakeholders. Thus, as in most cases, India's RTAs also have detailed provisions of safeguard measures, addressing different economic concerns. A brief profile of such measures is presented in the section that follows.

III Liberalization and the Need for Safeguard Mechanisms

III.1 Developmental Perspective as against Protection

Safeguard measures are often confused with protectionist devices. While protection may mean not committing to trade liberalisation at all, safeguards are meant essentially to tackle any possible import threat to the domestic industries on account of import liberalisation commitments.

III. 2 Balancing Liberalization and Safeguards

At times, it has been noticed that while studying the feasibility of an RTA, there is an overemphasis on either the liberalisation commitments or the safeguards. This also gets reflected in various RTA negotiations between India and regional partners. It must be highlighted that to reap the full benefits of RTAs, it is imperative to balance the liberalisation commitments with adequate safeguard measures.

III. 3 Different Objectives Achieved Through Different Safeguards

In India's RTAs, different objectives have been sought to be addressed by setting in place different safeguard measures. These are presented in a synoptic way below.

III. 4 Safeguard Mechanisms

III.4.1 Tariff and NTBs Liberalization

- Tariffs
    - Time-frame
    - Coverage
    - Extent of reduction/elimination
    - Country-specific treatment

- NTBs
    - Across-the-board Liberalization
    - Sectoral Approach
    - Examples: QRs/TRQs/TBT/SPS/MRAs

III.4.2 Sensitive List

- Various Determinants
    - Exporters
    - Importers
    - Manufacturers Targeting Domestic Market
    - Public Morals/Environment/ Archaeological etc.
    - All Trade minus Substantially All Trade
    - Stages of Development: S&DT for LDCs

- PTA: Positive List Approach
- Can Sensitive List be Common between Economic Partners and Across Partners?

III.4.3 Tariff Rate Quota

- Combination of Two Instruments
- Sensitivities Taken Care of: Not Through Sensitive List
- India-Sri Lanka FTA
    - Tea, Garments
- India-Nepal Trade Treaty
    - Vanaspati, Acrylic Yarn, Copper, Zinc Oxide

III.4.4 Rules of Origin

- Rules of Origin: Conceptual Issues
- Economic Effects of ROO
- Nuances of Different Modalities of Origin Determination
    - Change in Tariff Classification
    - Percentage Test
    - Specific Process Test
    - Merits and Demerits
    - A Combined Approach

III.4.5 Trade Remedial Measures

- Objective to Check Unfair Trade Practices
- Measures:
    - Anti-dumping Duty: Price-discrimination
        - Causal Link between Imports and Injury
        - Dumping Margins
    - Countervailing Duty: Foreign Export Subsidy
        - Imports, Injury and Margin

III.4.6 Safeguards

- Not a Trade Remedial Measure
- Objective to Check Import Surge (Fair Trade Practices)
- Consultation
- Provisions of Investigation
- Basis of Injury
- Provisional Safeguards
- Duration and Termination

IV. India's Recent Regional Economic Engagements

IV.1 Bilateral:

INDO-BHUTAN

The bilateral Trade Agreement between India and Bhutan provides for free trade and commerce. Commercial transactions are carried out in Indian Rupees and Bhutanese Ngultrum. India provides unhindered transit facilities to landlocked Bhutan to facilitate its trade with third countries. Bilateral trade and economic relations continued to run smoothly during the year. India is Bhutan's largest trade partner. During the year 2001-2002, inclusive of electricity, Bhutan's exports to India totalled Rs.4.43 billion and constituted 94per cent of its total exports. Imports from India were of the order of Rs.7.04 billion, constituting 78per cent of its total imports.

Petroleum products, cereals, motor vehicles and spare parts, iron and steel and its products, machinery and mechanical appliances, chemical products, edible oil, wood charcoal and coal are India's main exports to Bhutan. Besides electricity, calcium carbide, gypsum, ferro-silicon, particleboard and Portland cement are the main imports from Bhutan. Indian vehicles dominate the automobile market and have captured more than 80per cent of the market. GoI funded projects have also contributed to increasing imports from India (MEA, 2004 and MOC, 2004).

INDO-NEPAL

Indo-Nepal relations on trade and other related matters are governed by the bilateral Treaties of Trade and Transit, and Agreement for Cooperation to Control Unauthorised Trade. The Treaty of Transit as modified on 5th January 1999, is automatically extendable for a period of seven years at a time, unless either party gave to the other a written notice, six months in advance, of its intention to terminate the Treaty. The Treaty of Trade and the Agreement for Cooperation to control Unauthorised Trade, which was valid upto, December 5, 2001, had been extended for a period of three months upto March 5, 2002, on ad-hoc basis.

Though under the international conventions, Nepal being a landlocked country, India is obliged to provide only one transit route to facilitate Nepal's trade with third countries, 15 transit routes have been provided through the Indian territory and more such routes can be added to the list with mutual agreement. In addition, facilities have also been provided for Nepalese trade with Bangladesh by road and rail route and with Bhutan by road route. Movement of Nepalese goods from one part of Nepal to another part of Nepal through the Indian territory is also permitted. On the request of Government of Nepal, an additional transit route was opened during 1997 through Phulbari-Banglaband to facilitate movement of Nepalese goods to and through Bangladesh over a shorter distance.

Goods of Nepalese origin were allowed duty free entry in India as a special privilege given to that country. This led to large-scale duty free import into India of items using substantial inputs of third country origin with minimal value addition in Nepal causing injury to Indian industry.

Accordingly, as provided in the Treaty, the process of negotiations was initiated for making modifications in the Treaty and its Protocols to address the problems faced by the Indian industry. The India-Nepal Treaty of Trade was reviewed and modified on March 2, 2002 restoring the concept of value addition in imports from Nepal and making the value addition criteria more transparent. The Treaty of Trade is now valid for five years from March 6, 2002. The Agreement for Cooperation to Control Unauthorised Trade was also renewed for a period of five years with effect from 6th March, 2002. The India-Nepal Treaty of Transit would remain in force up to January 5, 2006 and shall be automatically extendable for further 7 years at a time unless either party gave a notice for its termination (MOC, 2004).

INDO-SRI LANKA

Sri Lanka has traditionally been an important export market for India, and is the second largest importer of Indian goods in the region after Bangladesh. The bilateral trade is carried out in accordance with the provisions of the Trade Agreement signed in 1961. The trade is in freely convertible currencies and on MFN basis. The trade has grown strongly in recent years, with India enjoying a favourable trade balance. Both countries are signatories to WTO, SAARC and the Bangkok Agreement. Within the framework of SAARC Preferential Trading Arrangement and the Bangkok Agreement, mutual preferential trade concessions are extended to each other. India and Sri Lanka have signed a Free Trade Agreement on 28th December, 1998, under which tariff on a large number of items are being phased out within an agreed time frame except in the Negative List.

INDIA-THAILAND

Trade between India and Thailand had been steadily expanding in recent years. However, in 1997, due to the economic problems faced by the East Asian region, Indian exports to Thailand declined. During the year 1998-99 although there was a slight improvement in the overall trade (US$ 594), yet Indian exports declined and Thai exports increased.

The subsequent years have shown consistent increase in bilateral trade. The total bilateral trade in 1999-2000 increased to US$ 777.66 million while during 2000-01 bilateral trade further grew to US $ 842.28.During 2001-02 the bilateral trade has grown to US $ 1055.63 with an increase of over 25per cent in the total trade. Our exports grew by 19.9per cent while imports grew by 34.5per cent during the year. The balance of trade is in our favour.

During the State visit of the Thai Prime Minister, Dr. Thaksin Shinawatra to India in November 2001, it was agreed that India and Thailand should explore together the possibility of establishing a bilateral Free Trade Area (FTA) with a view to intensifying trade and economic relations between the two countries. It was also decided that a Joint Working Group (JWG) at Government level be set up to undertake feasibility study on a FTA. JWG has in its fourth meeting in Thailand on December 22-23, 2002 finalized its Report (Das, Ratanakomut and Mallikamas, 2002). The Study has concluded that there exists immense potential for enhancing cooperation in trade and other

areas such as services and investment and the proposed FTA was feasible and mutually beneficial. A Joint Negotiating Group (JNG) has been formed which would draft a framework agreement on the India-Thailand FTA. The first meeting of the JNG was held back – to - back with the fourth meeting of the JWG on December 22-23, 2002. A Draft Framework Agreement towards an FTA was signed in 2003 and subsequent to completion of rules of origin negotiations an early harvest scheme, covering 82 items at HS 6-digit level, was implemented on 1 September 2004. The full FTA is envisaged to be operational in 2010.

It is worth highlighting the delay between the signing of the Indo-Thai Framework Agreement on FTA was primarily due to a lack of consensus on rules of origin. One of the major dimensions of disagreement was on the question whether to have a general set of rules of origin or have system of product specific rules or both. While India insisted on having both a general set of rules entailing change in tariff heading at HS-4 digit level and a 40 per cent local content norm with products specific derogations wherever necessary, the Thai side remained inflexible on their demands for having just 40 per cent value addition norms representing substantial transformation.

India-Singapore

After a long-drawn negotiations the CECA with Singapore was concluded in 2005. The India-Singapore CECA was signed on 29 June 2005, during Prime Minister Lee Hsien Loong's State Visit to India. This landmark agreement is India's first ever CECA. It is also Singapore's first comprehensive bilateral economic agreement with a major developing country. The Agreement encompasses trade in goods and services, investment protections and other features like the Mutual Recognition Agreements that will eliminate duplicative testing and certification of products in specific sectors. The CECA process has also encompassed a review of the existing Avoidance of Double Taxation Agreement between India and Singapore. The India-Singapore CECA became effective from August 1, ’05.

INDIA-ASEAN

India and the Association of Southeast Asian Nations (ASEAN) are setting out measures to enhance their comprehensive economic partnership. A Framework Agreement on Comprehensive Economic Cooperation between the Association of Southeast Asian Nations and the Republic of India, signed in 2003 lays out measures to be taken by both sides to work toward an ASEAN-India Regional Trade and Investment Area (RTIA). Negotiations on rules of origin for trade in goods and the modality for tariff reduction and elimination is being conducted and for trade in services and investments, the negotiations on the respective agreements shall commence and be concluded by 2007.

INDIA-CHINA

India and China resumed trade officially in 1978. (Note: The 1954 Trade Agreement between India and China lapsed in 1962.) In 1984, the two countries signed the Most-Favoured Nation Agreement. The India-China Joint

Group on Economic Relations and Trade, Science and Technology (JEG) at the level of Minister of Commerce and Industries was established in 1988 during the visit of Indian Prime Minister to China. The JEG has met six times till date, the last being in February 2000. During this meeting, India and China signed an agreement on issues relating to the World Trade Organisation (WTO) and an MOU for setting up a Joint Working Group in the field of steel.

INDIA-MERCOSUR

The Brazilian President, Mr Lula Da Silva's state visit to India in January 2004 marked the signing of the India-Mercosur Preferential Trade Agreement (PTA). A key feature of the PTA is that it links countries on distant continents emphasising the inter-regional potential of south-south cooperation. Renewed interest in such agreements reflects both commercial and political considerations.

Trade between India and Mercosur doubled between the mid-1990s and 2002 but remains modest. At between 1.3 billion dollars and 1.8 billion dollars in 2002, it represented just 1.1 and 1.2 per cent of India's and Mercosur's total trade respectively. Studies on 2000-2002 trade flows aimed at identifying complementary products show that the indicative trade potential for Mercosur exports to India is up to 13.6 billion dollars (almost 16 times actual trade) and that of Indian exports to Mercosur is up to 12.7 billion dollars

IV.2 Regional:

SAARC

The South Asia region comprises Afghanistan, Bangladesh, Bhutan, Maldives, Nepal, Pakistan and Sri Lanka. With the exception of Afghanistan, these countries including India have organised themselves as members of the South Asian Association for Regional Cooperation (SAARC). The South Asian region has attempted to intensify regional economic integration over the past decade through regional, sub-regional and bilateral approaches. The progress of SAPTA in terms of tariff liberalization has been rather slow because of product-byproduct or positive list approach adopted. Trade liberalization in the region has also been attempted under bilateral FTAs such as between India-Sri Lanka, besides India-Bhutan and India-Nepal. Several new bilateral FTAs between other South Asian countries i.e. Maldives, Pakistan, Bangladesh, Sri Lanka and Nepal are being discussed. In addition a number of South Asian countries and Southeast Asian countries are participating in BIMST-EC that is moving towards an FTA. Even the limited experience with trade liberalization under SAPTA has produced encouraging results in terms of trade expansion. The bilateral FTAs in the region appear to have led to equitable expansion of trade flows with exports from smaller and lesser-developed partners growing faster. The FTAs have also led to investment flows and trade-creating joint ventures, which facilitate development of, supply capabilities of lesser-developed partners. These experiences have prompted the governments to expand the scope of India-Sri Lanka FTA to cover trade in services and investments in the framework of a Comprehensive Economic Partnership Agreement.

SAARC has now achieved a milestone in terms of signing of the SAFTA Treaty in Islamabad in January 2004. The studies suggest that SAFTA could lead to substantial expansion of mutual trade and efficiency-seeking investment in the region (RIS, 2004).

More recently, SAFTA negotiations have been finalized. In the area of rules of origin, change of tariff heading (CTH) at four-digit HS has been agreed upon along with domestic value content of 40% for non-LDCs and 30% for LDCs. Product Specific Rules (PSR) for 191 tariff lines on technical grounds where both inputs and outputs are on the same four-digit HS level have also been agreed.

With respect of sensitive list, India has kept 884 tariff lines in the Sensitive List for non-LDCs and 763 for LDCs. India's Sensitive Lists include mainly goods from agriculture sector, textile sector, chemicals & leathers and sectors reserved for small- scale industries. On the market access to Bangladesh, a limited market access through Tariff Rate Quota (TRQ), it has been decided to accord 6 million pieces of fabrics with the condition that sourcing of fabrics should be either from India or of Bangladesh origin. Also, TRQ of 2 million pieces without any conditions of sourcing of fabrics has been agreed.

A mechanism for compensation of revenue loss to LDCs has also been agreed at. It has been decided that the compensation to LDCs except to Maldives will be available for four years and to Maldives for six years. The compensation shall also be subject to a cap of 1%, 1%, 5% and 3% of customs revenue collected on non-sensitive items under bilateral trade in the base year. However, the extent of compensation shall not apply in case of claims of compensation by Maldives from India in the event of loss of revenue being higher than the above annual ceilings.

Moreover, it has been agreed that Non-LDCs would provide technical assistance in areas like capacity building in standards, protect certification, training of human resources, data management, institutional upgradation, improvement of legal systems & administration, customs procedures & trade facilitation and market development & promotion.

IV.3 Pan-Asian:

Asian Economic Community

In recent years, there has been a growing realization of the importance of intensive economic integration at the pan-Asian level in the region. It is considered that stimulus for future growth in the Asian region would have to come from within. It has also been observed that rich scope for complementarities exist among Asian economies that remain to be exploited for their common benefit. 'For instance, while the region has economies that are surplus in capital resources, there are also economies, which have inadequate domestic savings for rapid development. The region is similarly characterized by complementarities in the demand and supply of other resources such as technology, and skilled manpower' (Kumar, 2005).

The major areas of cooperation on which studies are being conducted include monetary and financial cooperation, formation of a regional trade bloc, foreign direct investment and transfer of technology and skills, among other sectors.

IV.4 Inter-regional:

BIMSTEC

The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation, or BIMSTEC, groups together Bangladesh, Bhutan, India, Myanmar, Nepal, Sri Lanka and Thailand. The seven-country forum aims to achieve its own free trade area by 2017. The leaders of the grouping agreed in 2004 on steps designed to take forward initiatives, which formed the group's first line of action - transport infrastructure, energy, communications, tourism, trade and fisheries. They will cooperate on research and development based on resources available from their own rich natural biodiversity, aimed at producing breakthrough affordable drugs, and also agreed to cooperate on energy issues. Working groups were set up to move the sectoral agenda, with India proposing and obtaining a commitment to form a joint counter-terrorism team that will share intelligence and build joint capabilities.

India-EU, India-US and India-Brazil-South Africa Economic cooperation initiatives are also being discussed.

V. Some Empirical Evidence

V.1 Global Growth Asymmetries and Regional Integration

Under the β-convergence framework the following equation has been estimated econometrically:

$$(\log Y_{Tt,I} - \log Y_{0t,I})/n_t = \alpha + \beta \, Log(Y_{0t,i}) + \varepsilon_{t,I} \quad \text{.....(i)}$$

where, $Y_{Tt,I}$ refers to the real GDP per capita in the last year of period t (t = 1,2,3,4,…..) the corresponding sub-periods) for country i, $Y_{0t,I}$ is the value of real GDP per capita in the initial year of period t, n_t is the number of years and T the last year in period t.

The same set of data was also used to estimate the conditional β-convergence in the fourth step by further augmenting the model with additional variables (data sourced form WB, World Development Indicators). These are Government Consumption (GC) as a % of GDP, openness of the economy (OP) as imports in % of GDP, the FDI as % of GDP (FDI) and percentage of annual inflation (INF) as a deflator of GDP. These variables have been chosen on the basis of our own inferences drawn from various economic growth theories and some of them used in other empirical studies on the subject. In this step, it is obvious that the β-convergence would give results on convergence or divergence in a global setting. This implies that convergence or divergence would include intra-developing country, intra-developed country and developing-developed country effects in a combined manner.

The following equation was estimated:

$$(\log Y_{Tt,I} - \log Y_{0t,I})/n_t = \alpha + \beta_1 \, Log(Y_{0t,i}) + \beta_2 \, (GC) + \beta_3 (OP) + \beta_4 (FDI) + \beta_5 (INF) + \varepsilon_{t,I} \text{....(ii)}$$

The same methodology was used to estimate the equation for the prominent regional groupings viz. EU-15, NAFTA, Mercosur, ASEAN, SAFTA and SADC including both developed world groupings and developing countries groupings across continents. However, in this context, intra-regional trade as a percentage of each regional grouping's total world trade was taken as an additional variable to see in the presence of high or low intra-regional trade if the convergence or divergence estimates change.

The estimates of Conditional β-convergence for prominent regional groupings separately is shown in Table 1 and 2.

Table 1 shows that more integrated regional groupings like EU, NAFTA, Mercosur and ASEAN are converging and lesser integrated groupings like SARRC and SADC are growth diverging when we estimate the

same equation. However, the results do not conform to the openness variable in some instance.

Thus, to extend the analysis we included intra-regional exports as a proportion to total world trade of the grouping as a measure of the depth of regional integration and the results are presented in Table 2.

It is clear that trade integration is a significant factor in reducing the global growth asymmetries. The conditional beta convergence regression for different regions shows a negative and highly significant Beta coefficient. It implies that the countries of the sample are converging towards each other with respect to real GDP per capita. From this we can calculate the rate of convergence/divergence.

The rate of convergence for all regions is quite high for the period concerned. It is around 7% for regions like EU, NAFTA, ASEAN, MERCOSUR and SADC and around 12% for SAFTA. This supports our argument that Regional Trade Integration which has been a new development in the international trade arena will be an effective policy instrument for the countries across the world to follow and remove the asymmetries that are plaguing the rate of growth of many countries. Also, openness defined as Imports as a % of GDP also has the expected positive sign. This shows that trade openness along with regional trade integration has played an increasingly important role in reducing the growth asymmetries.

The explanatory power of the independent variables included is also very high for almost all the regressions. The Durbin Watson statistic also shows that there is no problem of autocorrelation. The Wald test shows that all coefficients of the additional variables in the model are jointly significant in explaining the convergence within the regional trading blocs.

We find that it can be concluded that regional integration leads to growth convergence and both openness to global trade and regional openness captured by intra-regional exports are important in this regard.

Table 1: Panel Data Regression Results for Conditional Convergence for Different Regional Economic Groupings (Fixed Effects)

Variable	EU-15	NAFTA	ASEAN	MERCOSUR	SAFTA	SADC
Constant	0.033 (1.38)	0.05 (3.51)	0.14 (3.29)	0.09 (3.00)	-0.03 (-0.87)	-0.01 (-0.14)
Initial Per Cap GDP	-0.004 (-0.58)	-0.01 @ (-2.63)	-0.04 @ (-2.63)	-0.02 * (-2.51)	0.03** (2.09)	0.0003 (0.07)
FDI	4.32E-05 (0.26)	0.004 (2.22)	0.006 (1.98)	-0.0003 (-0.12)	-0.02 (-1.27)	-0.0005 (-1.11)
Govt. Consumption	-0.0005 (-2.49)	0.0003 (0.96)	-0.001 (-0.96)	-0.0003 (-0.51)	-0.002 (-1.81)	-2.42E-05 (- 0.06)
Openness	7.00E-05 (1.56)	-0.0004 (-2.32)	-0.0001 (-0.48)	-0.0005 (-2.37)	0.0008 (2.25)	0.0002 (2.79)
Inflation	-0.0003 (-1.73)	-0.0003 (-4.36)	-0.001 (-2.09)	-5.27E-06 (-0.85)	-0.002 (-1.58)	-0.0002 (-1.48)
R^2	0.31802	0.79505	0.61659	0.48735	0.41764	0.27333
Adjusted R^2	0.249822	0.624266	0.424896	0.231029	0.255869	0.166472
Durbin-Watson Statistic	2.094563	2.640758	2.226182	2.958406	1.914701	1.374469

Note: @99.5% Level of Significance, * 99% Level of Significance, **97.5% Level of Significance, *** 95% Level of Significance, # 90% Level of Significance

Table 3: Panel Data Regression Results for Conditional Convergence for Different Regional Economic Groupings (Fixed Effects)

Variable	EU-15	NAFTA	ASEAN	MERCOSUR	SAFTA	SADC
Initial Per Cap GDP	-2.673147 (-5.803273)	-4.990330 (-2.394842)	-7.440070 (-5.785915)	-7.383730 (-2.612764)	-2.649437 (-1.522123)	-4.053724 (-1.012069)
FDI	0.009232 (2.361190)	0.012439 (0.413688)	-0.013774 (-0.374970)	-0.007713 (-0.151395)	0.151979 (1.233226)	0.001983 (0.030715)
Govt. Consumption	-0.096125 (-5.888433)	-0.139156 (-3.675862)	-0.099492 (-1.605896)	-0.058347 (-1.427832)	0.009181 (0.132478)	-0.011574 -(0.324602)
Openness	0.015940 (3.286657)	0.017721 (1.441796)	0.019460 (1.973965)	0.020979 (1.075854)	0.009785 (0.349963)	0.009429 (0.526162)
Inflation	-0.033881 (-6.026702)	-0.031375 (-3.342175)	-0.047225 (-7.043683)	-0.000287 (-2.155428)	-0.061292 (-3.224152)	0.006276 (1.487893)
Intra-regional Exports (% of Total Exports to World)	0.004939 (2.584232)	0.000558 (1.382015)	0.050144 (2.298402)	0.020449 (2.216748)	-0.025784 (-1.843808)	-0.017733 (-0.843272)
R^2	0.608129	0.387068	0.701042	0.370187	0.615116	0.108441
Adjusted R^2	0.564855	0.238479	0.642551	0.246963	0.482397	-0.042671
Durbin-Watson Statistic	1.167292	2.143394	1.400654	1.737550	2.365883	2.084743
WALD	144.6812	16.89538	59.67342	13.33240	18.70952	2.925624

Note: @99.5% Level of Significance, * 99% Level of Significance, **97.5% Level of Significance, *** 95% Level of Significance, # 90% Level of Significance

V.2 Static and Dynamic Trade Gains

Table: Projected Increase in Intra-SAARC Exports under SAFTA

(Percentage Change)

Country	Scenario I	Scenario II	Scenario III	Scenario IV
Bangladesh	24.05	39.67	73.81	106.13
Bhutan	16.66	31.15	56.20	79.05
Nepal	12.61	23.94	41.65	64.81
Sri Lanka	19.38	37.60	61.50	93.17

Notes: Scenario I: 75% Tariff Reduction, Scenario II: 100% Tariff Reduction, Scenario III: 25%
Reduction in Costs of Production (due to Scale Effects), Scenario IV: 50% Reduction in Costs of Production (due to Scale Effects).

Two important inferences could be drawn from the projected increase in intra-SAARC exports as presented in the table in four possible scenarios. On one hand, relatively underdeveloped countries of SAFTA would gain in substantial terms. In fact the gains would be greater for them than the bigger countries. This would happen because in the static scenario, smaller countries would have access to bigger markets. One may raise a question that countries like Nepal, Bhutan and Sri Lanka already have free trade arrangements with the biggest country that is India. But it may be argued that they would gain from SAFTA as they would simultaneously get access to other big and small members. On the other hand, the dynamic gains emanating from economies of scale and better product competitiveness appear to be noteworthy. This would further help the underdeveloped members to increase their intra-SAARC exports. It may be mentioned that the gains accruing to a country like Bangladesh would be initially due to an improved market access in bigger countries whereas in the case of Sri Lanka, its somewhat better export supply capability would serve as an additional force.

However, there is a limit to which such a process could be sustained. What would be an imperative further is facilitating trade-investment linkages. This would help building export competitiveness in underdeveloped members while the bigger members would get an additional investment and production space with geographically-proximate locational advantages. This would provide avenues for creating fresh trade complementarities and reaping the trade-creation effects.

Some of the successful examples of these are already well-known in the context of India-Sri Lanka FTA and Indo-Nepal Trade Treaty. Such synergies are being tapped already in the case of India-Bangladesh trade and investment interactions. SAFTA is well-placed in providing impetus to this process.

VI. Summing Up

The analytical arguments in this paper and the empirical evidence suggest that there is a strong case for India to pursue regional economic integration and regional trade openness along with openness of trade, globally. However, to mitigate the possible adverse effects adequate safeguard mechanisms need to be set in place so as to derive net positive economic gains from such processes.

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