Assignment On

SAFTA

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Submitted To

Mohammad Shariful Islam
Course Instructor
International Business
Department of Business Administration
East-West University, Dhaka

Submitted by

S. M. Benzir Ahmed
0000-0-00-000
Department of Business Administration
East-West University, Dhaka

East-West University, Dhaka
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Background

South Asian Association for Regional Co-operation (SAARC) was established in 1985. The SAARC's member countries are India, Pakistan, Sri Lanka, Nepal, Bhutan, and the Maldives. The South Asian Preferential Trade Agreement (SAPTA) was drawn up in 1993, providing for bilateral reductions in tariff and non-tariff barriers on specified commodities on a reciprocal basis, but with special treatment given to the least developed states. The eventual objective is for SAPTA to become a South Asian Free Trade Area (SAFTA), based on multilateral tariff reductions. On the whole, the achievements of SAARC and SAPTA have been limited. Although tariff concessions have not been negligible, they have been introduced on items that represent no more than 1 percent of the total trade of the seven-country grouping.

The SAARC summit declaration of Islamabad promises a South Asian Free Trade Area (SAFTA). It calls for reduction in import duties to 20 per cent by 2006 and between 0-5 per cent by 2013 but allows the less developed economies to reduce the rate of duties to 0-5 per cent by the year 2016. SAFTA allows the countries to notify the negative list which will not enjoy concessional import duties. Obviously, if the negative list is quite large, the impact of the agreements will be little. Considering the significance of trade to welfare, it is hoped that the South Asian countries will keep the negative list small.

South Asian exports face a challenging external environment. World growth and demand have weakened, commodity prices are expected to decline further, and the phasing out of the textile quote system in 2005 will leave many of these countries' exports more vulnerable to competition from other developing countries. Export growth in the region has slowed; yet reviving export growth will be crucial to boosting the region's sagging GDP growth rates, which have fallen from about 7 percent in 1996, to 5 percent in 1997-1998, and are widely expected to fall further in recent years. This agreement is expected to have rather modest an economic impact, with some benefits for consumers and some increased competition or domestic produces. Politically, it can help sustain the improved political relations the region's leaders all say they want.

The SAARC members' trade imbalances with India would probably increase. Although under the trading agreement India's neighbours would have greater access to the large Indian market, it is likely that the flow of trade will remain unbalanced. India exports a broad range of commodities to Bangladesh and Sri Lanka, including transport equipment, cotton yarn and fabrics, pharmaceuticals, machinery, iron and steel products, and food commodities, but its imports from these countries are limited. India is the leading source of imported goods for both Bangladesh and Sri Lanka and both run significant trade deficits with India. High tariff nations, such as India and Pakistan, would lose import tariff revenues from any tariff reductions. Unofficial trade between India and her neighbours (particularly Bangladesh and Pakistan) could, however, be converted to official trade resulting in significant revenues for the governments concerned. Trade liberalization that converted all smuggled goods into legally imported goods at a given import duty could yield significant customs revenues for Bangladesh.

At Today

The preponderance of the global economic powers in the field of trade and development and the uncertainties about outflow of goods from countries of South Asia is clear. That being so, countries in the region needed to take effective measures for augmenting trade deals. The quantum of trade deals among SAARC countries remains limited to around 4.5 percent of the total trade flows worth around 135 billion dollars per annum. As against that, inter-country trade deals among countries in the European Union accounts for 55 percent of total trade. If the ultimate end of augmenting trade between and among the countries in South Asia is to be attained, then a vigorous move for opening bilateral deals and strengthening regional deals has to be taken forthwith.

The agreement on South Asian Free Trade Area (SAFTA) becomes operational under a pre-set tariff-cut roadmap aimed at boosting regional trade among the seven-nation grouping. Bangladesh will have to allow for next six months imports other than items under its sensitive list from the contracting states by reducing 2.5 percent tariff from the existing rates. The highest rate of customs duty in Bangladesh is 25 percent. India, Pakistan and Sri Lanka will reduce their tariff for Bangladesh and other LDC contracting states by 10 percent from their existing rates for next six months as per the negotiation concluded at the maiden SAFTA Ministerial Council here on April 20, 2006. Under the SAFTA roadmap, the developing members will bring down their tariffs to 0-5 percent in three years while the SAARC LDCs like Bangladesh will do it in 10 years.

“The tariff-cuts take effect as per schedule,” said an official in the National Board of Revenue (NBR). He, however, said Bangladesh did not issue necessary official order in this regard until today (Friday), but it was in the final stage. The official order will be issued immediately after the weekly holidays. The NBR official could not inform whether other contracting states issued the order, but said that at least no problem has been notified yet. “So, the agreement becomes operational tomorrow (July1, 06).”

Local businesses, however, apprehended that non-tariff and para-tariff barriers would be a stumbling block to reaping immediate benefits out of the agreement. They said that it would not yield the desired results without removing the NTBs and PTBs. “Even zero tariffs will not help achieve what we want from the SAFTA agreement,” said a leading businessman.

The SAFTA Ministerial Council at their first meeting, however, formed a subgroup on the NTBs and PTBs to remove the trade barriers as soon as possible. It would review the existing NTBs and PTBs from time to time, identify the barriers and take steps to remove the snags through bilateral and regional negotiations. The member-states had decided to notify non-tariff measures (NTMs) and para-tariff measures (PTMs) facing their exports to other SAARC states by October 1, 2006.

Commerce Ministry officials said the sub-group already met in their first meeting in Katmandu on May 16-17, finalising the terms of reference of the group. They also decided to hold the second meeting in Bhutan on August 1-3. To effectively address the issue of NTMs including standards, testing and certification so that these do not become barriers to intra-regional trade, the meeting agreed on the elements to incorporate in the TOR.

In Future

Regional groupings have proliferated around the globe. While some have been successful, others have not. World Bank (2004) reviews the regional experiences around the world and points out six broad conclusions for the success of such groupings of free trade. Firstly, a regional trade agreement does not automatically result in increased trade and growth. Whereas the intention at the time of formation of the group is always to promote intra-regional trade and economic cooperation in all the fields, a large number of interest groups emerge who on the grounds of injury to their industry, call for exemption of reduction in the import duties. The experience with SAPTA has been disappointing for this reason. SAFTA allows a sensitive list and if the list is large, then it may not see higher intra-regional trade. Whenever trade would be promoted, the industries in which the country does not have comparative advantage will close down. Moreover, agreements that kept in place high external border barriers, protect inefficient activities and undermine the competitiveness of all countries.

Second, the trading arrangements with unilateral efforts among members to reduce external protection have been more successful. Reducing trade barriers vis-à-vis the rest of the world creates an incentive for all members to export. It augments competition that drives domestic productivity [see Muendler (2002)]. When external protection is generally low, trade creation usually dominates trade diversion, and so the risk that regional agreements will be a drag on growth is substantially reduced. Indeed regional agreements where members have had low external protection have enjoyed greatest success [see Baldwin and Venables (1995) and Burfisher, et al, (2003)].

Third, the agreements between the countries with different factor endowments have shown more consistent success because of the opportunities to exploit different comparative wage rates, capital availability, technological levels that give rise to differing factor proportions in production [Schiff and Winters (2003) and Lederman et al, (2003)]. However, this conclusion runs contrary to the success of EU. The promotion of intra-industry trade would result in higher growth even if factor endowments are similar. Fourth, a regional integration framework that helps in trade creation and competition amongst regional countries would help in lowering domestic prices and providing new technology. It is impossible to have the benefits of a regional agreement without exposing the member economies to new competition.
[Hoekman and Schiff (2002)]

Fifth, competition in services also results in successful integration. Lowering the cost of telecommunications, finance, business services, and retail and wholesale commerce would result in productivity gains. Finally, there is a need to streamline borders transactions through trade facilitation. Increase in efficiency within the region often spills over into trade outside the region as well, because improving customs or improving efficiency of ports helps both intraregional trade and international trade.

RIS (2004) reports results of studies conducted in the framework of gravity model. It suggests that complete elimination of tariffs under SAFTA may increase the intra-regional trade by 1.6 times. It further suggests that in the dynamic framework the gains from liberalisation are at least 25 per cent higher than the static gains. However, these gains are grossly in view of SAARC's large trade potential; it exists both in trade diversion from traditional sources towards SAARC countries by removing the constraints and trade creation and expansion by easing import restrictions on products which SAARC countries are not trading in but are their major exports. While more than half the exports of manufactured goods from South Asia consist of textiles and leather products, they are subject to very high rates of import duties and/or quantitative restrictions and even outright bans in South Asia.

In the short term, the economic impact of free trade within South Asia is likely to be modest, especially for the large Indian economy. The more important effect of trade liberalisation, if it continues to move forward, is political. The impetus for all the recent agreements between India and Sri Lanka and between India and Bangladesh, as well as the high profile SAARC has given to its trade initiatives, comes from the political level. Continuing liberalisation can serve as a demonstration of India's interest in creating constructive relationships in the area. For India-Bangladesh relationships, expanded trade can also start to create linkages between the trade and business communities in both countries, creating some of the political and economic "infrastructure" needed to sustain improved relations.

Besides the issue of trade linkages, these are several possibilities for enhanced economic co-operation in the region, most notably in the energy sector. There is also potential for Bangladesh to export part of its natural gas reserves to India, a subject that has generated considerable political controversy within Bangladesh.

The SAFTA has great potential and South Asian countries should accept the short-term costs for long-term benefits.

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