

## **Preferential Trade among the SAARC Countries: Prospects and Challenges of Regional Integration in South Asia**

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### **Abstract**

The prospects and challenges of preferential trade liberalisation and regional integration in South Asia are analysed by analysing regional and international trade structures of South Asian countries through conventional trade measures such as commodity composition and direction of trade, and bilateral trade shares. Findings indicate that, with the existing low level of bilateral and intra-original trade shares and low trade with South Asian countries, the gains from free trade arrangements in this region are likely to be minimal. The region accounts for a very insignificant share of world trade but persistent high levels of tariff barriers. Thus, preferential trade liberalisation is more likely to bring about trade diversion than trade creation leading to more gains for large countries and more losses for small countries. Further, trade policies of individual countries are shaped more by political considerations than economic factors. Therefore, implementation of a free trade area and deriving benefits from it will be challenging.

**Key words:** Trade liberalisation, regionalism, South Asia.

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## Introduction

Interest in economic analysis of preferential trade liberalisation has increased with the rise of regionalism in recent years. It is argued that trade liberalisation and regional economic integration can help a region increase intra-regional trade by exploring the size of the market. This may in turn yield efficiency and bring benefits not only by exploration of economies of scale but also by dynamic and upward shifts in production function. By exposure to a regional market, previously shattered domestic firms become more competitive and gain the confidence to enter into global competition. Driven towards integration by the pressure of economic interest of the region, seven South Asian countries- Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka- formed the South Asian Association for Regional Cooperation (SAARC)<sup>3</sup> in 1985. They formed the SAARC Preferential Trading Agreement (SAPTA) in 1993 and transformed it into South Asian Free Trade Area (SAFTA) in 2004 with a view to enhancing their productive capacity and the region's trading interests.

However, since the emergence of SAARC, the achievement has been considered very insignificant and the level of intra-regional trade among SAARC countries is still very low. With the present low level of intra-regional trade and the perceived competitiveness among the SAARC countries, a question has arisen whether regionalism would benefit countries of this region. Based on this question, this study has attempted to analyse the implications of a regional preferential trade among seven SAARC countries. Thus, the main objective of this study is to examine the prospects and challenges of trade liberalisation and regional integration in South Asia.

Many studies attempted to shed light on the economic integration in South Asian region. Mehta and Kumar (2004) argued that signing of SAFTA agreement was a landmark in the evolution of SAARC since its formation in 1985. SAARC would benefit from regionalism if its cooperation would extend beyond formal trade. Dhungel (2004) noted that actual progress and achievement in implementation of SAARC agendas were considered very insignificant. Jhamb (2006) supported Dhungel's view and argued that it was primarily due to the tenuous political relations between India and Pakistan and a general environment of mistrust among member countries. However, by using a gravity model, Rahman, et al. (2006) showed that elimination of trade barriers and structural rigidities originating from adverse political relationship could lead to substantial increase in intra-SAARC trade. Pitigala (2005) found that the trade structures that evolved among the South Asian countries might not facilitate a rapid increase in intra-regional trade due to weak trading relations among the SAARC countries. This view was supported by a study of Baysan, et al. (2006). They argued that the economic cases for SAFTA were relatively weak. From an economic standpoint, neither a qualitative argument nor a quantitative assessment that was available to give one reason in order to feel enthusiastic about the arrangement. Moreover, compared to the rest of the world, this region was tiny both in terms of economic size as measured by GDP (and per capita income) and the share in the world trade. Therefore, trade preferences to the regional partners would likely be leading to a consequence of trade diversion rather than trade creation. Similarly, Das (2007) argued that evidence of trade complementarity in South Asia is mixed, so preferential trading initiative was based on a weak proposition. Recently, Newfarmer and Pierola (2007) found that the arrangements of preferential trading in South Asia including SAFTA fell short of their potential because of product exemptions, special arrangements for selected products and restrictive rules for point of origin. Therefore, though upside potentials for SAFTA were great, benefits from this trading arrangement were uncertain. So, the policy makers will require relentless determination to make it successful in future.

<sup>3</sup> In 2007 Afghanistan has become a member of SAARC. As this country is a new member and its involvement is still insignificant in SAARC, this study hasn't included Afghanistan in analysis.

This paper contributes to this literature by analysing and explaining further in-depth prospects and challenges of preferential trade liberalisation in South Asian region. Moreover, this study attempts to analyse the potential of regional economic integration in South Asia under a political economy perspective.

### SAARC Economies: an overview

South Asia, with more than 1.4 billion people, is one of the most densely populated regions in the world (Table 1). Population density is 275 people per sq km which is six times higher than that of the world average population density. This region is the home of 23 percent of the world's population comprising an area of only 3.8 percent of the total global land. Considering the market-size in terms of population, SAARC is one of the largest economic blocs in the world. This region covers almost 67 percent of the low income population of the world economy.

However, as measured by GDP as well as per capita income, the size of the economy of this region is very small compared to the rest of the world. It accounted for 2.2 percent of world's GDP with US\$ 691 GNI per capita in 2005. Similarly, in terms of shares in the world trade, South Asia is considered as an insignificant region which accounts only for 1.70 percent of total global trade.

**Table 1:** South Asia and the rest of the world: A comparison, 2005

	South Asia	Low Income Countries (US\$ 905 or less)	High Income Countries (US\$ 11116 or more)	World
Land area (million sq km)	5.1	29.3	34.5	133.8
Population ( billion)	1.4	2.1	1.00	6.1
GNI per capita (current US\$)	691	585	35263	7011
GDP (current US\$, trillion)	1.0	1.4	34.7	44.6
Literacy	57.8	60.0	98.5	82.2
Life expectancy	63.5	58.9	79.0	67.6
Total Trade (current US\$, trillion)	0.443	0.688	18.956	25.924
Exports (% of GDP)	20.0	24.9	...	24.6
Imports (% of GDP)	24.6	29.0	...	24.8
Merchandise trade (% of GDP)	31.0	41.1	43.9	47.3

Source: Data compiled and calculated from World Development Indicators database, The World Bank, April 2007

Considering the size of land area, population and economy, India is by far the largest country in South Asian region; while Pakistan and Bangladesh are the second and third largest country respectively (Table 2 and Table 3). It is argued that, because of their size, these three economies are of crucial importance for successful regional integration and cooperation; and more importantly, India and Pakistan would be the dominant states of any formal regional integration agreements (Das, 2007, Behera, 2008).

Bhutan, Maldives and Nepal are very small economies in the region. The important fact is that Bhutan and Nepal are land-locked while Maldives is an island. Under the World Bank designated category, amongst the seven countries, four economies namely Bangladesh, Bhutan, Maldives and Nepal, are least-developed countries (LDCs); and India, Pakistan Sri Lanka are considered developing countries. On the basis of income Bhutan, Maldives and Sri Lanka are lower-middle-income countries; and Bangladesh, India, Nepal and Pakistan are low-income countries (Das, 2007; World Bank, 2007).

Despite the region has been performing steadily for the last two decades in terms of economic growth and other criteria (Table 2), it has still remained one of the poorest regions in the world.

**Table 2:** Basic development indicators of SAARC countries, 2005

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
<b>Land area (000 sq km)</b>	144	47	3288	0.300	141	796	66
<b>Population (million)</b>	142	0.918	1095	0.33	27	156	20
<b>GNI per capita (current US\$)</b>	470	870	720	2320	270	690	1180
<b>Life expectancy</b>	63	63	64	67	62	65	75
<b>Adult literacy</b>	51	60	61	96	49	50	91
<b>Average annual growth of GDP (%)</b>							
<b>1985-95</b>	5.4	5.7	6.0	4.6	5.0	5.2	4.4
<b>1995-05</b>	4.2	6.9	8.5	6.7	3.9	3.7	4.2
<b>2005</b>	6.0	6.1	7.1	9.5	4.0	7.0	6.00
<b>GDP per capita (2005)</b>	3.5	3.3	5.5	6.0	0.3	5.2	4.4

Source: Data compiled from World Development Reports 2007 and other World Bank's data files

### Regional and International Trade in South Asia

Compared to the rest of the world, this region is not open enough in international trade, rather, it is very much inward oriented. Intra-region's trade flow in this region is also very insignificant. This is partly because the major economies such as India, Pakistan and Bangladesh are not outward-oriented. The indices of trade to GDP ratio for Bangladesh, India and Pakistan are 38.0, 27.4 and 37 respectively (Table 3). A higher index indicates a more open economy towards international trade. Though, Maldives and Sri Lanka have a higher percentage of trade to GDP ratios, their economies are very small. Therefore, they have insignificant contribution to the amount of region's trade.

Although Bangladesh, India and Pakistan have been continuing trade liberalisation since the early 1990s, the progress is still very slow. Considering tariff levels, South Asia has still been considered one of the most highly protected regions in the world (Table 4). Amongst the seven economies, Sri Lanka has got the lowest protection level with 11.2 percent of average tariffs for all goods and Bhutan has persistently the highest average tariffs level with 22.1 percent. The tariff levels for three large economies-

Bangladesh, India and Pakistan are also very high with 15.2, 19.2 and 14.3 percent respectively. This figure is 16.6 percent for South Asian region. Moreover, trade liberalisation in South Asia is far from uniform. Bangladesh, India and Pakistan are still adhering to several interventionist policies (Das, 2007).

**Table 3:** SAARC economies and international trade, 2005

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
<b>GDP (current US\$, billion)</b>	60.0	0.844	805.7	0.817	7.40	110.70	23.5
<b>Share of SAARC GDP (%)</b>	5.95	0.083	79.85	0.080	0.733	10.97	2.33
<b>Sectoral share of GDP (%)</b>							
<b>Agriculture</b>	21.1	24.7	19.3	---	39.2	21.6	16.8
<b>Industry</b>	27.2	37.3	27.3	---	21.0	25.1	26.1
<b>Service</b>	52.6	38.0	54.4	---	10.8	53.3	57.1
<b>International Trade (US\$, million)</b>							
<b>Total trade (exports+ imports)</b>	23158	617	221491	1405	2690	41277	15250
<b>Trade to GDP ratio (%)</b>	38.0	73.2	27.4	171.9	36.3	37.2	64.9
<b>Exports</b>	9190	252	89843	473	830	15942	6275
<b>Imports</b>	13968	365	131648	932	1860	25335	8975

**Source:** Data compiled and calculated from WTO trade data, April 2007, and World Development Indicators database, World Bank, April 2007

**Table 4:** Tariff rates in the SAARC countries, 2006 (in percent) (simple average of ad-valorem duties)

	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
<b>All goods</b>	15.2	22.1	19.2	20.2	13.9	14.3	11.2
<b>Agricultural goods</b>	17.3	41.3	37.6	18.4	14.9	16.3	23.8
<b>Non-agricultural goods</b>	14.9	19.2	16.4	20.5	13.7	14.0	9.2

**Source:** WTO Trade database, April 2007

Regional and international trade structure of South Asian countries are analysed by using conventional trade measures such as commodity composition of trade, direction of trade, and bilateral trade shares.

## Commodity Composition of Trade

As shown in Table 5, the export and import structures are almost similar in all South Asian countries. Manufactured products claim the major shares of exports and imports of all countries individually. The region is a net exporter of such products. While the region is commonly perceived to be a food deficit

**Table 5:** Commodity composition of South Asian trade, 2005

		Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
<b>MERCHANDISE TRADE (MT)</b>								
<b>MT Exports f.o.b.(million US\$)</b>		9272	258	99472	162	830	16051	6347
<b>MT Imports c.i.f. (million US\$)</b>		13889	386	139369	745	1860	25357	8834
<b>Share of MT exports and imports (in %) by main commodity groups</b>								
<b>Agricultural products</b>	<b>Export</b>	9.2	15.0	10.1	63.5	21.4	13.5	23.6
	<b>Import</b>	27.7	19.2	5.1	19.1	22.5	14.4	12.8
<b>Fuel and mining products</b>	<b>Export</b>	0.4	45.4	20.0	23.7	4.2	4.6	3.5
	<b>Import</b>	10.3	11.2	38.4	17.9	20.0	24.2	15.9
<b>Manufactures</b>	<b>Export</b>	83.5	39.9	69.4	8.0	73.0	81.8	68.2
	<b>Import</b>	61.8	69.6	48.5	63.1	57.5	58.4	64.7
<b>COMMERCIAL SERVICES TRADE (CST)</b>								
<b>CST exports (million US\$)</b>		472	46	54422	311	271	2043	1519
<b>CST imports (million US\$)</b>		1983	57	49498	187	424	7208	2051
<b>Share of CST exports and imports (in %) by main services item*</b>								
<b>Transportation</b>	<b>Export</b>	23.8	...	10.6	7.1	12.0	52.7	44.3
	<b>Import</b>	76.9	...	40.4	50.5	38.0	36.3	61.8
<b>Travel</b>	<b>Export</b>	14.8	...	12.0	92.1	48.4	8.9	28.3
	<b>Import</b>	6.6	...	11.9	37.3	38.5	17.8	15.3
<b>Other commercial services</b>	<b>Export</b>	61.4	...	77.4	0.8	39.6	38.4	27.4
	<b>Import</b>	16.5	...	47.8	12.2	23.5	45.9	22.9

Source: Compiled and calculated from WTO trade data, April 2007

area, it is in fact a net exporter of food items and this is because of India's much higher exports of agricultural products relative to its imports of such products. The region is a net importer of fuel and mining products because of higher amount of imports compared to the exports of such products, as well as, high demands for energy for industrial development.

Being vastly endowed with labour resources, the region's exports are generally dominated by labour-intensive manufacturing products, for example, textiles and clothing products form the bulk of the region's exports. These products contribute to more than 75 percent of export earnings of Bangladesh and Pakistan, and more than 50 percent of Sri Lanka's and nearly 30 percent of India's export earnings (Das, 2007).

The import of commercial services for all countries of South Asia is much higher than the export of such services (Table 5). Therefore, the region is a net importer of commercial services.

**Table 6:** Ranking five major trading partners of South Asian countries, 2005

Reporter ↓ Partner →		Rank-1	Rank-2	Rank-3	Rank-4	Rank-5
<b>Bangladesh</b>	Exports	European Union (56.1)	United States (26.2)	Canada (4.0)	Japan (1.5)	India (1.3)
	Imports	China (13.9)	India (12.0)	European Union (9.9)	Japan (9.6)	Singapore (4.3)
<b>Bhutan</b>	Exports	India (94.4)	Bangladesh (4.2)	United States (0.5)	Nepal (0.5)	European Union (0.1)
	Imports	India (74.4)	Singapore (12.7)	Japan (3.3)	Thailand (3.1)	European Union (1.3)
<b>India</b>	Exports	European Union (22.5)	United States (16.9)	UAE(8.3)	China (6.6)	Singapore (5.3)
	Imports	European Union (17.2)	China (7.3)	United States (6.3)	Switzerland (4.4)	Australia (3.3)
<b>Maldives</b>	Exports	UAE (24.2)	European Union (18.1)	Thailand (15.3)	Japan (14.6)	Sri Lanka (12.5)
	Imports	Singapore (24.1)	UAE (15.5)	European Union (14.2)	India (11.3)	Malaysia (7.2)
<b>Nepal</b>	Exports	India (52.4)	United States (29.1)	European Union (9.6)	China (3.4)	Bangladesh (0.9)
	Imports	India (53.0)	China (8.4)	Singapore (6.3)	European Union(6.3)	Malaysia (3.3)
<b>Pakistan</b>	Exports	European Union (26.5)	United States (24.8)	UAE (7.8)	Afghanistan (6.6)	Hong Kong (3.7)
	Imports	European Union (17.4)	Saudi Arabia (10.6)	UAE (9.9)	China (9.4)	Japan (6.5)
<b>Sri Lanka</b>	Exports	United States (32.2)	European Union (31.0)	India (9.1)	Russian Fedaratio2.6)	UAE (2.4)
	Imports	India (17.3)	European Union (15.5)	Singapore (8.9)	Hong Kong (7.8)	China (7.6)

**Note:** Figures in parentheses indicate percentage share of exports and imports

**Source:** Data compiled from WTO database files, April 2007

## Direction of Trade

The south Asian countries are basically not natural trading partners. Driven by their desire for export-led development, they began expanding their export towards industrialised countries, moving from basic agricultural exports to labour-intensive manufactured exports. South Asian countries perform their trade mainly with non-Asian countries. Most of the region's trade is performed with the European Union and United States (Table 6).

The region's exports are mainly destined to developed countries, whereas, both developing and developed countries are equally important origins for imports from this region (Table 7 and 8).

**Table 7:** Direction of trade of four major South Asian economies: 1995-2000 and 2001-05 (average, in percent)

EXPORTS: By Country of Destination								
Reporter → Partner ↓	Bangladesh		India		Pakistan		Sri Lanka	
	1995-00	2001-05	1995-00	2001-05	1995-00	2001-05	1995-00	2001-05
<b>Developed Economies</b>	86.40	89.80	55.90	46.70	59.50	57.00	75.00	72.50
- Asia Pacific	3.15	2.15	6.30	3.90	5.00	2.60	5.50	4.70
- Europe	44.60	51.25	27.40	23.30	30.00	29.00	29.00	32.50
- North America	38.65	36.40	22.20	19.50	23.00	25.50	40.50	35.30
<b>Developing economies</b>	13.60	10.20	44.10	53.30	40.50	43.00	25.00	27.50
- South Asia	2.50	2.00	4.30	6.70	4.30	7.50	3.60	7.50
- South-East Asia	2.50	1.70	5.20	7.60	3.60	2.70	3.00	2.30
- East Asia	3.60	2.50	10.00	12.00	13.00	9.20	2.50	2.20
- West Asia	1.90	2.00	11.00	14.00	11.20	15.00	7.60	7.50
- Africa	1.50	0.70	4.50	6.00	4.20	5.00	1.50	1.40
- Latin America	0.60	0.40	1.80	2.60	2.00	1.80	1.50	1.60
<b>Other</b>	1.00	0.90	7.30	4.40	2.20	1.80	5.30	5.50

**Source:** Data calculated from a) UNcomtrade database, United Nations Commodity Trade Statistics, August 2007; and b) IMF, Direction of Trade Statistics database, August 2007

Amongst the South Asian countries, only Bhutan and Nepal perform their international trade within the region, due to their geographical constraints (land locked) and tiny nature of economies, mainly with India. Almost 95 percent exports and 75 percent imports of Bhutan take place with India. Similarly,

Nepal's largest trading partner is India with more than 50 percent both export and import shares alone from India (Table 6 and 7). Except for these two countries, all other South Asian countries are involved with a very insignificant amount of trade within the region.

**Table 8:** Direction of trade of four major South Asian economies: 1995-2000 and 2001-05 (average, in percent)

IMPORTS: By Country of Origin								
Reporter → Partner ↓	Bangladesh		India		Pakistan		Sri Lanka	
	1995-00	2001-05	1995-00	2001-05	1995-00	2001-05	1995-00	2001-05
<b>Developed economies</b>	27.00	24.50	48.50	45.50	43.00	34.50	35.60	31.00
- Asia Pacific	9.50	10.00	9.50	8.40	11.00	8.00	13.00	9.50
- Europe	12.00	10.20	30.00	27.60	22.00	18.00	18.10	17.30
- North America	5.50	4.30	9.00	9.50	10.00	8.50	4.50	4.20
<b>Developing economies</b>	73.00	75.50	51.50	54.50	57.00	64.50	64.40	69.00
- South Asia	17.50	15.80	2.60	2.90	4.00	4.50	13.50	21.50
-South-East Asia	13.00	17.00	9.80	10.00	11.00	12.00	15.50	16.00
- East Asia	25.00	26.50	7.50	7.00	10.50	12.50	24.00	23.00
- West Asia	2.00	4.20	15.00	16.50	25.70	30.20	6.00	5.50
- Africa	1.00	1.20	9.00	10.00	2.90	3.10	1.20	0.80
- Latin America	5.00	4.50	1.50	1.10	1.70	1.20	1.30	0.50
<b>Other</b>	9.50	6.30	6.10	7.00	1.2	1.00	2.90	1.70

**Source:** Data calculated from a) UNcomtrade database, United Nations Commodity Trade Statistics, August 2007; and b) IMF Direction of Trade Statistics database, August 2007

### Regional Trade Patterns and Bilateral Trade

Bilateral trade shares are used to analyse the intra-regional trade patterns of South Asian economies. The bilateral trade share is the ratio of one country's trade with its partner to its total trade with the world. This share can range from 0 to 100. Higher bilateral trade share reflects a higher level of interdependence between a pair of countries.

From Table 9 it is clear that the South Asian countries engage in small trade within the region. In 2005, amongst the four major economies of the region, Bangladesh and Sri Lanka import relatively more from the region than do the others. Sri Lanka has got the highest bilateral shares of trade with SAARC. These

figures for exports and imports are 10.35 and 19.05 percent respectively. The region's export and import shares destined to and originated from, this region have been in declining trend over the last few years. That is partly because of a low and insignificant level of involvement in bilateral trade by the region's large countries such as India and Pakistan.

**Table 9:** Bilateral trade shares of four major SAARC countries: 2000-04 and 2005 (in percent)

EXPORTS										
Partners → Reporters ↓	Bangladesh		India		Pakistan		Sri Lanka		SAARC	
	2000-04	2005	2000-04	2005	2000-04	2005	2000-04	2005	2000-04	2005
Bangladesh	na	na	1.15	1.35	0.60	0.75	0.09	0.08	1.90	2.20
India	2.30	1.60	na	na	0.45	0.65	1.75	1.95	5.45	5.25
Pakistan	1.75	1.45	1.10	2.10	na	na	1.02	0.95	3.90	4.55
Sri Lanka	0.22	0.24	5.35	9.05	0.70	0.70	na	na	7.35	10.35
SAARC	1.80	1.40	0.90	0.80	0.45	0.60	1.45	1.65	4.70	4.50
IMPORTS										
Bangladesh	na	na	14.55	12.02	1.45	1.70	0.10	0.10	16.20	13.85
India	0.09	0.08	na	na	0.10	0.12	0.35	0.40	0.90	0.95
Pakistan	0.35	0.25	3.05	2.30	na	na	0.35	0.25	3.80	2.85
Sri Lanka	0.09	0.09	18.85	17.30	1.25	1.40	na	na	20.55	19.05
SAARC	0.10	0.10	3.35	2.35	0.30	0.25	0.40	0.35	4.20	3.10

**Note:** na means not applicable.

**Source:** Data calculated from UNcomtrade database, United Nations Commodity Trade Statistics, August 2007

As shown in Table 5, Bhutan's bilateral trade share with India, for both exports and imports, is almost 100 percent which represents highest bilateral trade share in the region. On the contrary, in terms of imports, India (the largest economy of the region) has got almost zero linkage with other individual SAARC countries with nearly zero percent of bilateral trade share in imports (Table 8), and India's bilateral import share with the whole region (SAARC) is less than one percent. Although, in 2005, India's bilateral export share with SAARC was 5.25 percent the second highest in the region, this figure is even marginally lower than that of the average of previous five years. More importantly, India's export share is mainly attributed to the high and significant imports by neighbouring countries, Bangladesh and Sri Lanka as well as by two other land locked countries, Bhutan and Nepal. Similarly, Pakistan, the second largest economy of the region, has got a very insignificant involvement in bilateral trade with other SAARC countries as reflected by both bilateral export and import shares in Table 8.

For the of whole SAARC economy, the share of intra-regional trade to its global trade has declined over the period in 2000-04 and 2005. The share of intra-regional imports to global imports of SAARC economy has declined from an average of 4.20 percent in 2000-04 to 3.5 percent in 2005. Similarly, its

share of intra-regional exports to global exports has declined marginally over the same period and remained around 4.5 percent.

### **Trade Intensity Index and Complementarities**

Trade intensity index concentrates attention on variations in bilateral trade levels that result from differential resistances by abstracting from the effects of the size of the exporting and importing countries. The higher value of this index means the higher bilateral trade (Drysdale and Garnaut, 1982). In order to explore the potentials of intra-regional trade expansion within SAARC, Bhalla and Bhalla (1996) have estimated trade intensities for the SAARC countries individually and for the region as a whole. They have found that except India, all other major SAARC countries like Bangladesh, Pakistan and Sri Lanka show a low and declining trend of trade intensity index. India shows a higher intra-SAARC trade intensity in 1994 than that in 1985. They argue that increase in this index for India seems to be due to trade reforms as part of economic reform resulting in the increase in economic growth. The declining values of trade intensity for other countries suggest low trade complementarity among themselves as well as continuing barriers to intra-SAARC trade. At the same time there is an increasing trend of trade expansion with the rest of the world, especially, with industrialised countries.

Similarly, Pitigala (2005) argued that the overall trade intensity indices and their movements from pre-reform to post-reform periods did not demonstrate a consistent positive relationship for the whole South Asian region. A positive increase in trade intensity index appeared only between India and Nepal; in all other cases, the bilateral trade relationships are asymmetric and/or in decline. Though it has a unique geographical position, South Asia does not appear to fit the hypothesis that geography is the strong determinant of trade and, therefore, the geographic proximity and relative size of the trade cannot be interpreted as a positive sign for a rapid increase in regional trade in South Asia.

Recently, Das (2007) has found that the evidence of trade complementarity in South Asia is mixed. India's and Pakistan's exports are complementary to the imports of some South Asian countries such as Bangladesh and Sri Lanka. Other economies show efficiency in only a small number of export areas and cannot be considered complementary to India's imports, or any other country's imports. Lacking in complementarity in trade, South Asian economies compete in their export markets in a narrow range of products, particularly in textiles and apparel and other light manufactured goods. Thus, the prospects of regional integration are seriously inhibited by this trade structure. It is argued that the economies of SAARC countries, along with their trade infrastructure, are mainly for primary producers in the exports and import markets which mean that they have little scope to develop any complementarities in production patterns.

### **Trade Creation and Trade Diversion**

Formation of a free trade area in South Asia has raised intensive debates on welfare gains and losses from this arrangement by member countries. Differences in welfare gains among members depend on the trade creation effects. Welfare gains arise from trade creation resulting from reduction of tariffs on imports from the rest of the world. Factors that influence trade creation are the elasticity of import demand, the pre-agreement level of protection and import from the rest of the world. It is argued that large countries like India and Pakistan have relatively high levels of trade with the rest of the world and their import demands are relatively elastic and, therefore, they gain more from trade creation than they lose from trade diversion. Small countries like Bangladesh and Sri Lanka lose because of relatively low level of trade creation and diversion capability. The other three countries Bhutan, Maldives and Nepal have very insignificant influence over intra-regional trade due to their very small size of their economy (Hossain 1997; Newfarmer and Pierola 2007).

Even considering the whole region, given the very low level of production in South Asia which accounts for only around 2 percent of the world's production and with a high tariff level, the risk of trade diversion from preferential trade liberalisation is high. Therefore, with nearly 98 percent of the world production outside the region, the likelihood that the most efficient and competitive producers of large numbers of products within the region is very low. This means that the scope for trade diversion is substantial (Baysan, et al. 2006; Jhamb 2006).

## Conclusion

South Asia is a large regional bloc with huge potential but achievement in regional economic integration is insignificant so far. Conventional trade measures indicate that the region is engaged in trade with the outside world- not within the economies of the region. In a static sense, small countries may lose and large countries may gain from a free trade area. The static welfare effects should not be the sole criterion for judging a discriminatory trading area, however. The static losses may be outweighed by dynamic gains. The dynamic gains for countries are likely to come from improvement of their terms of trade with the rest of the world in exports of primary products. Therefore, the gainers from SAFTA should compensate losers by way of assistance in restructuring their economies. From SAFTA, the region can achieve considerable gains due to enhanced bargaining powers to the outside world if the region can improve its terms of trade with the rest of the world by acting in concert.

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