CHAPTER I

INTRODUCTION

1.1 Background of the Study

The irreversible process of globalization is throwing up many daunting challenges for developing countries in general and the SAARC countries in particular. One of the ways of meeting these challenges is to overcome regional apprehensions and constraints and irreversible and speedily move towards regional cooperation and integration.

In recent years, one important policy concern regarding trade relations among South Asian countries is whether the creation of South Asian Free Trade Area (SAFTA) would ensure gains for its member countries or not. In December 1985, seven countries of South Asia i.e. Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka formed the South Asian Association for Regional Cooperation (SAARC) to promote economic, social and cultural cooperation. In 1993, the South Asian Preferential Trade Agreement (SAPTA) was initiated by the SAARC to promote greater regional economic cooperation, which came into effect from December 1995. Subsequently, the member countries of SAARC planned to transform SAPTA into a South Asian Free Trade Area (SAFTA) will come into effect at the start of 2006. The main motivation behind the creation of SAFTA is to enhance intra-regional trade among SAARC members through the removal of tariff and non-tariff barriers and thereby to enjoy the gains of regional integration and at the same time to become more competitive in the global market.

The agreement envisions a free trade regime among seven SAARC member countries, which provide home to one-fifth of the world's population. Implementation of new tariff regime offers three sets of deadlines according to member states' varying economic prowess. Among the non-least developed countries, India and Pakistan SAFTA implementation (reduce tariffs to 0-5 percent) by the year 2013 while Sri Lanka do the same in year 2014. Where as least developed countries (LDC) (Bangladesh, Bhutan, Maldives and Nepal) have received longer dead line to complete the SAFTA implementation by year 2016.

In twelfth SAARC summit held at Islamabad decides to initiate a study on advancing the deadline for a South Asian Economic Union from 2020 to 2015, including a common currency. This was in fact, an Indian proposal, which won prompt and quick support at the meeting of the Council of Ministers.

Even though the regional integration initiatives commenced with the formation of the SAARC, intra regional level in the region is very low remained at 4. 2 percent in 2002. This is a serious impediment for regional cooperation and economic integration and therefore, it is important to apply right policy measures to boost up intra regional level among the SAARC members.

1.2 Low Intra Regional Trade and Foreign Direct Investment

The table 2 below illustrates the pattern of intra regional trade among SAARC member countries and other regions as a percentage of total trade in years 1981-1998.

Table 1.1 Intra-Regional Trade as a Percentage of Total Trade

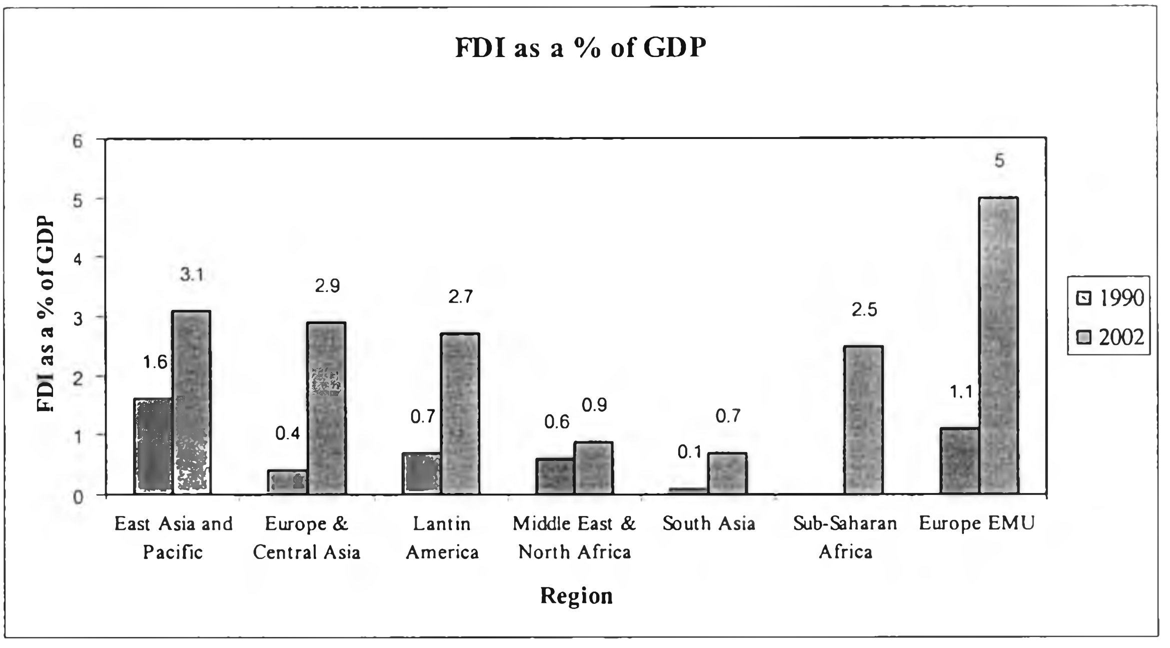
Country	Intra-Regional Imports				Intra-Regional Exports				Total Intra-Regional Trade			
	1981	1990	1995	1998	1981	1990	1995	1998	1981	1990	1995	1998
India	1.3	0.4	0.6	1.1	2.9	2.7	5.1	5.6	1.8	1.4	2.7	3.2
Pakistan	1.9	1.6	1.5	2.4	5.5	4.0	3.2	4.9	3.1	2.7	2.2	3.6
Bangladesh	4.7	7.0	17.7	17.5	7.9	3.1	2.3	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	-	10.9	57.5	59.9	-	9.6	87.9	81.9	-	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**
MERCOSUR	**-**	**14.5**	**18.1**	**-**	**8.9**	**8.9**	**20.5**	**-**	**10.7**	**14.0**	**21.3**	**-**
ANDEAN COMMUNITY	**-**	**6.4**	**12.6**	**12.0**	**-**	**4.1**	**11.8**	**11.9**	**-**	**7.9**	**-**	**-**
ASEAN	**13.2**	**14.6**	**16.9**	**20.9**	**17.2**	**18.2**	**23.4**	**19.8**	**15.2**	**16.3**	**20.0**	**20.3**

Source: Estimated from IMF direction of Trade Statistics

From the year after independence in 1948, officially recorded intra-regional trade shrank from about 19 percent of total South Asian trade to less than 4 percent by 1974, picking up only to 4.9 percent of total trade by 1998, mainly due to general trade liberalization on the part of the countries on India's periphery. However, the level of intra-trade is still remaining at very low level comparative similar trading blocs.

The diagram below illustrates the foreign direct investment in South Asian region comparison to other regions. It could be noted that South Asia still attracts the lowest rate of foreign direct investment (FDI) comparing to other regions, just 0.7 percent of GDP in 2002. It is widely known that the South Asian region has fallen far behind in the global competition for FDI (Jacobs, 2002).

Figure 1.1 **FDI as a percentage of GDP**

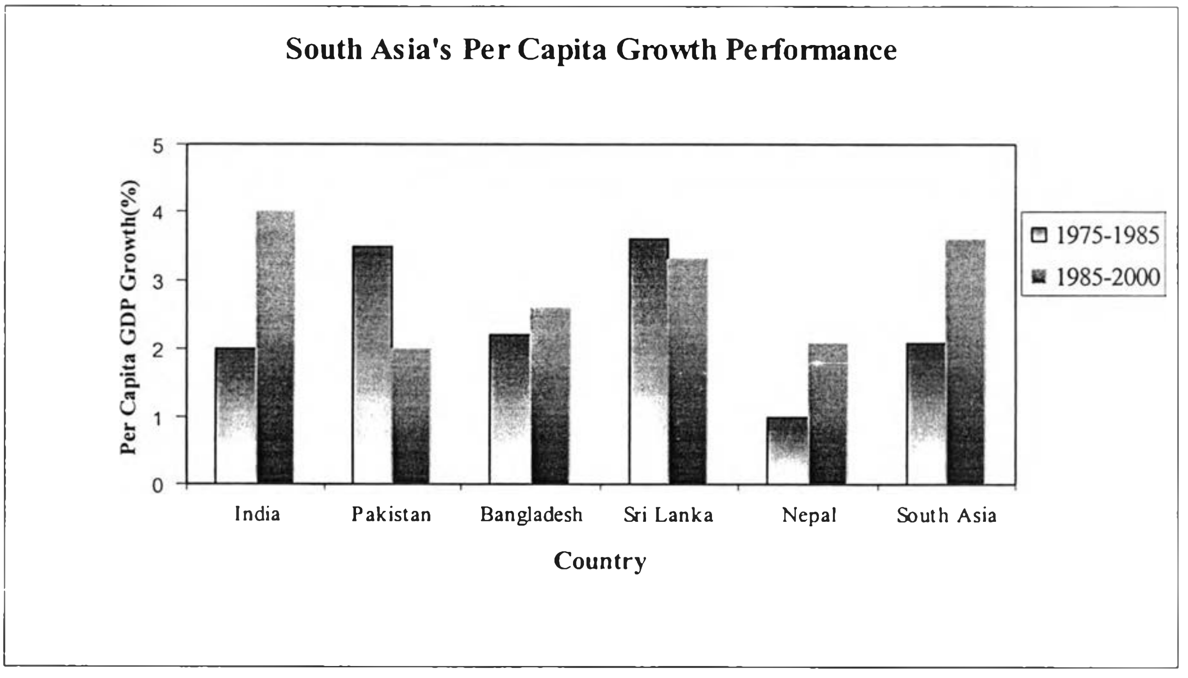


Source: World Development Indicators: 2004

The member countries of the SAARC have identified the low level of intra regional trade and foreign direct investment is a serious threat to its regional integration and South Asian countries gradually start to open up its economies in mid 1980s. After years of inward looking economic policies and tight regulation, structural reforms starting in the 1990s led to a period of accelerated growth. South Asian nations reduced tariffs, removed trade barriers, dismantled restrictions on domestic and foreign private investment and reformed their financial systems. Trade liberalization was an important component of structural reform efforts among South Asian countries since mid 1980s, with Sri Lanka leading the way.

Trade liberalization will help the region to become dynamic and take fuller advantage of global flows trade and investment into the South Asian region in future. Yet, structural liberalization and tariff reductions are not sufficient to make a country attractive to investors today. In order to achieve successful regional integration and integration into the world economy South Asia countries need to do more to be competitive with other regions in Asia.

Figure 1.2 South Asia's Growth Performance: 1975-1985 and 1985-2000



Source: Trade Policies in South Asia: An Overview, 2004, The World Bank

It is vital for South Asian countries to take the experience of other regions such as the ASEAN, which has intra regional trade level high, as 23.7 percent in 2002. Therefore, it is important to review the trade policies and other factors, which impede the intra trade level and foreign direct investment in South Asia to enhance the future intra trade level and investment in the region.

1.2.1 Impediments to Intra-Regional Trade and Foreign Direct Investments

i. The Trade and Financial Regime in South Asia

South Asian countries, that had very open economies in the immediate post – independence period in the 1940s, had become most highly protectionist economies in the world by the 1970s. Tariff and even more importantly non tariff barriers (NTBs) were extremely high, state interventions in economic activity had become pervasive, attitude to foreign investments were negative, often hostile, and stringent exchange rate controls were in place. Until the early 1990s, except for Sri Lanka, which went for deep liberalization in the late 1970s and benefited from it, most South Asian countries largely ignored these lessons. By mid 1980s however, some momentum in the direction of trade liberalization became noticeable in the region, with trade policy being introduced during the late 1980s and early 1990s, in India, Pakistan, Bangladesh and Nepal. These trade policies can be further discussed as follows:

a) Protected domestic industries in support of import- substitution strategies that were considered a sure way to rapid industrialization, growth and job creation.

Table 1.2 Openness in South Asia and South East Asia Trade Share of GDP (%)

SAARC	**1980**	**1990**	**1999**	**2003**
Bangladesh	24	23	29	31
India	17	16	19	22
Nepal	30	24	44	40
Pakistan	37	36	33	36
Sri Lanka	87	64	77	64
ASEAN				
Indonesia	54	44	62	54
Malaysia	113	138	202	194
Philippines	52	50	99	87
Singapore	440	327	296	302
Thailand	54	70	107	115

Source: World Bank, World Development Report, various years

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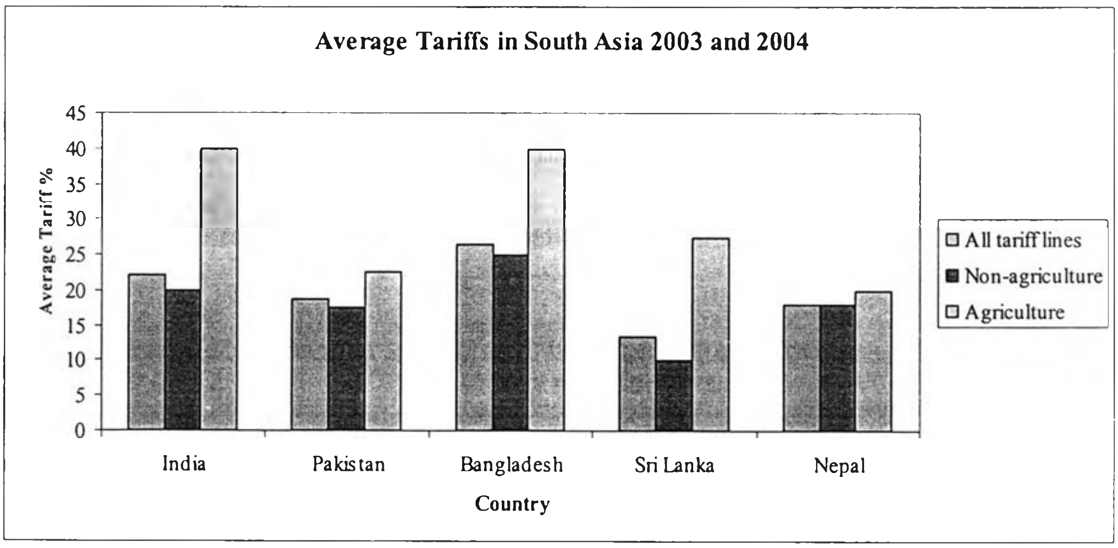
The table 1.2 above illustrates the degree of openness of South Asian countries and some members of the ASEAN. From the above statistics it could be seen that most of ASEAN countries degree of openness is much higher than the SAARC countries. The open regionalism led the ASEAN to achieve higher intra trade level.

b) Discriminated against agricultural sector where most poverty was located, through the use of state monopolies and other restrictions over agricultural exports, and indirectly through much higher protection of manufacturing than of agriculture.

Figure 1.3 Average Tariff in South Asia



Source: Trade Policies in South Asia: An Overview, 2004, The World Bank

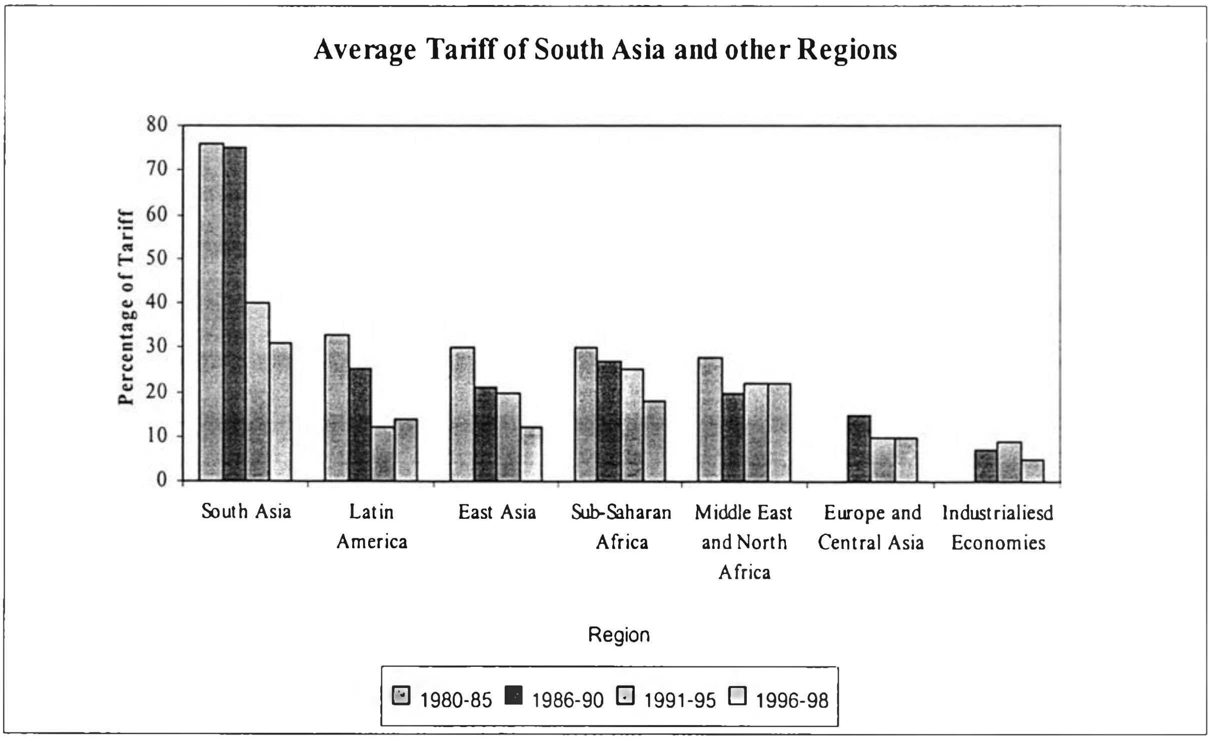
The above illustrated figure 1.3, brings out a number of important points about current tariff policies in South Asia:

- There has been a major reduction in the average Indian ad valorem tariff since 2002/2003, which has come down from 35% to 22.2%. Where as previously Indian tariff were much higher than tariffs in the other South Asian countries, on average they are now well below Bangladesh's tariffs and only about 3 to 4 percentage points higher than tariffs in Pakistan and Nepal.
- Bangladesh has by far the highest tariffs in South Asia. After allowing for para tariffs the average protective rate has declined only slightly since 1995/1996, from 32% to 29.2% in 2003/2004, with sharp drop to 26.5% occurring in the budget of FY 2005.

- On average, protective tariffs are about the same in Pakistan and Nepal and slightly lower in both countries than in India, but Sri Lanka's are markedly lower than tariffs in the other South Asian countries. With the important exception of agriculture, Sri Lanka is a low-to-medium tariff country by the general standards of developing countries.

The graph below illustrates the average tariff of South Asia comparative to the other regions.

Figure 1.4 Average Tariff of South Asia and the other Regions



Source: Trade Policies in South Asia: An Overview, 2004, The World Bank

c) Discriminated against exports through export control and taxes, overvalued exchange rates, and the use of tariffs and other controls including non-tariff barriers (NTB), which impeded access to, and increased the cost of the inputs needed for successful exporting.

ii. Low complementarity of the products in the region

South Asian countries trade little with each other but trade much with other nations of the world including, particularly with North America, Europe and Group of Eight (G8) countries. The composition of each country exports to these regions is almost similar, with the overwhelming share accounted for by ready-made garments. Therefore, the trade between South Asian countries is more competitive than complementary.

iii. Similarity of factor endowments

The World Bank suggests that in order to have successful regional integration is that the arrangements with countries that have substantially different factor endowments are superior to those with similar factor endowments. However, in South Asia the acute of similarity of factor endowments (including the quality and capabilities) has rendered regional trade unattractive. While the South Asian countries have comparative advantage in relation to rest of the world in similar, mostly labour intensive products, therefore the trade and economic benefits from trading these products among themselves are limited.

iv. Non-supportive business investment climate

Most studies shows that the quality of the business environment (governance) is more important in influencing FDI flows than traditional investment incentives such as low wages, tariff cutting and special investment inducements. Another important determinant of FDI flows is the relative size of the export sector. Countries that export more attract more FDI. This is another channel by which efforts to reduce business cost and increase competition can support FDI inflows.

The famous Djankov study (2002) of entry barriers in 85 countries found that countries with heavier regulation of entry have higher corruption and larger unofficial economies, but not better quality of public or private goods. Countries with more democratic, limited government interventions and have lighter regulation of entry.

Table 1.3 Results from the Djankov study of entry barriers (2002)

	No. of Screening Procedures	Days to get started in Business	Fees as a % of GDP per capita
Global Average	6.04	47	47
Sri Lanka	8	23	19.72
Pakistan	8	50	34.96
India	10	77	57.76

Source: Djankov: 2002

The study found that the worldwide average number of screening procedures facing a new entrant is 6.04, and that meeting the official entry requirements in the average sample country requires 47 days and fees of 47 percent of GDP per capita. His sample included three South Asian countries, of which India is substantially worse than the global average. India was among the ten top reformers in 2003, yet it remains in the bottom quartile in rank amongst 145 countries. Pakistan is at about the global average in burdens, suggesting that it also could improve competitiveness by improving the efficiency of start-up procedures. Sri Lanka performs better than the global average on most sectors.

v. **Informal Trade among member countries**

According to some of the recent studies, there has been considerable amount of so-called "informal" trade among member countries of the region. According to the study undertaken by the World Bank on South Asia, it was revealed that the official trade statistics omit large volumes of unrecorded informal trade (as much as half of the recorded trade or even more during some periods) in the region, which takes a number of forms, including traditional smuggling which physically by-passes Customs ports (especially at the land borders), "official" or "technical" smuggling which involves misclassification, under invoicing etc at Custom, and direct smuggling which includes, for example exports from Pakistan from India which are routed through Dubai or Afghanistan.

This was not only to evade the high tariffs that must be paid on official trade but also to carry out some trade what would have not been permitted at all. For example, Pitigala et al (2000) report that once we add the informal trade, intra trade of

Bangladesh in 1995 jumps from 17.7 percent to 21.8 percent. For Sri Lanka, the jump is from 11.4 percent to 14.4 percent in the same year.

vi. Inter-state conflicts

Moreover, some analysts believe that the political tension between two large countries in the region (i.e. India and Pakistan) is another main constraint to the regional integration. Recent nuclear tests conducted by India and Pakistan, the border war and the political change in Pakistan are major obstacles for regional cooperation. As a consequence of the political issues, SAARC failed to hold a previously scheduled summit in November 1999, which causes extending the deadline for SAPTA to 2006.

For all these reasons the South Asian countries would do much better economically if they were to increase their trading negotiations with the rest of the world rather than pursuing regional preferential arrangements by reducing their tariffs and other forms of protection generally on an MFA basis, thus increasing the shares of both imports and exports in their economies (World Bank: 2004).

1.2.2 The Potential Gains from Expanding Intra Regional Trade

The regional cooperation and its advanced form of regional economic integration would enable SAARC countries to integrate more efficiently with the rest of the world in the new era. In promoting regional integration the region should look both the demand and supply side factors. Further, it is important for the region to take right measure to enhance its intra trade level and attract foreign direct investment into the region. This is important due to the following factors:

i. Promote Open Regionalism through Trade and Financial Liberalization

In expanding the intra regional trade it is important that all members of the SAARC must dismantle trade barriers and stringent foreign exchange controls.

a) Reducing cost by complete elimination of tariff

Kumar *et.al.* (2002) argue that even if trade complementarities are low in South Asia, the potential for gains from intra-industry trade exists. Trade flow could increase by as much as 1.6 times with the complete elimination of trade barriers. There are experts who also believed that although unilateral liberalization offers greater benefits nevertheless regional cooperation are also likely to prove beneficial in a wide range areas (Srinivasan and Canonero1993 and Srinivasan, 1998). There is argument that South Asian countries still continue to impose tariffs on their most highly traded products and so that have yet to come close to achieving the benefits of trade liberalization. Consequently, removing the duties on a single industry or sub sector would be enough to significantly increase welfare through greater intra regional trade (Mohanty, 2003). Thus, if tariffs were reduced, say, in a few key markets, trade might increase enough to meet the criterion of high intra regional trade.

For instance in the case of Sri Lanka ready-made garment sector is expected to gain, as it would access to cheaper raw materials imported from India, Bangladesh and Pakistan. This important for Sri Lanka as her main export item is ready made garments and the country does not have raw material base to produce garments.

b) Elimination of NTBs and facilitate free trade

Elimination of NTBs and other prospective measures would substantially enhance trade. For instance, the government of India, which had maintained a higher number of quantitative restrictions (QRs), decided to unilaterally remove all NTBs within SAARC countries in August 1998. This amounted to over 2000 items. Then again, India moved forward to unilaterally dismantle most of the QRs on a global scale from 1999.

ii. Economic Growth and Poverty Reduction

Bhagwati's hypothesis of the early 1960s that growth was the principal driver of poverty reduction. Therefore, South Asian region should focus to achieve sustainable economic growth in reducing the poverty in the region.

a) Trade could serve as an engine of economic growth and poverty reduction

A major finding of recent empirical research on international economic integration (Art Kraay and David Dollar, 2001) has been that a third of the developing countries of the world, described as "rapid globalizers", did extremely well in terms of income growth and poverty reduction over the past two decades or so. These countries, which include Bangladesh, India and Sri Lanka in South Asia, have experienced large increases in trade and reduction of non-tariff barriers.

b) Expand FDI to accelerate economic growth

The importance of FDI to economic growth is widely accepted. FDI can either be a complement or a substitute for trade. If a corporation enters a foreign country with the intent to capture the local market, trade and FDI are substitutes. Foreign markets are often nationally protected by high tariffs and other obstacles that make access from non-domestic suppliers economically infeasible. Given these circumstances, foreign suppliers find relocation considerably attractive. Conversely, if a corporation enters a foreign country due to a location advantage, but the demand for the product or service remains unchanged, trade and FDI are compliments. The good or service being rendered will be exported back to the original market.

A study in five South Asian countries (India, Sri Lanka, Pakistan and Nepal) found that from 1980 to 2000, FDI inflows contributed more to GDP growth in South Asia than did an equal amount of foreign borrowing. This suggests that FDI is preferable to foreign borrowing (Agrawal, 2000).

iii. Integrated Market and Production Integration

Trade creates an integrated market and a bigger pool of consumers, which allows each country's industry to specialize in a narrow range of goods and produce on large scale. Consumers in all of the countries simultaneously benefit from larger variety of goods that are cheaper after trade due to the economies of scale (Krugman and Obsteld, 2000).

a) Creation of integrated market with large pool of diverse consumer base

In recent years, South Asia has been the second fastest growing region in the world. The total population in South Asia is 1,424.7 million, which accounts for 22.8 percent of the world population. This diversified customer base is important factor to enhance the trade among the region.

b) Vertical integration within the region and increase value addition in traditional exports

Trade complementarities did not develop within the region due to lack of vertical specialization through production sharing agreement. Vertical specialization allows the countries to reap economies of scale by concentrating on a specific production process in the process in the value addition chain. For example, trade can take place if one country specialized in yarn and fabrics while another in finished garment products. In case of primary commodity exports, regional cooperation will allow greater value addition since South Asia is exporting these commodities in bulk, and value addition takes place in importing countries thereby resulting in lower realization. A good example of such cooperation and joint venture was the jute industry when Bangladesh producing jute and West Bengal had processing mills. Similarly, India has good cotton base, which can produce textiles and Sri Lanka and produce finished garments. Joint Ventures are an effective way of expanding and diversifying the production base and trade structure of the economy.

iv. Human Resource Development

In a new economic era South Asia should take steps to remove the barriers on free movement of people to enhance their skills, knowledge and attitudes to work. This is important in the case of South Asian region as there is a huge pool of unskilled workers and therefore, it is vital to enhance their skills. Similarly the professionals and other skilled employees could also be freely move form one country to another in delivering their services.

v. Sectoral Opportunities for Future Exchanges

Potential gains exit in the following sectors from expanding the intra regional trade among SAARC countries.

a) Development of Financial Sector

There is an acute need of adequate financial infrastructure including, banking, insurance mechanisms and capital market for facilitating trade and investments. This sector is not fully developed in this region and exiting network is both insufficient and fragile. A well-developed banking sector will help in simplification of procedures for import financing. The state of development of the capital market is yet another area of concern. Most of the member states have a long way to go for appropriates development and modernization of capital market institutions. Since, India has relatively well-developed capital market, it may help smaller economies to develop stock exchanges, train stock brokers and other intermediaries. Till date, Sri Lanka is the only country with which India has executed a Memorandum of Understanding (MoU) for securities market, although discussions are also underway with Pakistan, in addition to Nepal.

b) Trade in Services

A free trade area in services in South Asia will complement the achievement of SAFTA, which is currently a free trade area of goods. A more liberal trading regime in services will increase the degree of competition among service suppliers in the region and make them more cost efficient thereby benefiting people of this region. The services such as health, educational, rural banking, environmental and entertainment have great business opportunities in the region. For rural development, Grameen Bank Model of Bangladesh should be replicated in other countries of South Asia.

c) Tourism

South Asia's diversity in offerings of tourism products is well known. The main tourism activities in this region involve pleasure/ sight seeing, trekking, mountaineering, and rafting, wildlife and cultural tourism. However, according to a former study about 75 percent of tourists are coming to this region are conventional tourists who come for pleasure and sightseeing and hence large potential is still untapped. This sector has wide ranging multiplier effects as it cuts across several other sectors and generates new employment opportunities. If it is well managed, tourism development will also contribute to the preservation of the culture and conservation of the ecology of the region.

d) Information, Communication and Technology (ICT)

South Asian Regional Cooperation for ICT is necessary because their combined resources, and shared gateways, will allow for traffic to flow to the region and from the region. The electronic commerce within the region will help develop the skills, expertise, essential institutions (banking, arbitrage, and logistics) and unique solutions that will allow merchants of South Asian countries develop roaming facilities and this can be driving force in increasing intra and interregional trade.

e) Traditional Medicine and Pharmaceuticals

South Asian countries possess a competitive advantage in the field of traditional systems. Since ancient times, it has been a supplier of herbal, Auyurvedic and Unani medicines through out the world. The production and exports of pharmaceuticals have become more and more knowledge based all over the world. According to a former study medical plants related trade is estimated at US$ 60 billion per year, and growing at about 7 percent annually. There is considerable potential to further expand the market as well as the market share of South Asia in the future. Among the South Asian countries India has emerged as a leading producer of pharmaceutical products. Due to the lower manufacturing cost and research and development (R&D) expertise Indian companies are able to produce and export drugs at extremely competitive prices. It is important for Sri Lanka to join with India to exploit the opportunities in this sector, as the country possesses valuable herbal plants and the availability of traditional Auyuvedic medical practitioners.

f) Agro Food Processing

Agro-food processing is one of the priorities of the most South Asian countries. However, food processing as a business concept is yet to gain ground in the region. India should exploit its IT knowledge to enhance the productivity of the food-processing sector and create more knowledge based food-processing activities. In Sri Lanka most of the food processing come under Small and Medium Enterprise (SME) category, especially those making beverages, squash, jam, chutney, pickles and sauce. The industry by and large is into processing fruits and vegetable, cereals, milk, confectionery, oilseeds (coconut) and spices. Pakistan is doing well in fresh and dry fruits trade and made considerable advances in food processing. Thus, as a whole, South Asia has immense untapped business potential in this sector.

vi. Infra structure Development and Trade Facilitation

a) Transportation Infra structure

Availability of transport infrastructure is crucial in providing impetus to economic activities especially international trade. There is a need to strengthen trade instruments such as transport linkages among members. The current level of intra trade can be increased if appropriate regional agreements on roads, rail, shipping and air are put in place enabling seamless movement. For instance in Sri Lanka presently only Colombo port is capable of handling containers and it has been ranked 24th amongst the 352 container handling ports in the world (Trade Partners, 2002). Colombo also enjoys hub status for transshipment of cargo to and from countries on the Indian subcontinent. To attain competitiveness, Sri Lanka and other SAARC members need to cooperate with each other in building and operating infrastructure facilities. South Asian region is strategically suited at crossroads of Asia between the oil-rich countries in West and Central Asia and the dynamic economics of South East Asia. The region should make full use of this geographical advantage.

b) Electricity and Energy

Electricity demand in most of South Asia is currently outstripping supply. Despite having diversity of energy resources among South Asian countries, there is little energy/electricity traded within the region. The potential of cooperation in improving energy supply in South Asia is enormous. Hence development of regional energy resources by exploiting complementarities will result in grater welfare of the region as a whole.

Hydroelectricity: Nepal and Bhutan have substantial untapped hydroelectricity potential, estimated at 43,000 MW and 30,000 MW respectively which, could be developed both for domestic consumption as well as for exports.(Energy Cooperation in South Asia: Potential and Prospects).

Natural Gas Exploitation: Bangladesh is endowed with gas reserves but gas trade is constrained by the region's inadequate domestic infrastructure. Pakistan has an important role in this regard as a transit state, as they provide the best route for access to Central Asia's energy.

Non-conventional Energy: India has proven capability in the field of wind energy, with its installed capacity of 900 MW, second only to the United States. This capability needs to shared with other countries in the region where there is potential for tapping wind energy.

Thermal Power: Thermal power is the dominant source of energy in this region and accounts for about 92 percent of the capacity in Bangladesh, 73 percent in India and 69 percent in Pakistan. India has a large reserve of coal accounting for about 7 percent of the world reserves. Since energy demand in these countries is likely to record higher growth in the years to come, there is a scope for cooperation for their mutual benefit.

This is important for Sri Lanka since electricity is mainly generated from hydropower, which is not sufficient to cater the increasing demand for electricity in the country. The demand for electricity, gas and water increases over 10 percent annually (Jayawardene, 2002). Unlike in East Asia there is no private participation in supplying electricity and utilities in Sri Lanka, and therefore is good opportunity for Sri Lanka to overcome its problem of power shortage by cooperating with the regional partners.

c) Trade Facilitation

According to a study by Rohit and Taneja (2000), the sources of transaction costs in Indo-Napal and Indo-Bangladesh trade are delays caused by complex customs and transit procedures. It is thus, essential to work out harmonization arrangements in areas such as customs procedures, arbitration, double taxation, proper channels to access market information and legal systems and electronic data exchange leading to paperless trade, which would help reduce transaction costs and make intra-SAARC trade more efficient and prosperous for business and eliminate informal trade within the region.

It is clear that trade liberalization will bring benefits to the South Asian region. Therefore, all members in the region should take necessary steps to liberalize their economies to achieve fast economic integration in South Asian Region. In this thesis particularly an attempt is made to investigate the impact of South Asian economic integration on Sri Lankan economy.

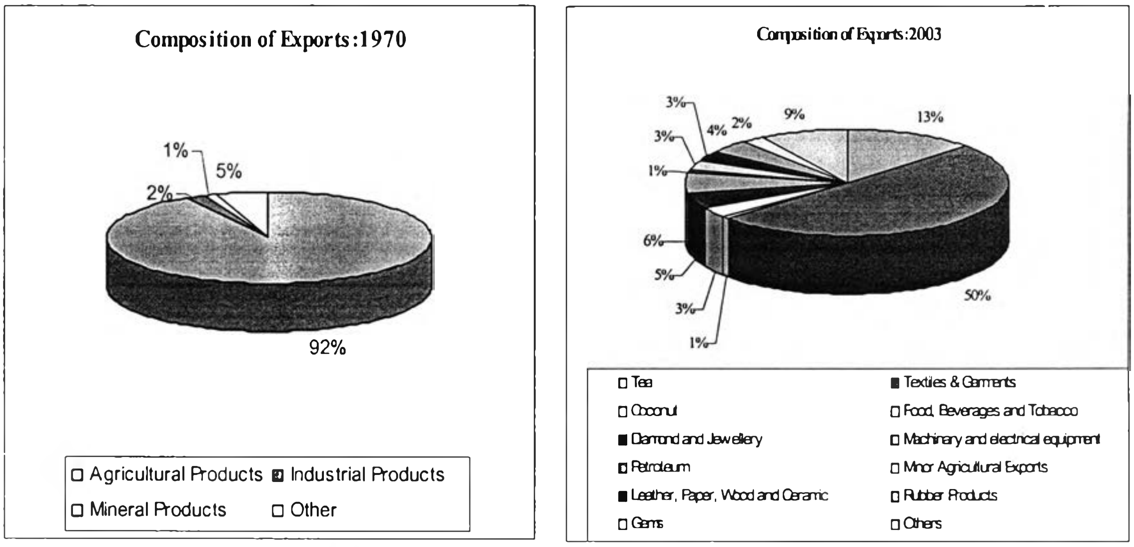
1.3 Sri Lanka Integration with South Asian Economy

Sri Lanka has led an industrial policy of heavy state intervention and direct involvement in economic activities. Trade policy supported the industrial policy, protecting industries through high tariffs, import licensing and import quotas. By mid 1970s Sri Lanka had become one of the most regulated economies in the world outside the centrally planned economies (Athukorala and Jayasuiya, 2000). The import substitution policy did not yield the expected results. Manufacturing value added grew at a rate of only 3.6 per cent during the period 1970-76, capacity utilization fell to only 54 per cent and only 4 per cent of output was exported (Athukorala and Jayasuiya, 2000). In order to rectify the situation, far-reaching economic reforms were introduced in 1977. The reforms included trade liberalization, opening the market to foreign direct investment in export-oriented industries and in the financial sector and exchange rate realignment. Trade liberalization implied both the reductions of trade barriers and making the trade barriers less distorting. The effective duty rate (import duties as share of total import value) declined from 18 per cent in 1984-86 to about 8 per cent in 1995 and further to 5 per cent in 2000.

1.3.1 Pattern of Trade in Sri Lanka

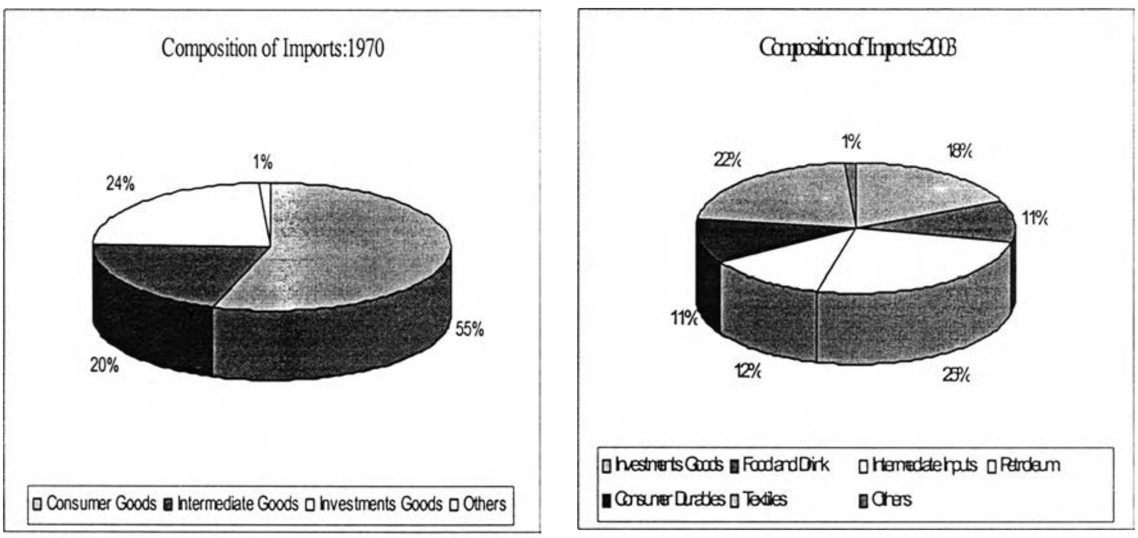
At independence, Sri Lanka was predominantly an agricultural economy with production and trade in three plantation crops, viz. tea, rubber and coconut, contributing to major share of national income. However, after the new economic reforms the relative share of agriculture decline and manufacturing and services sector contributes major share to GDP. The diagram below illustrates the composition of exports and imports pre and post liberalization periods.

Figure 1.5 Compositions of Exports: 1970 and 2003



Source: Central Bank of Sri Lanka

Figure 1.6 Compositions of Imports: 1970 and 2003

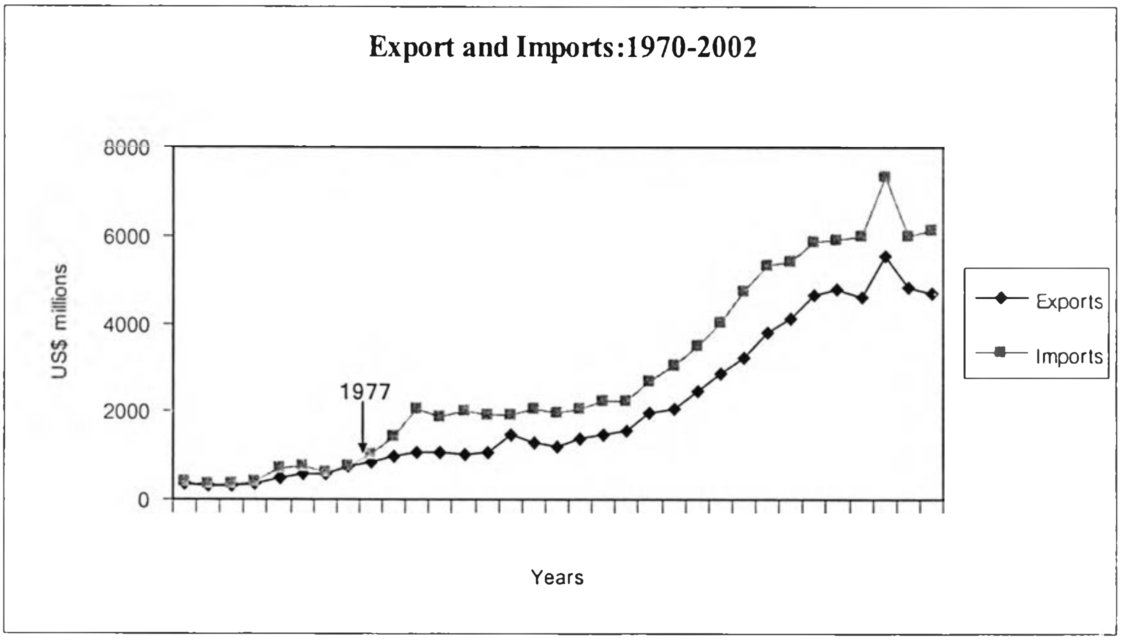


Source: Central Bank of Sri Lanka

Clothing sector dominates the picture in 2003, and its share in total exports increased to 50 per cent during the period. The changing pattern of exports also affects imports. Thus, the share of textiles in imports increased to 25 per cent in 2003 due to increased demand from the expanding clothing sector. Imports of textiles were prohibited during the import substitution era, and state-owned textile mills were established in order to supply the local clothing industry. Almost garment factories import textile usually from the outside the country (Indonesia, Malaysia, China, Hong Kong and South Korea) utilizing the facilities offered to them such as tariff free import raw materials, parts and components. Therefore, firms do not maintain direct contact with domestic firms and linkages of zone enterprises with local industries are limited. This has adversely affected the, local textile mills and most of the textile mills had to close down their business.

The diagram below illustrates the pattern of trade from the period of 1970-2002, and it can be seen that exports and imports have been rapidly increased after the trade liberalization period and trade deficit also widening over the period. During the import substitution period, Sri Lanka's main exports were tea. After reforms were introduced labour-intensive exporting industries, clothing became the major exporting sector.

Figure 1.7 Total Exports and Imports of Sri Lanka: 1970-2002

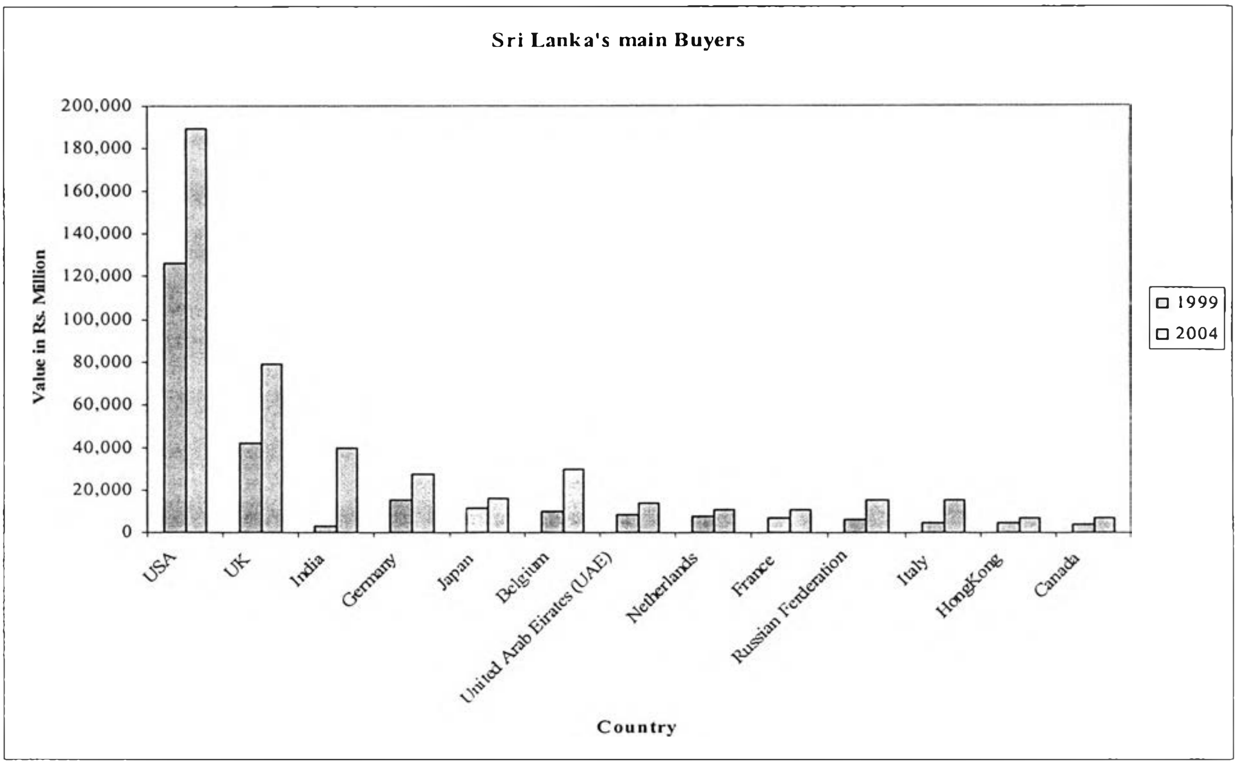


Source: Central Bank of Sri Lanka

1.3.2 Sri Lanka's Trade Partners

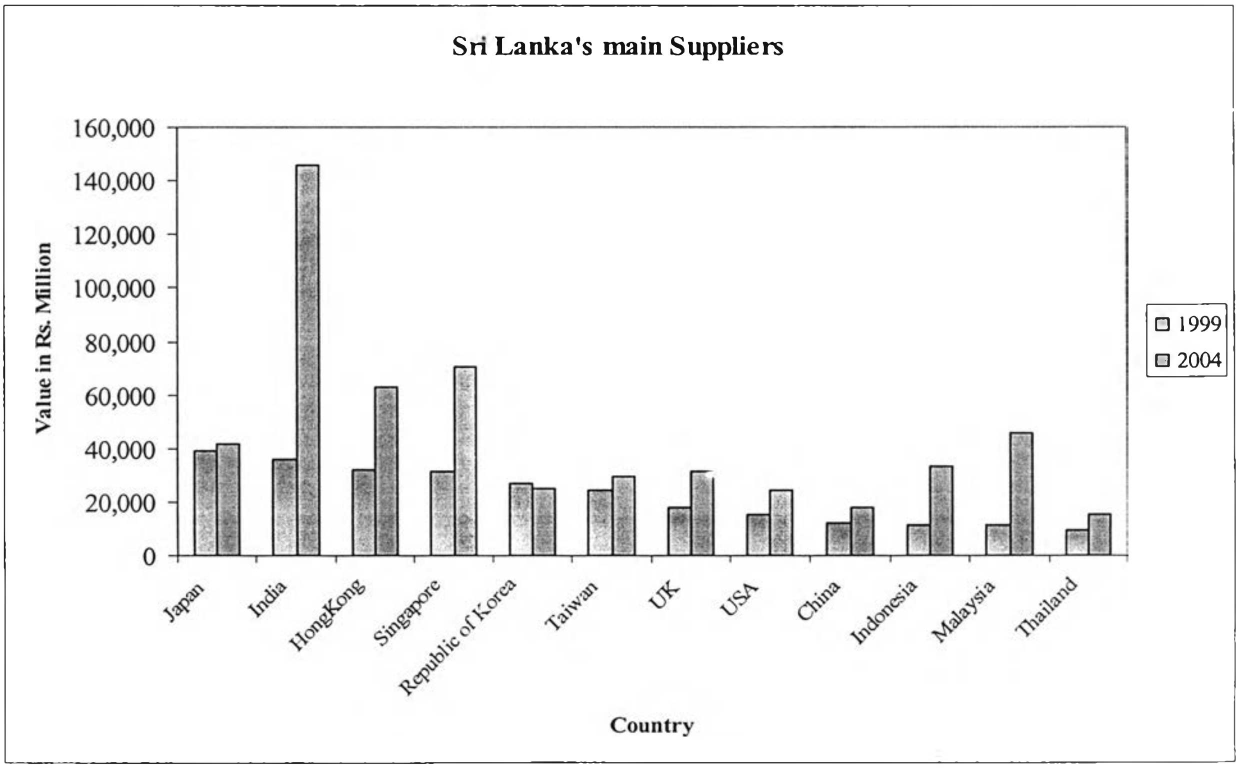
The diagram below illustrates the major trading partners of Sri Lanka in year during years 1999-2004.

Figure 1.8 **Sri Lanka's Main Buyers**



Source: Central Bank of Sri Lanka, Annual Report, Various Issues

Figure 1.9 **Main Suppliers of Sri Lanka**



Source: Central Bank of Sri Lanka, Annual Report, Various Issues

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It can be identified that USA is the largest single destination for Sri Lanka's exports (35%) during the year 2004. Sri Lanka's exports to USA are mostly garments (77%). The European Union (EU), dominated by the United Kingdom, was the second largest destination of Sri Lanka's exports (29%), while Asian countries 12%. Among the Asian countries India is the largest export destination of Sri Lanka, which is 5% of total exports became third largest export destination of Sri Lanka.

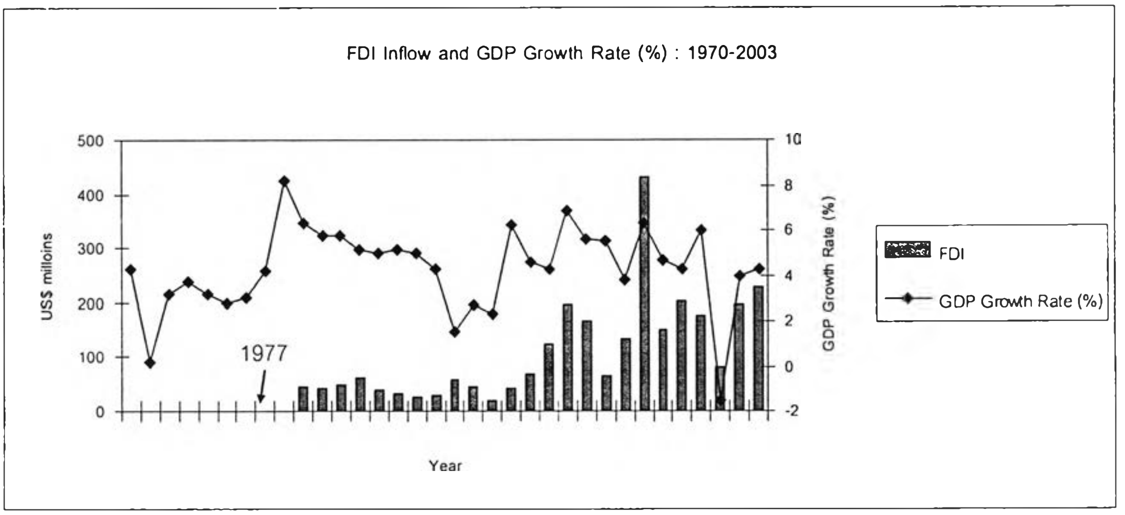
When analyzing the importing trade partners in the year 2004, India became the largest single exporter to Sri Lanka (18%) of total imports, followed by Hong Kong (9%), Singapore (8%), South Korea, Malaysia and China (5% each). Accordingly, Asian countries as a group continue as the main origin of Sri Lanka's imports, accounting for 57% of total imports.

The direction of Sri Lanka's trade has distinct characteristic features her main suppliers such as India, Japan, Hong Kong, Taiwan, Singapore etc. are in the East whereas her major buyers or markets such as USA, EU etc. are in the West. Sri Lanka's major suppliers are not necessarily the Sri Lanka's major buyers, except Japan, resulting in favourable balances with the countries in the West and unfavourable balances with the countries in East.

1.3.3 Pattern of FDI in Sri Lanka

Even before liberalization, foreign direct investment in exporting industries was allowed and encouraged. In 1978 Sri Lanka opened its first Export-Processing zone (EPZ) near the Colombo International Airport. Subsequently, two additional EPZs were opened, one in 1982 and one in 1991. In the export processing zones, foreign firms were allowed to hold 100 per cent of the equity, enjoyed a tax holiday for up to 10 years, and were exempted from duties on imported inputs. The investment policy was further liberalized in 1990 when export-oriented foreign companies enjoyed free-zone status in all parts of the country (WTO, 1995).

Figure 1.10 Foreign Direct Investment and GDP Growth Rate: 1970-2003



Source: UNCTAD data base and Central Bank of Sri Lanka, Annual Report, Various Issues

Foreign direct investment was an important factor in the expansion of the clothing sector, and Sri Lanka attracted investment from countries that had exhausted their national quotas under the Multi fiber Agreement. From the above diagram it could be seen that FDI inflow is high during high economic growth period.

However, high dependence on single industry, which has little linkages with other domestic industries, will not help Sri Lanka to achieve sustainable economic growth. Sri Lanka will lose the guaranteed and secured market under the quota regime in year 2005. In quota free world Sri Lanka need to compete with other countries such as China in the open market which capable of producing garments at low cost. Therefore, Sri Lanka need to diversify its export product base and promote other products such as agro based products, tea which gained already reputation in the world market, coir products etc. In new era, Sri Lanka should expand its opportunities to world market by integrating with her neighbouring FTA partners in South Asia. Integrating smaller economies into larger regional economic space expands the size of the market and facilitates cost reductions through economies of scale and scope and this will help small economies like Sri Lanka to integrate into the world economy.

With the regional cooperation making only modest progress, bilateral free trade agreements are gaining momentum in the region. Sri Lanka entered into bilateral free trade agreement with India and also with Pakistan. There is a proposal to enter bilateral FTA with Bangladesh as well. These kinds of bilateral free trade agreements with regional trade partners are important in enhancing the future trade relationships in promoting regional integration.

1.3.4 Bilateral Trade Agreements between Sri Lanka and South Asian Countries

Recently, there has been proposal, mainly from the business community to initiate bilateral free trade arrangements with India. Another proposal is to go for bilateral free trade arrangement with Sri Lanka. The table below depicts Sri Lanka's trade with South Asia.

Table 1.4 Sri Lanka's Trade with South Asia

(US$ millions)

Country	Sri Lanka's Exports to						Sri Lanka's Imports from					
	1990	%	1995	%	2003	%	1990	%	1995	%	2003	%
Bangladesh	10.0	14.5	12.0	11.9	10.41	3.0	9.0	4.9	6.0	1.1	5.63	0.50
India	20.0	29.0	32.0	31.7	241.14	70.2	118.0	64.1	469.0	86.1	1076.17	91.6
Maldives	7.0	10.1	14.0	13.9	54.39	15.8	6.0	3.3	17.0	3.1	22.65	1.9
Nepal	0.0	0.0	0.0	0.0	1.66	0.5	0.0	0.0	1.0	0.2	0.01	0.00
Pakistan	32.0	46.4	43.0	42.5	36.13	10.5	51.0	27.7	52.0	9.5	70.98	6.0
Total (South Asia)	69.0	100	101.0	100	343.73	100	184	100	545.0	100	1175.44	100
World	1983.0		3798.0		4931.5		2685.0		5185.0		6523.15	
As %	3.5		2.7		6.9		10.6		10.5		18.01	

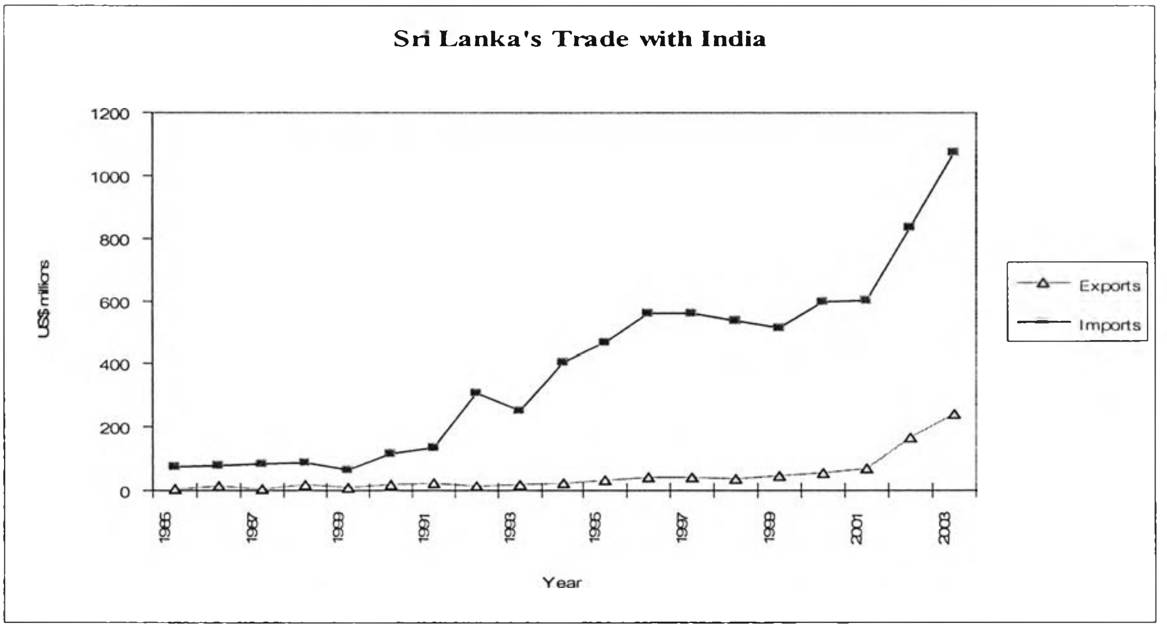
Source: Department of Commerce, Ministry of Trade: Sri Lanka

According to the figure in the table 1.4, it could be seen that India appears to be the major trading partner of Sri Lanka in South Asia. Though Pakistan appears to be the second important trading partner for Sri Lanka in the region, its relative importance is on a declining trend. While the trade between Sri Lanka and Bangladesh has also declined over recent years, exports to Maldives show a healthy growth in 2003.

a) Indo-Lanka Free Trade Agreement (ILFTA)

The Indo-Lanka Free Trade Agreement (ILFTA) which was signed in December 1998 between India and Sri Lanka has shown a promising start to trade liberalization among SAARC countries. Since then it took further, period of negotiations to decide exact terms and conditions in March 2000. Bilateral trade between India and Sri Lanka has grown phenomenally by 128 per cent after the operation of the FTA in March 2000. Indian exports to Sri Lanka increased from $ 600.12 million to $ 1076.17 million while Sri Lankan exports to India increased from $ 55.65 million to $ 241.14 million over the last four years. Indian exports to Sri Lanka in the last four years increased by 113 per cent while Sri Lankan exports to India registered an increase 333 per cent. However, according to the figures 1.10, it could be seen that Sri Lanka's trade deficit against India has widened at an alarming rate after 1998, which means period after signing FTA between India and Sri Lanka. (Source: http://www.tradenet.sl). The below figure illustrates Sri Lanka's trade with India.

Figure 1.11 Sri Lanka's Trade with India



Source: Department of Commerce, Ministry of Trade: Sri Lanka

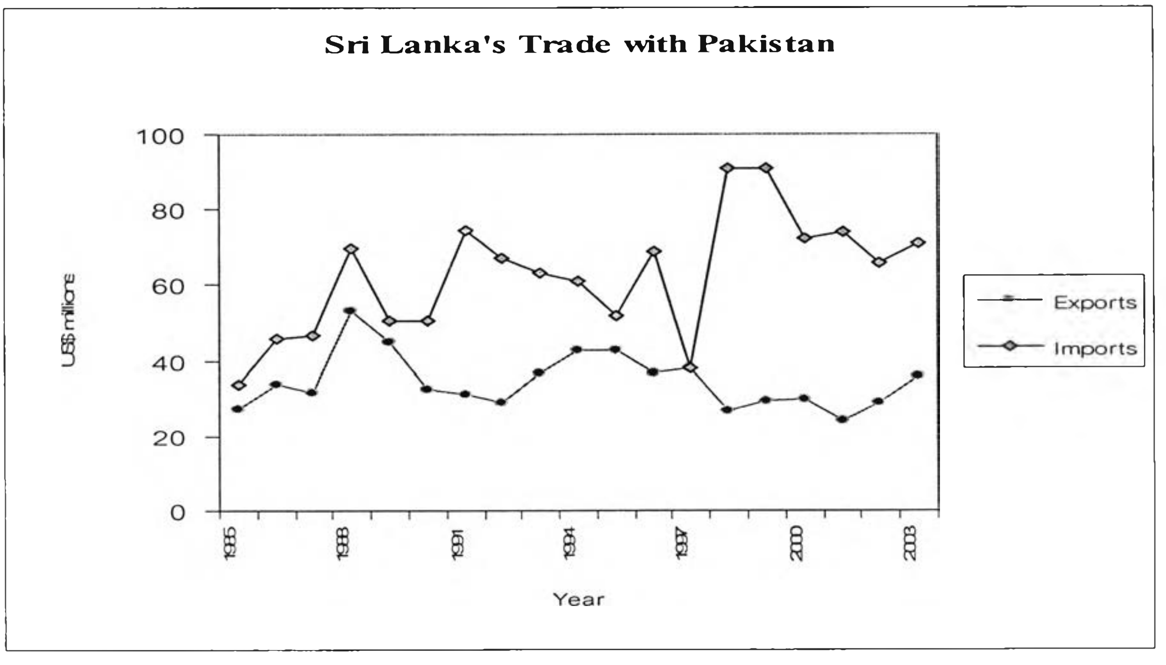
Presently India has 78 projects in operation in Sri Lanka. Indian Direct investments in Sri Lanka during 1996 to 2002-2003 (till December 2, 2002) are in the field of manufacturing, trading, telecommunication, information technology, financial and non-ffinancial services sectors. Total Indian direct investment in Sri Lanka during 1996-2002 is US$ 161.5 (Source: http://www.tradenet.sl).

Even though the volume of trade increases after entering into Indo-Lanka FTA, there is a considerable opposition to the FTA by domestic industrialists in both Sri Lanka and India. Sri Lanka's major exports to India are basic metal products, electronic products, general machinery and electrical products, paper & paper products, pepper, chemicals & plastic products, food, beverages and tobacco, wooden products, cloves and woven fabrics. Similarly, India's major exports to Sri Lanka are agricultural products, textiles, transport goods, machinery and base metal. Both economies have an important import-competing sector, which is likely to be hurt as two countries move free trade. Therefore, it is important to identify the benefits that Sri Lanka could gain from Indo-Lanka FTA.

b) Sri Lanka-Pakistan Free Trade Agreement

Sri Lanka entered into an FTA with Pakistan on 22nd of November 2004, which come to effect from 1st of January 2005.

Figure 1.12 Sri Lanka's Trade with Pakistan



Source: Department of Commerce, Ministry of Trade: Sri Lanka

The trade balance between the two SAARC countries is presently in favour of Pakistan since 1996-97 as Pakistan's exports increased from $82.6 million in 1996-97 to $102.2 million in 1997-98, but fell to $73.82 million in 2000-01. Imports from Sri Lanka were $41.9 million in 1996-97, which dropped to $29.68 million in 2000-2001. Coconut products, tea, vegetable and fruits, beetle leaves, rubber and broom sticks are the major products being imported from Sri Lanka, where as Pakistan exports textile yarn and fabrics, fish (fried/salted), some chemicals, pharmaceutical products, urea, rice, iron, leather etc. Both countries expect the trade would grow as a result of this agreement. Pakistan is one of the major consumers of tea in the world, but most of tea is being imported from Kenya due to CTC tea it consumes is not produced in adequate quantities by Sri Lanka. Previously, Pakistan used to import Sri Lankan tea, but slowly Kenyan tea replaced it. The share of Sri Lankan tea in overall import of the product is merely three to four per cent against Kenya's 80 percent. Traders feel that the share of Sri Lankan tea in Pakistani market can increase manifold, if the total duty on Sri Lankan tea is abolished.

c) Proposed Sri Lanka-Bangladesh Free Trade Agreement

In response to the proposal of the government of Sri Lanka to enter into a FTA with Bangladesh, the government of Bangladesh expressed its willingness to have FTA with Sri Lanka for mutual benefits.

Initial discussion on the FTA was held in Dhaka in November 2003. Bangladesh has now proposed for a further round of negotiations on the proposed FTA. Bangladesh is the forth trading partner of Sri Lanka in the SAARC region in terms of both exports and imports. Sri Lanka's exports to Bangladesh are now close to US$ 10.41million while imports remain at US$ 5.63 million with a favourable balance of trade to Sri Lanka. There is potential to increase our exports to Bangladesh, which should be facilitated through an arrangement to avoid tariff and non-tariff barriers.

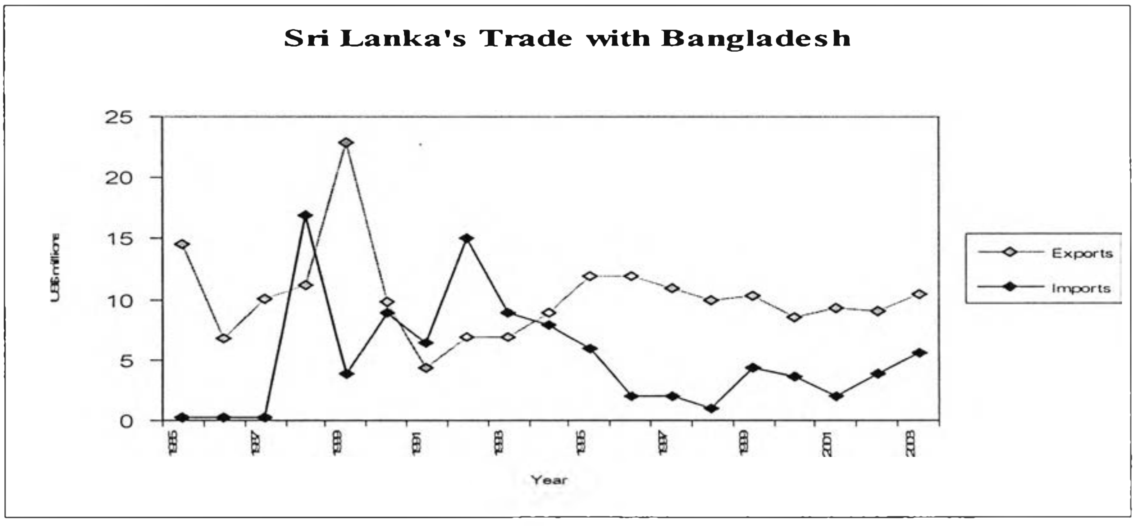
The major items of export interest to Sri Lanka are currently subject to high custom duties that encourage entering illegal and counterfeit products to Bangladesh through neighbouring boarders which have negative effects on Sri Lanka in the long run.

Bangladesh is one of the traditional major markets for some of Sri Lanka's exports such as coconut oil, rubber products etc.

Total Population in Bangladesh is more than 140 Millions people. There will be opportunities to attract FDI to Sri Lanka for the projects that have targets to enter the Bangladesh Market by using infrastructure facilities in Sri Lanka. Sri Lanka has the advantage of entering into service sector in Bangladesh through a FTA. Some of Sri Lankan investments have already entered the services such as Banking, Hotels and Hospital in Bangladesh.

Sri Lanka also will have the chance of mobilizing its resources to improve its competitiveness in the global market by making the way for absorbing competitive advantages of Bangladesh to Sri Lanka's production process. However, Sri Lanka should not forget that it has to offer more benefits (differentiated treatments) to Bangladesh through the FTA as it is a least developed country in the region. During the meeting held in November 2003, Bangladesh side pointed out the asymmetries of the two economies and the need of fair reflection of such asymmetries in the FTA. They expect extended phasing out period of import duty and other measurers on the product schedules than the offer given by Sri Lanka. Sri Lanka should request the details on economic asymmetries that Bangladesh intends to take up during the negotiations and assess their justifications and implications on the national economy.

Figure 1.13 Sri Lanka's Trade with Bangladesh



Source: Department of Commerce, Ministry of Trade: Sri Lanka

สำนักงานวิทยทรัพยากร จุฬาลงกรณ์มหาวิทยาลัย

The major products of export interest to Bangladesh are garments, textiles and textile products, frozen fish, jute and jute products, leather and leather products, tea, urea fertilizer and ceramic tableware. 80% of Bangladesh exports consist of textiles and garments. Their exports are benefited from the concessionary access provided by major buyers such as USA and EU.

Out of the total imports from Bangladesh to Sri Lanka around 36% consists of textile yarn and fabric which is used as raw material in the garment industry in Sri Lanka. These items are duty free to Sri Lanka from any source and therefore it is likely that Bangladesh would request concessionary access to products such as jute and jute products, steel products, chemical products, plastic products and selected agricultural products. There is a possibility to experience adverse consequences on the local industries in similar fields. On the other hand Bangladesh likely to insist on concessionary access for such products as they are the major exportable products of the country.

1.4 Rationale for the Study

Previous studies (Srinivasan: 1994, Samarathunga: 1999, Bandara and Yu: 2001) have expressed divergent views about the possible impact of SAFTA on its members. While some have expressed optimism about the impact, others are skeptical.

South Asia was slow to take up the issues of regional economic cooperation, although SAARC was established in 1985. Therefore, recently there has been a proposal, mainly from the business community to initiate bilateral free trade agreements among SAARC member countries, particularly with India. In the case of Sri Lanka, for example, its support for SAFTA was prompted largely by the desire to gain access to the Indian market. Having already achieved that under the ILFTA, and also the FTA with Pakistan, Sri Lanka's the other major trading partner in South Asia, its questionable the benefits that Sri Lanka could gain as a member of SAFTA.

Moreover, if bilateral trade agreements are continue alongside the SAFTA process, this will mean that countries will have to contend with a multitude of bilateral and regional agreements- what economists have referred to as a "spaghetti bowl" of overlapping trade agreements. However, the question is whether such alternative initiatives will benefit the nation as a whole or only a few segments in the society. To reach a conclusion and suggest a policy advice, a quantitative assessment is needed of the impacts of SAFTA and other policy options on Sri Lanka. In this thesis, an attempt is made to fulfill that need by assessing the impacts of South Asian Free Trade Area (SAFTA) and other policy options on the Sri Lankan economy.

1.5 Objectives of the Study

According to the background to the research it is interesting to examine whether Sri Lankan economy as a whole could benefit by being a member of SAFTA or else the other policy options would ensure greater welfare to the Sri Lankan economy than the former one. To reach conclusion and to suggest policy advice, a quantitative assessment is needed to ascertain the impacts of SAFTA and the other policy options on Sri Lankan economy. The objectives of the study can be presented as follows.

i. To examine the key economic indicators of the South Asian economies, trade investment trends and policies, some salient features of the trade agreements and the importance of the ASEAN economic integration to South Asia's future economic integration.

ii. To investigate the impact of SAFTA on trade and welfare of the Sri Lankan economy.

iii. To investigate the impact of the other policy options on trade and welfare of the Sri Lankan economy.

iv. To make policy recommendations to Sri Lanka to strengthen her trade relationships between SAARC countries and the rest of the world to maximize the welfare of the country.

1.6 Scope of the Study

The study focuses on investigating the impact of South Asian Free Trade Area (SAFTA), which come to effect from 1st of January 2006, on Sri Lankan economy. Further, the study analyses the other policy options such as bilateral free trade agreements between Sri Lanka and India and proposed bilateral trade agreement between Sri Lanka and Bangladesh. The impact of free trade agreement between Sri Lanka and Pakistan will not be considered in the study as GTAP data base does not have a separate region for Pakistan. Further, the study incorporates the other policy scenarios such as South Asian Customs Union and multilateral trade liberalization. The study intends to make policy recommendation to Sri Lanka, based on the impact of changes in trade and welfare level (changes in allocative efficiency, changes in the country's terms of trade, changes in endowments and investment and savings effect) from each of the trade policy options on Sri Lankan economy. The analysis of the study is confined to the officially recorded trade between Sri Lanka and its trade partners. The impact on the Sri Lankan industries under different trade policy options will be determined according to the GTAP industry classification. The study uses GTAP version 6 database, which reflects the world economy of 2001 for quantitative assessment of the trade and welfare level.

1.7 Chapter Organization

At the outset, chapter two is devoted to undertake a literature review in order to gain understanding about the theoretical framework and empirical research findings. Further, the methodology of the study will be presented to achieve the above mentioned objectives of the study.

The descriptive analysis will be presented in chapter three to provide the background information which the results of the later analysis have to be assessed. This chapter illustrates the trends in trade and investments and trade and investment policies in South Asia. Further, some salient feature of RTAs in South Asia will be presented to get insight into the simulation design. Finally, the importance of the ASEAN economic integration for the South Asia's future economic integration will be discussed as it is vital for the South Asian region to take these experiences.

The forth chapter is devoted to undertake the simulation analysis that arise under different trade policy scenarios. The findings will be discussed by analyzing the impact of each policy option on the trade and welfare of the Sri Lankan economy.

Finally, the conclusions and the policy recommendations will be presented in chapter five that would help the policy makers in Sri Lanka to strengthen the trade relationships among trade partners and to achieve economic integration.