

# **SAFTA and the Bangladesh Economy: Assessments of Potential Implications**

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## Table of Content

|  |    |
|--|----|
| Acronyms and Abbreviations .....   | iv |
| 1. Introduction.....   | 1  |
| 2. Bangladesh’s Trade with Neighbouring Countries: Patterns and Trend .....  | 1  |
| 3. SAFTA and the LDCs in South Asia: Implications for Bangladesh.....  | 5  |
| 4. Potential Implications of SAFTA on Bangladesh’s Economy:  |    |
| A Review of Qualitative and Quantitative Studies .....   | 9  |
| 4.1. Welfare Effects of SAFTA: Some Qualitative Assessments of<br>Potential Implications for Bangladesh.....   | 9  |
| 4.2. Empirical Studies on Welfare Effects of SAFTA:  |    |
| Some Quantitative Assessments of Potential Implications for Bangladesh.....  | 12 |
| 4.2.1. The Gravity Models .....  | 12 |
| 4.2.2. Partial Equilibrium Models .....  | 13 |
| 4.2.3. The CGE Models .....  | 14 |
| 4.2.4. SAFTA and the Expansion of Bangladesh’s Exports into Indian Market: A<br>Simulation Exercise using the Partial Equilibrium WITS/SMART Model ..... | 17 |
| 4.2.5. Some Final Observations on the Partial Equilibrium and<br>General Equilibrium Simulation Results.....   | 19 |
| 5. Feedback from the Policy Makers and Business People in Bangladesh .....   | 19 |
| 6. The Prospect of Multilateralism with Regionalism for Bangladesh .....   | 21 |
| 7. Challenges and policy options for making SAFTA an effective vehicle of<br>rade-led growth for Bangladesh: The Call for a ‘SAFTA-Plus’ Agreement.....  | 22 |
| 8. Conclusion .....  | 23 |
| References.....  | 24 |

## **List of Tables**

|   |    |
|---|----|
| Table 1: Share of Bangladesh's Exports with Neighbouring Countries<br>in her Total Exports .....                | 4  |
| Table 2: Share of Bangladesh's Imports with Neighbouring<br>Countries in her Total Imports.....                 | 4  |
| Table 3: Exports rise for top 30 products (HS 6-digit) from<br>Bangladesh to India ('000 US\$) under SAFTA..... | 18 |
| Table 4: Non-tariff and Para-tariff Barriers Faced by Bangladeshi Exporters in India .....                      | 20 |

## **List of Boxes**

|  |    |
|--|----|
| Box 1: LDCs Have Longer Time-span for Tariff Reduction<br>Compared to Non-LDCs .....               | 6  |
| Box 2: Sensitive Lists Among the SAFTA Members .....   | 7  |
| Box 3: Trade Creation and Trade Diversion Effects of FTA .....                                     | 9  |
| Box 4: The GTAP Model .....  | 15 |
| Box 5: Trade Creation and Trade Diversion Effects of SAFTA Simulations .....                       | 16 |
| Box 6: Changes in Imports to Bangladesh from Different<br>Countries under SAFTA1 (in US\$mn) ..... | 17 |

## **List of Figures**

|  |   |
|--|---|
| Figure 1: Country-wise Share (%) in Intra-SAARC Imports in 2003.....         | 2 |
| Figure 2: Country-wise Share (%) in Intra-SAARC Exports in 2003.....         | 2 |
| Figure 3: Bangladesh's Trade with Neighbouring Countries (million US\$)..... | 3 |

## Acronyms and Abbreviations

|                 |   |
|-----------------|---|
| <i>ASEAN</i>    | <i>Association of Southeast Asian Nations</i>   |
| <i>BIMSTEC</i>  | <i>Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation</i> |
| <i>CGE</i>      | <i>Computable General Equilibrium</i>   |
| <i>CU</i>       | <i>Custom Union</i>   |
| <i>DFQF</i>     | <i>Duty Free Quota Free</i>   |
| <i>EU</i>       | <i>European Union</i>   |
| <i>GDP</i>      | <i>Gross Domestic Product</i>   |
| <i>GTAP</i>     | <i>Global Trade Analysis Project</i>  |
| <i>EU</i>       | <i>European Union</i>   |
| <i>FTA</i>      | <i>Free Trade Area</i>  |
| <i>LDCs</i>     | <i>Least Developed Countries</i>  |
| <i>NAFTA</i>    | <i>North American Free Trade Area</i>   |
| <i>NTBs</i>     | <i>Non-Tariff Barriers</i>  |
| <i>RMGs</i>     | <i>Readymade Garments</i>   |
| <i>RoO</i>      | <i>Rules of Origin</i>  |
| <i>RTA</i>      | <i>Regional Trade Agreement</i>   |
| <i>QRs</i>      | <i>Quantitative Restrictions</i>  |
| <i>SAARC</i>    | <i>South Asian Association of Regional Cooperation</i>                                |
| <i>SAFTA</i>    | <i>South Asian Free Trade Area</i>  |
| <i>SAPTA</i>    | <i>South Asian Preferential Trade Agreement</i>                                       |
| <i>S&amp;DT</i> | <i>Special and Differential Treatment</i>   |
| <i>TLP</i>      | <i>Trade Liberalisation Programme</i>   |
| <i>WTO</i>      | <i>World Trade Organisation</i>   |

## **1. Introduction**

In recent years, there has been increased interest in regional economic integration in South Asia. With the stalemate of the World Trade Organisation (WTO) negotiations, it is expected that the interest in regional trading arrangements will increase further. Regional integration in South Asia got the momentum in 1995 when the South Asian Association for Regional Cooperation (SAARC) Preferential Trading Arrangement (SAPTA) was signed. In early 2004, the SAARC member countries agreed to form a South Asian Free Trade Area (SAFTA), which has become a parallel initiative to the multilateral trade liberalisation commitments of the south Asian countries. SAFTA has come into force since July 01, 2006, with the aim of boosting intraregional trade among the seven SAARC members.

There have been some strong arguments for the regional economic integration in South Asia, as this integration is believed to generate significant intraregional trade and welfare gains for the South Asian countries. There are also aspirations among the policy makers and business community in Bangladesh about the positive impacts SAFTA might have on the Bangladesh economy. It is expected that the SAFTA mechanism, when fully implemented, will provide Bangladesh improved market access, help boost its exports to the region, and improve the country's intra-regional trade balance. SAFTA is expected to generate substantial new trade – the so-called static gains. The dynamic gains could be even higher than the static gains due to the possible expansion in the scale of operation by getting access to the markets of the relatively larger member countries.

However, critics have pointed out a number of factors which could undermine the potential benefits from the SAFTA. For example, it is argued out that there are limited complementarities in the region. Therefore, even under the free trade mechanism the expansion of intra-regional trade would not be very substantial. Secondly, these countries trade very little among themselves and major trading partners of the individual South Asian countries are located in the West. Thirdly, it is alleged that SAFTA may lead to substantial trade diversion than trade creation for some of the member countries. And, finally, it may work as a stumbling bloc to multilateral trade liberalisation. These concerns have also been endorsed by some studies while examining the potential impacts of SAFTA on the Bangladesh economy.

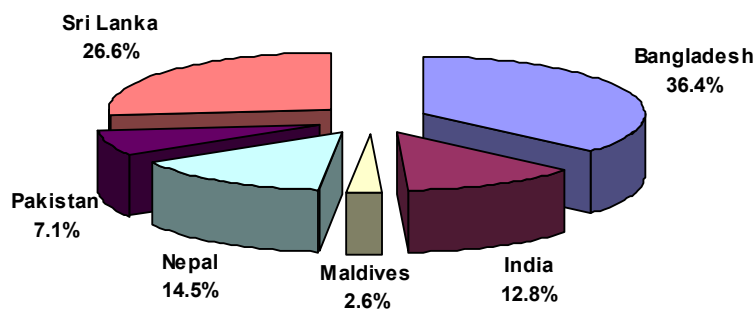
Against the backdrop of the aforementioned arguments and counter-arguments the purpose of this paper is to examine the implications of SAFTA for Bangladesh. The structure of the paper is as follow: Section 2 provides an evolution of Bangladesh's trade with its neighbouring countries; Section 3 depicts the current status of SAFTA with special reference to any favourable treatment given to least developed countries (LDCs); Section 4 undertakes a review of the studies on potential implications of SAFTA; Section 5 reviews the feedback from the key policymakers and representatives of other stakeholders in Bangladesh on SAFTA; Section 6 assesses the prospect of multilateralism with regionalism for Bangladesh; Section 7 identifies the challenges and policy options for making SAFTA an effective vehicle of trade-led growth for Bangladesh; and finally Section 8 presents the conclusion.

## **2. Bangladesh's Trade with Neighbouring Countries: Patterns and Trend**

While examining Bangladesh's trade with her neighbouring countries it should be kept in mind that the intra-regional trade among the South Asian countries is very low. Until 1951, total intra-regional trade in South Asia as a percentage of the region's total trade was in the

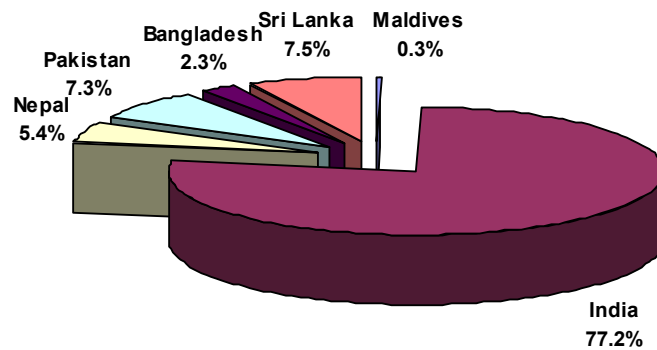
double digits. However, as South Asia became progressively more closed relative to the world market and also the political rivalry between India and Pakistan intensified over time, by 1967 intra-regional trade fell to just two percent of the region's total trade. The share began to recover during the 1990s and by 2002 it rose to 4.4 percent (Baysan et al, 2006). Figure 1 suggests that even with a low intra-regional trade Bangladesh is the single largest importer in South Asia. In 2003, Bangladesh accounted for 36.4 percent of total intra-regional import. In contrast, Figure 2 indicates that in 2003, Bangladesh's exports to the region accounted for only 2.3 percent of the total regional exports.

**Figure 1: Country-wise Share (%) in Intra-SAARC Imports in 2003**



Data Source: UN COMTRADE

**Figure 2: Country-wise Share (%) in Intra-SAARC Exports in 2003**

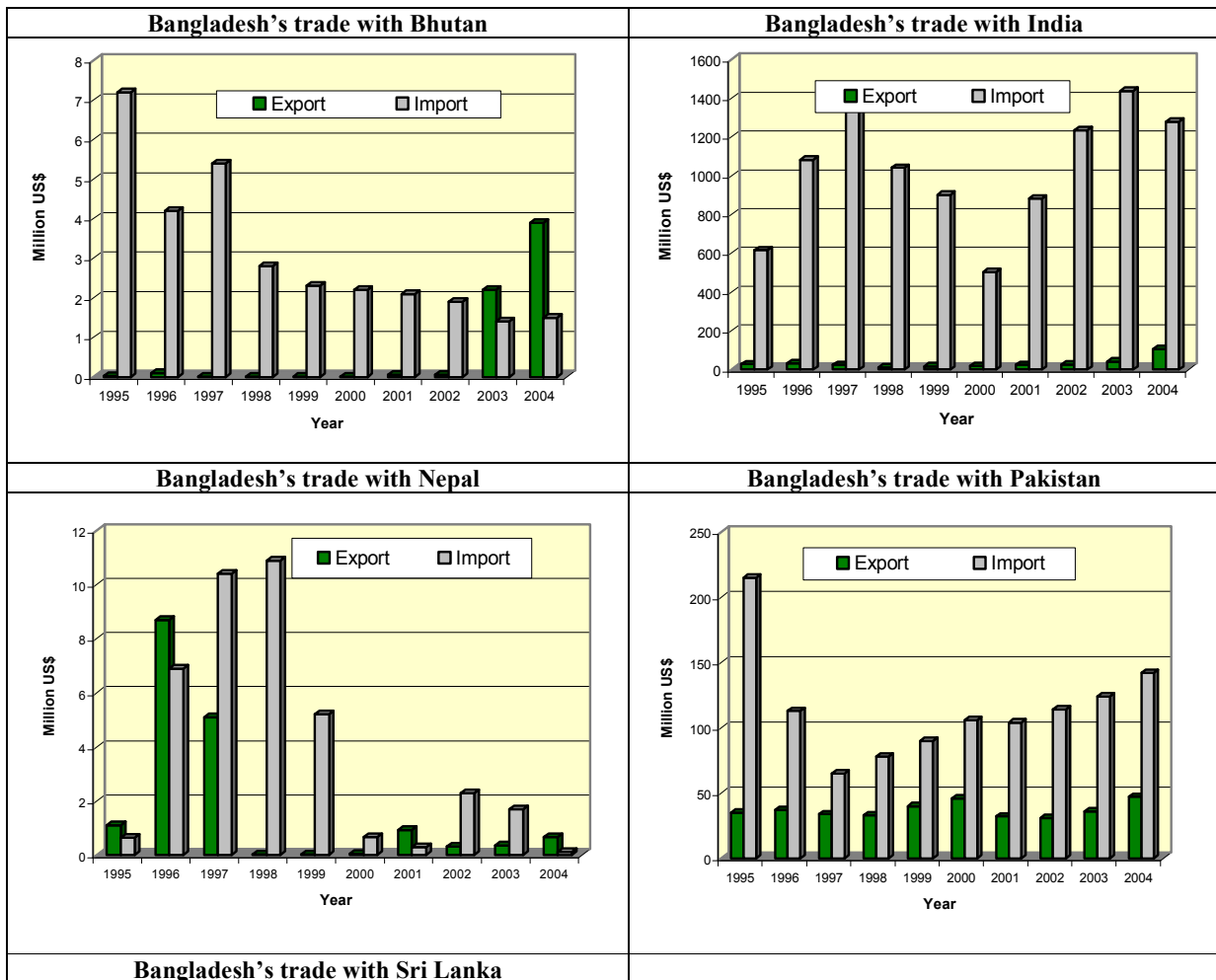


Data Source: UN COMTRADE

Bangladesh's trade with her neighbouring countries is also highly unequally distributed. It appears from Figure 3 that Bangladesh trade very little with Bhutan, Nepal and Sri Lanka. In South Asia, India is the major trading partner of Bangladesh followed by Pakistan. But, the trade with India is largely one-sided, as the volume of imports from India to Bangladesh is

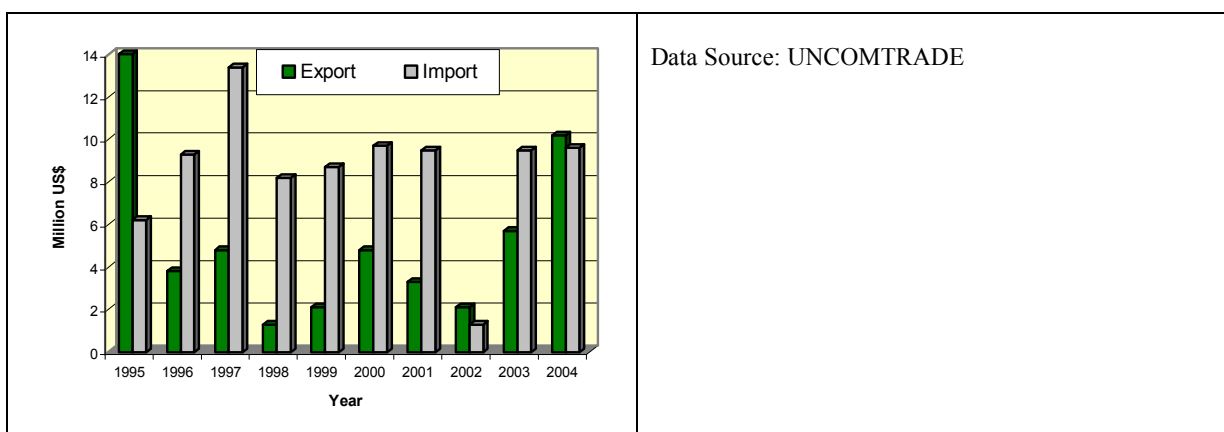
considerably very large, whereas the volume of exports from Bangladesh to India is very low. It, therefore, appears that Bangladesh has high bilateral trade deficit with India, which has been an issue for debate whether it is a matter of any concern (Raihan and Rahman, 2007).<sup>1</sup> Bangladesh exports a miniscule (one percent) share of India's imports, a negligible share (one percent) of its own exports, and a small range of products (fertiliser and jute goods made up two-thirds of exports). Though ready-made-garments (RMG) is the major export item for Bangladesh, its exports to India are very much insignificant.<sup>2</sup>

**Figure 3: Bangladesh's Trade with Neighbouring Countries (million US\$)**



<sup>1</sup> Bangladesh's perennial large bilateral trade deficit with India might be a cause for concern but it has not led to any balance of payments problem for Bangladesh as consistent trade surpluses with such trading partners as US and EU compensate for these deficits.

<sup>2</sup> It is alleged that, one of the major reasons behind very low exports of RMG products from Bangladesh to India is India's relatively high specific tariffs on Bangladesh's RMG products (-----)



It is clearly evident from Table 1 that in terms of exports, South Asia has not been a significant export destination of Bangladesh. In fact, over the last 10 years, there has not been any major change in this pattern. In 1995, Bangladesh's exports to the South Asian region accounted for only 2.3 percent of her total exports, which by 2004 came down to only 2 percent. Table 2 also suggests that over time Bangladesh's dependence on South Asia as a source of her imports declined. In 1995, Bangladesh's imports from the South Asian region accounted for 15.5 percent of her total imports, which by 2004 declined to 12.6 percent. India has been one of the major sources of imports for Bangladesh, as India accounted for, on average, 12 percent of Bangladesh's total annual imports in recent years.

**Table 1: Share of Bangladesh's Exports with Neighbouring Countries in her Total Exports**

|                         | 1995        | 1996        | 1997        | 1998        | 1999        | 2000        | 2001        | 2002        | 2003        | 2004        |
|-------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| Bhutan                  | 0.00        | 0.00        | 0.00        | 0.00        | 0.00        | 0.00        | 0.00        | 0.00        | 0.03        | 0.05        |
| India                   | 0.79        | 0.91        | 0.59        | 0.20        | 0.31        | 0.35        | 0.43        | 0.47        | 0.64        | 1.27        |
| Nepal                   | 0.03        | 0.25        | 0.13        | 0.00        | 0.00        | 0.00        | 0.02        | 0.01        | 0.01        | 0.01        |
| Pakistan                | 1.03        | 1.05        | 0.85        | 0.65        | 0.79        | 0.91        | 0.56        | 0.57        | 0.56        | 0.57        |
| Sri Lanka               | 0.41        | 0.11        | 0.12        | 0.03        | 0.07        | 0.10        | 0.06        | 0.04        | 0.09        | 0.12        |
| <b>South Asia Total</b> | <b>2.26</b> | <b>2.31</b> | <b>1.69</b> | <b>0.88</b> | <b>1.17</b> | <b>1.36</b> | <b>1.07</b> | <b>1.09</b> | <b>1.33</b> | <b>2.02</b> |
| Rest of the World       | 97.74       | 97.69       | 98.31       | 99.12       | 98.83       | 98.64       | 98.93       | 98.91       | 98.67       | 97.98       |

Source: Computed using the data from UN COMTRADE

**Table 2: Share of Bangladesh's Imports with Neighbouring Countries in her Total Imports**

|                         | 1995         | 1996         | 1997         | 1998         | 1999         | 2000        | 2001         | 2002         | 2003         | 2004         |
|-------------------------|--------------|--------------|--------------|--------------|--------------|-------------|--------------|--------------|--------------|--------------|
| Bhutan                  | 0.13         | 0.07         | 0.08         | 0.04         | 0.03         | 0.03        | 0.03         | 0.02         | 0.01         | 0.01         |
| India                   | 11.31        | 17.38        | 19.69        | 14.82        | 12.37        | 6.66        | 10.88        | 13.40        | 14.16        | 11.24        |
| Nepal                   | 0.01         | 0.11         | 0.15         | 0.16         | 0.07         | 0.01        | 0.00         | 0.02         | 0.02         | 0.00         |
| Pakistan                | 3.95         | 1.82         | 0.96         | 1.11         | 1.24         | 1.40        | 1.28         | 1.24         | 1.22         | 1.25         |
| Sri Lanka               | 0.11         | 0.15         | 0.20         | 0.12         | 0.12         | 0.13        | 0.12         | 0.01         | 0.09         | 0.08         |
| <b>South Asia Total</b> | <b>15.52</b> | <b>19.52</b> | <b>21.08</b> | <b>16.24</b> | <b>13.83</b> | <b>8.22</b> | <b>12.31</b> | <b>14.70</b> | <b>15.51</b> | <b>12.59</b> |
| Rest of the World       | 84.48        | 80.48        | 78.92        | 83.76        | 86.17        | 91.78       | 87.69        | 85.30        | 84.49        | 87.41        |

Source: Computed using the data from UN COMTRADE



One important aspect of Bangladesh's trade with India is that Bangladesh's informal border imports from India have always been thought to be very high. Though there has not been any comprehensive quantitative assessment on the informal border trade between India and Bangladesh, it is pointed out by a few studies that the informal and illegal trade between India and Bangladesh could be as high as three quarters of recorded trade (World Bank, 2006). However, such informal trade is mostly one way – from India to Bangladesh. Therefore, if such informal imports from India were taken into consideration, India's share in Bangladesh's total imports would rise considerably.

The upshot of the aforementioned analysis points us to the fact that, apart from the imports from India, South Asian countries have not been the major trading partners of Bangladesh. As far as export destinations are concerned, Bangladesh's major trading partners are the EU and US. On the other hand, apart from India, other major import sources for Bangladesh are China, Singapore and Japan. Any evaluation of the prospects of SAFTA should, therefore, take note of these facts.

### **3. SAFTA and the LDCs in South Asia: Implications for Bangladesh**

Four LDCs in South Asia, namely Bangladesh, Bhutan, the Maldives and Nepal have been provided some special and differential treatments (S&DTs) within the SAFTA Treaty Text. These special provisions may have important implications for Bangladesh. This section critically analyses these special provisions and the stakes Bangladesh might have in these provisions.

The S&DTs in the SAFTA Treaty Text are contained in: (i) three sub-paragraphs in Article 3 (Objectives and Principles); (ii) four paragraphs in Article 7 (Trade Liberalisation Programme); (iii) entire Article 11 (Special and Differential Treatment for the Least Developed Contracting States); and (iv) one paragraph in Article 16 (Safeguards Measures). A discussion on these S&DTs for the LDCs and the related concerns include the followings:

- (a) The Treaty Text allows longer timeframes to reduce or eliminate tariffs of the LDC members. Also, the Treaty asks for a rapid tariff reduction or elimination by non-LDC partners on products originating from LDCs (see Box 1). This provision has been argued to be favourable to the LDC members. However, concerns have been raised on two grounds: firstly, the first stage of tariff reduction seems to be redundant for all the South Asian countries, as currently in these member countries, because of unilateral tariff liberalisation, tariff rates on most of their products are less than 20 percent or so. Therefore, LDC members are unlikely to have any significant gain during the first two years of the Tariff Reduction Programme. Secondly, there are also concerns about the second stage, as the 3-year gap between LDC and non-LDC members appears to be low. Also the presence of negative lists by the non-LDC members restricts significantly the potentials of market access of the products to the LDC members in the non-LDCs.

**Box 1: LDCs Have Longer Time-span for Tariff Reduction  
Compared to Non-LDCs**

LDCs will take eight years thereafter, instead of six years by Sri Lanka and five years by others, to reach the free trade level of 0-5 percent duties. The non-LDCs will reduce their duties for the products of the LDCs within three years compared with five years for reducing duties on each other's products.

| Country Category | First Stage                              | Second Stage                           | Target year for FTA                            |
|------------------|--|--|--|
| LDCs             | From existing tariff to 30% over 2 years | From 30% or below to 0-5% over 8 years | 2016<br>(0-5% for items outside negative list) |
| Non-LDCs         | From existing tariff to 20% over 2 years | From 20% or below to 0-5% over 5 years | 2013<br>(0-5% for items outside negative list) |

- (b) The Treaty asks for special provisions when considering the application of antidumping and countervailing measures to LDCs. In order to protect domestic industry from possible injury due to increased preferential import, the Treaty provides scope for partial or full withdrawal of preference granted under SAFTA for a period of maximum three years. However, safeguard measures cannot be applied against the product of LDCs if the share of imports from an LDC of the product concerned in total imports of importing country is less than five percent. But, these provisions do not go far enough to ensure that the LDCs will be able to derive equitable benefits from SAFTA. At the penultimate stage of the negotiations, the Treaty got held up because Bangladesh wanted it to go further towards securing S&DT to the LDCs. At the final stage of the negotiations, a compromise was reached that only partially meets the demands of the LDCs. For example, instead of the LDCs' demand that the non-LDCs should refrain from imposing anti-dumping and countervailing measures against them during the period of negotiation, the Treaty contains the vague formulation that special regard shall be paid to the situation of these countries while considering the application of such measures.
- (c) The Treaty provides for greater flexibility for LDCs in the number of products contained in their sensitive lists (see Box 2). However, a major flaw of the Treaty is that it does not subscribe categorically to phasing out the negative list or eliminating non-tariff barriers (NTBs), let alone prescribing time limits for doing so. It only provides that the negative list shall be reviewed after every four years with a view to reducing the number of items.<sup>3</sup> It is also a matter of grave concern for Bangladesh with regard to the size of the negative list maintained especially by India, as the major export items of Bangladesh's interest (i.e. RMGs and chemicals) are included in India's negative list, which inhibit the potentials of export expansion of these products from Bangladesh to India.

<sup>3</sup> There are also concerns about the size of the negative lists, as they appear to be too long. This will detract from the provision of Article XXIV of GATT which lays down that a free trade area should cover substantially all trade.

### Box 2: Sensitive Lists Among the SAFTA Members

The Treaty provides scope for maintaining of sensitive lists, which are not subject to tariff reduction programme. Although it maintains that sensitive list shall be different for LDCs and non-LDCs, only three countries namely Bangladesh, India and Nepal maintain different sensitive lists for LDCs and non-LDCs. Besides, the LDCs maintain longer sensitive lists than the non-LDCs.

| Country    | Total number of Sensitive List |          | Coverage of Sensitive List as % of Total HS Lines |          |
|------------|--------------------------------|----------|---|----------|
|            | For Non-LDCs                   | For LDCs | For Non-LDCs                                      | For LDCs |
| Bangladesh | 1,254                          | 1,249    | 24.0  | 23.9     |
| Bhutan     | 157                            | 157      | 3.0   | 3.0      |
| India      | 865                            | 744      | 16.6  | 14.2     |
| Maldives   | 671                            | 671      | 12.8  | 12.8     |
| Nepal      | 1,335                          | 1,299    | 25.6  | 24.9     |
| Pakistan   | 1,191                          | 1,191    | 22.8  | 22.8     |
| Sri Lanka  | 1,079                          | 1,079    | 20.7  | 20.7     |

- (d) With respect to the elimination of quantitative restrictions (QRs) the Agreement allows greater flexibilities for the LDC members, as these countries are permitted to continue quantitative or other restrictions provisionally and without discrimination in critical circumstances on imports from other member countries. As far as the NTBs are concerned, the Treaty, however, calls for the elimination of all QRs in the member countries in respect of products included in the Trade Liberalisation Programme. This means that QRs will go as soon as a 0-5 percent tariff level is reached. This is in line with the ASEAN Free Trade Area provisions. Moreover, this appears to facilitate greater market access of Bangladesh's export products in India and other member countries. However, since the Treaty does not prescribe, let alone set the dateline for, the elimination of other non-tariff and para-tariff restrictions (which are reported to be prominent in most of the member countries<sup>4</sup>), the prospect of effective market access for Bangladesh's export products, even after the reduction of tariffs and some QRs in other member countries, appears to be doubtful.<sup>5</sup>
- (e) The Treaty also includes provisions for direct measures taken by the non-LDC members to enhance sustainable exports from LDC members. Such measures include long and medium-term contracts containing import and supply commitments in respect of specific products, buy-back arrangements, state trading operations, and government and public procurement. There are provisions for technical assistance for LDCs at their request to assist them in expanding their trade with other member countries in taking advantage of the potential benefits of SAFTA. Areas of Technical Assistance as agreed upon include: (i) capacity building (trade related); (ii) development and improvement of tax policy and instruments; (iii) customs procedures related measures; (iv) legislative and policy related measures, assistance for improvement of national capacity; and (v) studies on trade related physical infrastructure development, improvement of banking sector, development of export

<sup>4</sup> See World Bank (2004) for a discussion on such non-tariff and para-tariff barriers in South Asian countries.

<sup>5</sup> In the absence of a clear-cut time limit and the sequence for the phasing out of the negative list and non-tariff barriers other than QRs, it is doubtful whether the Agreement, when it comes under scrutiny in WTO, will be adjudged as being consistent with Article XXIV of GATT which prescribes the inclusion of a time and a schedule for reaching the free trade stage.

financing. However, there has not been any progress yet with respect to the development of modalities for these assistances.

- (f) A mechanism has been established to compensate the revenue loss to be incurred by the LDCs due to reduction of tariffs. The Compensation will be in cash and partial: maximum five percent of the customs duty collected from SAARC import in 2005. Compensation will be available for four years only (for Maldives it will be available for six years).
- (g) SAFTA allows differential rules of origin (RoO) for the LDC and non-LDC members. The RoO agreed under SAFTA are general in nature (i.e. one criterion for all products) barring 1991 products for which product specific rules are applied. SAFTA RoO requires that in order to enjoy the preference under SAFTA a product must undergo sufficient processing for changing the tariff heading from the non-originating inputs and for having value of at least 40 percent value addition measures as percentage of fob value. However, value addition requirements are lower for Sri Lanka and LDCs, which are 35 percent and 30 percent respectively. Given the fact that value-additions of most of Bangladesh's export products are very low, even a 30 percent value-addition requirement would act as a significant barrier for her export expansion in South Asia. Therefore, the problem of RoO will need to be resolved, keeping an eye on the manufacturing/processing capability of the LDCs. The RoO under SAFTA should also be made consistent with those that are currently in force in the various bilateral trade agreements within the SAARC region, which happen to be more liberal than the prevailing SAFTA rules. In addition, SAFTA should initiate the "Cumulative Rules of Origin", as in the case of India-Sri Lanka FTA, which has been claimed to be beneficial for Sri Lanka.<sup>6</sup> For the success of SAFTA, a sharp reduction and gradual convergence of the member countries' external tariffs will be essential. Note that a free trade area (FTA) needs a strict system of proof of origin mainly for preventing trade deflection. Since trade deflections can occur only when there are wide differences in the members' external tariffs, due importance should be given both to reduce the absolute levels of the members' external tariffs and to narrow down the inter-country differences in tariff rates. Wide differences in the members' external tariffs will make the RoO difficult to implement.

It appears from the aforementioned analysis that there are some special and differential provisions for the LDC members in the SAFTA Agreement. Bangladesh and other LDCs are likely to secure some gains from these provisions. However, a critical examination of these provisions reveals that most of these provisions are rather 'vague' in nature and thus require substantial clarification and revision so that Bangladesh and other LDC members can effectively take advantage of these provisions.

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<sup>6</sup> In the India-Sri Lanka FTA Agreement it is stated that in respect of a product, which complies with the origin requirements provided in rule 5(b) and is exported by any Contracting Party and which has used material, parts or products originating in the territory of the other Contracting Party, the value addition in the territory of the exporting Contracting Party shall be not less than 25 percent of the **f.o.b.** value of the product under export subject to the condition that the aggregate value addition in the territories of the Contracting Parties is not less than 35 percent of the **f.o.b.** value of the product under export.

#### 4. Potential Implications of SAFTA on Bangladesh’s Economy: A Review of Qualitative and Quantitative Studies

SAFTA has been able to generate significant interests among the policy makers, business community and researchers in Bangladesh. There are debates on whether Bangladesh stands to gain or lose from SAFTA. Findings of a number of qualitative and quantitative studies in this regard have been inconclusive, which have intensified this debate. The results of these studies have however been influenced by the differences in the methodologies used in these studies.

##### 4.1. Welfare Effects of SAFTA: Some Qualitative Assessments of Potential Implications for Bangladesh

The discourse on the qualitative assessment of SAFTA falls primarily on the theoretical analysis of regional trading arrangements (RTA). Trade theory and evidences suggest that there are several forms of RTAs<sup>7</sup>, which include: (i) Preferential Trade Area (PTA), where tariffs are lowered among the members but maintained against the outside world (i.e., SAPTA); (ii) FTA, where tariffs are removed among members but maintained against the outside world (i.e. SAFTA, NAFTA); (iii) Customs Union, where all tariffs amongst the members are eliminated, while external tariffs are adjusted to a common level; (iv) Common Market, which a Customs Union plus free movement of factors of production among the member countries; and finally (v) Economic Union which is a Customs Union plus common economic laws for the member countries (i.e. EU).

In trade theory, welfare effects of any RTA are analysed using two concepts: trade creation and trade diversion (see Box 3). The overall welfare effects of economic integration are ambiguous and require case-by-case judgment. The reason is that integration is both a policy of protection and a move towards free trade. The effect of the protectionist element of integration is called *trade diversion*, and the effect of the trade liberalisation element is called *trade creation*. The RTA’s overall effect on welfare for a member country is determined by comparing the trade-creation and trade-diversion effects. If trade creation dominates, the formation of a RTA will enhance welfare. On the contrary, if trade diversion effect is greater than the trade creation effect, the RTA will lead to a welfare loss for the country under consideration.<sup>8</sup>

**Box 3: Trade Creation and Trade Diversion Effects of FTA**

|              | Country A<br>(the home country) | Country B<br>(the FTA member country) | Country C<br>(rest of the world) |
|--------------|---------------------------------|---------------------------------------|----------------------------------|
| Supply price | 50                              | 40                                    | 30                               |

- Case  $\alpha$  : If A imposes a tariff of 100 percent on both B and C, only A’s own producers will be in the A’s domestic market.
- Case  $\beta$  : If A imposes a tariff of 50 percent on both B and C, only C will be the supplying country in A’s market.
- Case  $\gamma$  : If A forms a FTA with B, but retains the 50 percent duty on C, B will be the supplying country in A.

If  $\alpha$  was the initial condition, moving to  $\gamma$  will be considered as trade creation, welfare enhancing for A.

If  $\beta$  was the initial condition, moving to  $\gamma$  is an example of trade diversion with adverse consequences on welfare of A.

<sup>7</sup> For a general survey of the theory of preferential trading arrangements see Panagariya (2000).

<sup>8</sup> Note that if member countries are the low-cost producers of the traded good, there will be no trade diversion effect and integration will unambiguously increase welfare.

The fundamental arguments for regionalism rest on the evidences which suggest RTAs to be predominantly trade-creating (Rodriguez-Delgado, 2007). Krugman (1991) argued that most RTAs are likely to entail relatively low welfare losses resulting from trade diversion, since the countries involved are often geographical neighbours and hence already engage in a sizable amount of trade. It is also argued that through RTAs countries can ‘lock-in’ reform, which is often politically not feasible under multilateralism. Whalley (1996), for example, asserts that a desire for increased credibility of domestic reforms was a central preoccupation behind the Mexican negotiating position on NAFTA. Also, failure or stalemate of the multilateral trade talks means trade liberalisation can only take place through RTAs. It is highlighted that countries can build on the progress of regionalism and can ultimately move toward a freer trade regime on the whole.

There are, however, some critical arguments against formation of any RTA. It is alleged that through RTA the spirit of multilateralism is undermined. It is argued that the world might be divided into a few protectionist blocs and protectionists might accept RTAs to oppose further multilateral liberalisation. Therefore, RTAs might work as stumbling block rather than building blocs for multilateralism. Also, the ‘spaghetti bowl’ effect can emerge because of many complicated simultaneous RTA negotiations.<sup>9</sup> RTAs also discriminate against the non-member countries, and even LDCs could seriously be discriminated against due to the RTAs among the developed and developing countries. NAFTA is a good example in this regards, and it is argued that because of NAFTA, LDC like Bangladesh has been discriminated against while Mexico has been favoured in the US market (Razzaque, 2005). Furthermore, RTAs distort resource allocation, favouring regional producers to the potential detriment of local consumers (Rodriguez-Delgado, 2007). Recent research on RTAs also emphasises the global consequences of multiple and overlapping RTAs in terms of the transaction costs they impose (Feridhanusetyawan, 2005). It is further put forward that resources in trade ministries are limited. Therefore, too much involvement in RTA negotiations may distract attention from multilateral liberalisation.

There are also concerns that through RTA (reducing tariffs for the member countries) the prices of goods imported from the member countries in the domestic market may not fall as the member countries may see the home country’s market as a ‘captive market’ for their exporters. For example, it is often alleged by the critics of SAFTA that through this regional trading arrangement, Indian exporters may find a ‘captive market’ for their exporters in Bangladesh (World Bank, 2006). As a result, even though Bangladesh reduces the tariffs for Indian products, the prices of those products may not fall in Bangladesh as the Indian exporters will have the ‘freedom’ to raise prices up to the level at which the products from the rest of the world are sold in Bangladesh (with higher tariffs).

In general, there are some agreements among the economists about the pre-conditions for home-country welfare expansion from a RTA. For example, the home country could gain if there are: (i) high level of the home country’s tariffs prior to the agreement; (ii) high tariff level of the contemplated partner; (iii) high economic size of the partner; (iv) high share of the partner in providing the home country’s imports; (v) low ratio of imports from the rest of the world to the home country’s aggregate economic activity; (vi) relative prices in the partner’s economy close to those of the rest of the world; and (vii) similarities in economic activities of the partner with the rest of the world.

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<sup>9</sup> See Bhagawati and Panagariya (1996).

Bayson *et al* (2006) argue that the economic case for SAFTA is relatively weak. The authors point out three important features of the South Asian economies that make an FTA among them *economically* unattractive. First, the economies are relatively small in relation to the world both in terms of the GDP and trade flows. Though in terms of population, the region is substantial (one fifth of the world) the current per-capita incomes are tiny so that the economic size of the region remains small: less than one twentieth of the world in terms of the GDP. And if India is taken out of the picture, this proportion drops to 0.4 percent. Bayson *et al* (2006) further argue that the probability that most efficient suppliers of the member countries are within the region is slim. Therefore, the probability that the FTA is likely to be largely trade diverting is quite high.

The second reason relates to the relatively high levels of protection among the SAARC economies. If the country participating in a regional arrangement were itself open, it would not suffer from trade diversion even if it were tiny. It is, however, evident that the level of protection within the SAARC region remains high in all countries except, arguably, Sri Lanka. The simple average of the applied duties in non-agricultural goods ranges from 10.7 percent in Sri Lanka to 25.4 percent in Bangladesh. In India, this tariff is approximately 20 percent. In agriculture, the level of protection is even higher and ranges from 19.6 percent in Pakistan to 40 percent in India. And Bangladesh, through the use of several para-tariffs on top of the customs duties, has recently raised nominal protection levels for many import substituting industries to very high levels.

According to Bayson *et al* (2006), the third and final reason that makes the economic case for SAFTA weak concerns the political economy of the selection of excluded sectors and RoO. When countries are allowed to choose sectors that can be excluded from tariff preferences in an FTA, domestic lobbies make sure that the sectors in which they may not withstand competition from the union partner are the ones that get excluded. In addition, the RoO can also be subject to abuse by the bureaucrat administering them. In cases where imports from the partner may be threatening an inefficient domestic competitor, bureaucratic discretion may be employed to block entry of the imports.

Bayson *et al*'s first argument, however, may not be valid in some cases while considering the trade between Bangladesh and India. As has been mentioned in Section II, India has been one of the major sources of imports for Bangladesh. Therefore, there is a possibility that for a good number of products India might be the most efficient import source for Bangladesh (for example, most agricultural products, *sarees*, other textile items, cotton, yarn, sugar, and pulses). The second argument on high tariffs in South Asia also needs to be carefully examined. Pursell has shown that tariffs in India are often redundant. In the World Bank study, it was also highlighted that in certain industries, the protection provide by India to its domestic producers was redundant as competition amongst Indian producers was so intense that it helped them reduce prices in the domestic markets (even lower than world prices). The third argument, however, seems to be quite reasonable given the fact that the Sensitive Lists of the Member countries in the SAFTA are quite long.

In contrast to the arguments put forward by Bayson *et al* (2006) policy makers and many business people in South Asia and especially in Bangladesh are rather optimistic about SAFTA. They see SAFTA has significant potentials to expand trade among the member countries. It is also hoped that Bangladesh will be able to gain significantly by having greater market access in other South Asian countries, and especially in India. Those who argue for

SAFTA state that despite the little volume through formal channel, substantial trade is already taking place in South Asia with informal trade amounting to a large proportion of formal trade. Taking into account the informal trade the 'real' intra-regional trade would be anywhere between 8-10 percent. Although studies have shown that there are limited complementarities in the SAARC region, it is argued that this was also the case in ASEAN during the mid-1970s, and that dormant complementarities in the region could be invigorated by intra-regional investment and FDI.<sup>10</sup> They also argue the cost of non-cooperation to be quite high (RIS, 2004 and 1999; GEP, 1998; CUTS, 1996). The debate is, therefore, far from settled. Irrespective of the debate, there is a general belief that regional cooperation in South Asia should not be viewed only from the trade perspective, and that there are many gains from regionalism in other areas.

## **4.2. Empirical Studies on Welfare Effects of SAFTA: Some Quantitative Assessments of Potential Implications for Bangladesh**

Empirical studies on the quantitative assessments on SAFTA (and on SAPTA as well) differ significantly in terms of the methodologies employed. In broad, three types of techniques have been employed to examine the potential implications of SAPTA/SAFTA (Baysan *et al*, 2006). These are: (i) gravity model, (ii) partial equilibrium model; and (iii) computable general equilibrium model.

### **4.2.1. The Gravity Models**

The gravity models basically try to explain bilateral trade flows with a set of explanatory variables that try to predict the impact of the arrangement on bilateral trade flows<sup>11</sup>. Gravity models, for the analysis of any RTA, have been used widely to predict the impact of the agreements on the bilateral trade flows. The studies that employ the gravity model include Srinivasan and Canonero (1995), Sengupta and Banik (1997), Hassan (2001), Coulibaly (2004), Hirantha (2004), Tumbarello (2006), Rahman (2003), Rahman *et al* (2006) and Rodriguez-Delgado (2007). The findings of these studies have been mixed. For example, studies by Srinivasan and Canonero (1995), Sengupta and Banik (1997) predicted that the impact of a South Asian FTA on trade flows would be small for India but much larger on the smaller countries. Sengupta and Banik (1997) predicted a 30 percent increase in the official intra-SAARC trade and as much as 60 percent if illegal trade became a part of official trade. Coulibaly (2004) found net export creation, and Tumbarello (2006) and Hirantha (2004) found net trade creation from SAPTA. On the other hand, Hassan (2001) found net trade diversion effect from SAPTA, while Rahman (2003) found the dummy variable for South Asia to be insignificant, indicating that a regional integration is unlikely to generate significant trade expansion in this region.

Rahman *et al* (2006) used an augmented gravity model to identify trade creation and trade diversion effects originating from SAPTA. It was found that there was significant intra-bloc

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<sup>10</sup> Intra-regional trade in ASEAN was close to 6 per cent in the mid-1970s, but now has increased to around 23 per cent. ASEAN too was characterised by limited complementarities at the beginning but the situation changed with preferential trading, FDI and intra-regional investment (SACEPS, 2002a).

<sup>11</sup> Typically, the exercise involves estimating a bilateral trade-flow equation with bilateral trade (imports, exports or total trade at the aggregate or sector level) as the dependent variable and country characteristics such as the gross domestic products, population, land area, distance, the commonality of language or cultural ties and the existence of preferential trade arrangements as independent variables. Once estimated, the equation can then be used to predict the impact of a union between country pairs that did not have such a union during the sample period.



export creation in SAPTA; however, at the same time there was evidence of net export diversion in SAPTA. It was also appeared that Bangladesh, India and Pakistan were expected to gain from joining the RTA, while Nepal, Maldives and Sri Lanka were negatively affected.

Rodríguez-Delgado (2007) evaluated the SAFTA within the global structure of overlapping regional trade agreements using a modified gravity equation. It examined the effects of the Trade Liberalisation Programme (TLP) which started in 2006. The study predicted that SAFTA would have a minor effect on regional trade flows. The gravity model simulation suggests that SAFTA TLP would influence regional trade flows mainly by increasing India's exports, and imports from Bangladesh and Nepal. Of every US\$100 of new trade flows (exports + imports), less than US\$20 would originate within the other four members (Bhutan, Maldives, Sri Lanka, and Pakistan). For trade flows generated by SAFTA as a share of individual country's GDP, only the smallest countries obtain significant increases: Bhutan and Maldives experience increases in trade flows equivalent to two and one percent of GDP, respectively; and India, Bangladesh, Pakistan and Sri Lanka see trade flows increases of less than 0.25 percent of GDP.

It should, however, be pointed out that studies based on the gravity model to estimate the welfare gains from regional trading arrangements (RTAs) are methodologically flawed. Firstly, the left hand side of the gravity equation is the bilateral trade, not the welfare. But, the concepts of 'trade creation' and 'trade diversion' directly relate to the welfare of the country in question. Also, the impact of the RTA is captured by introducing the dummy variables in the equation which is a very weak methodology.

Furthermore, gravity models are partial equilibrium analysis; therefore, they fail to take into consideration the inter-sectoral and inter-regional linkage effects. Therefore, gravity models can not actually estimate the welfare effects of any RTA, and therefore not capable of estimating the trade creation and trade diversion impacts of RTAs. Also the theoretical basis of the gravity models has always been questioned.

#### **4.2.2. Partial Equilibrium Models**

The major partial equilibrium studies on RTA in South Asia are by Govindan (1994), DeRosa and Govindan (1995), Pursell (2004) and World Bank (2006). The advantage with these models is that they are generally based on disaggregated data, and are also flexible enough which facilitates sector-specific study. However, the major problem with these models is that they ignore general-equilibrium interactions, and thus can't capture the inter-sectoral effects on the economy.

A partial equilibrium model for food sector, used by Govindan (1994), shows the effect of preferential liberalisation within the region on intraregional trade in food. The study finds that such preferential liberalisation would generate welfare gains through increased trade in food within the region. The analysis by DeRosa and Govindan (1995), however, shows that the welfare gains are much higher when the member countries also go for unilateral liberalisation on a non-discriminatory basis. A partial equilibrium analysis on the cement industry by Pursell (2004) suggests that the preferential liberalisation of cement industry between India and Bangladesh would lead to substantial gains through increased competition within the regional market.

With a view to exploring the potentials of India-Bangladesh bilateral FTA, World Bank (2006) provides a comparative assessment between Bangladesh and India with respect to a few industries like cement, light bulbs, sugar, and RMGs. The partial equilibrium simulation results suggest that in the case of cement, lights bulbs and sugar the likely effects of an FTA between Bangladesh and India seem to be an expansion of Indian exports to Bangladesh, but no exports from Bangladesh to India. This is mainly because Indian export prices for these products are substantially lower than ex-factory before-tax prices of the same or similar products in Bangladesh.

The simulations for RMGs predicted increased Bangladeshi exports to India, but also increased RMG exports from India to Bangladesh. The study finds that a FTA will bring large welfare gain for consumers in Bangladesh provided there is adequate expansion of infrastructure and administrative capacity at custom borders. The study however cautions that the benefits of such a FTA to Bangladesh could be wiped out if it has the effect of keeping out cheaper third-country imports, i.e., from East Asia, and such trade diversion costs can be huge. The study suggests that the only way to minimise the trade diversion costs is through further unilateral liberalisation.

One very interesting implication emerges from the World Bank (2006) study that suggests India's having comparative advantage in RMG over Bangladesh, but still India has been very reluctant in allowing Bangladesh to export RMG in its own market. In recent time, India, however, has allowed Bangladesh, under tariff-rate-quota, to export one million pieces of RMG to its market without paying any duties. But, such a volume of exports appears to be very small while considering Bangladesh's total RMG exports to the world market.

#### **4.2.3. The CGE Models**

The studies based on computable general equilibrium (CGE) models predict the effects of the trading arrangement on all variables including production, consumption, trade flows in all sectors of the economy as also on welfare. The studies that apply the CGE model to SAFTA analysis are Pigato *et al.* (1997), Bandara and Yu (2003), and Raihan and Razzaque (2007). All these three studies employed the Global Trade Analysis Project (GTAP) database and model, though they differ in details due to the evolution of the GTAP itself (see Box 4). Pigato *et al.* (1997) find that SAFTA would produce benefits for member nations though unilateral trade liberalisation would yield larger gains.

The study by Bandara and Yu (2003) finds that, in terms of real income, SAFTA would lead to a 0.21 percent and 0.03 percent gains for India and Sri Lanka respectively, while Bangladesh would lose by 0.10 percent. However, the rest of South Asia (comprising Pakistan, Nepal, Bhutan and Maldives) would gain by 0.08. The authors also endorse the view that South Asian countries might gain much more from unilateral trade liberalisation and multilateral liberalisation than from SAFTA.

#### Box 4: The GTAP Model

The GTAP Model – the global computable general equilibrium (CGE) modelling framework of the Global Trade Analysis Project (GTAP) (Hertel, 1997) – is the best possible way for the *ex ante* analysis of economic and trade consequences of comprehensive multilateral or bilateral trade agreements. The GTAP model is a comparative static, global computable general equilibrium model, and is based on neoclassical theories. Full documentation of the GTAP model and the database can be found in Hertel (1997) and also in Dimaranan and McDougall (2002). The GTAP model is a linearised model, and uses a common global database for the CGE analysis. The model assumes perfect competition in all markets, constant returns to scale in all production and trade activities, and profit and utility maximising behaviour of firms and households respectively. The version 6 of GTAP database covers 57 commodities, 87 regions/countries, and 5 factors of production.

Raihan and Razzaque (2007) also use the global general equilibrium model (GTAP model) in explaining the welfare effects of any regional trading arrangements. The main contribution of their paper was to decompose the welfare effects of SAFTA (as calculated from the GTAP simulation results) into trade creation and trade diversion effects for individual South Asian countries.<sup>12</sup> The authors ran two simulations for two scenarios: SAFTA1 and SAFTA2. Under SAFTA1 scenario, all member countries eliminate their intra-regional tariffs and keep their tariffs with the rest of the world unaffected.

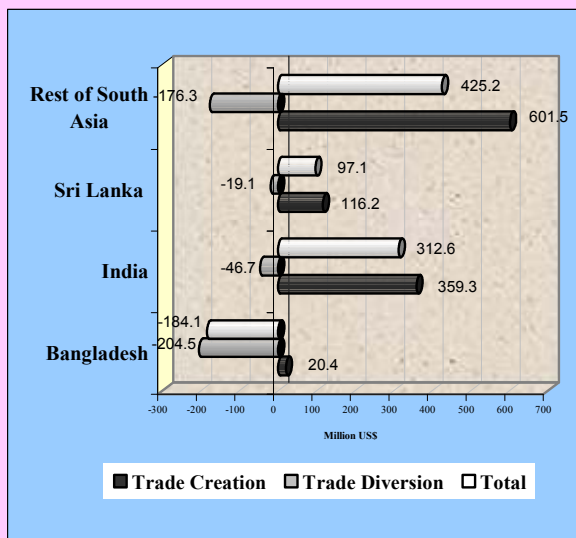
In the scenario SAFTA2, in addition to SAFTA1, Bangladesh eliminates her tariffs for the rest of the world by 50 percent. Box 5 provides the results of this exercise. It appears that Bangladesh would incur a net welfare loss from the SAFTA1 scenario. Though, for Bangladesh there was a positive trade creation effect, the negative trade diversion effect would be large enough to offset the positive gain. However, all other South Asian countries would gain from SAFTA1. The gain for India would be the largest as far as any individual country is concerned. In contrast to SAFTA1 under SAFTA2, the negative trade diversion effect of SAFTA1 for Bangladesh would be eliminated to a large extent, and the trade creation effect would be large enough to offset the trade diversion effect. As a result, there would be a net welfare gain for Bangladesh.

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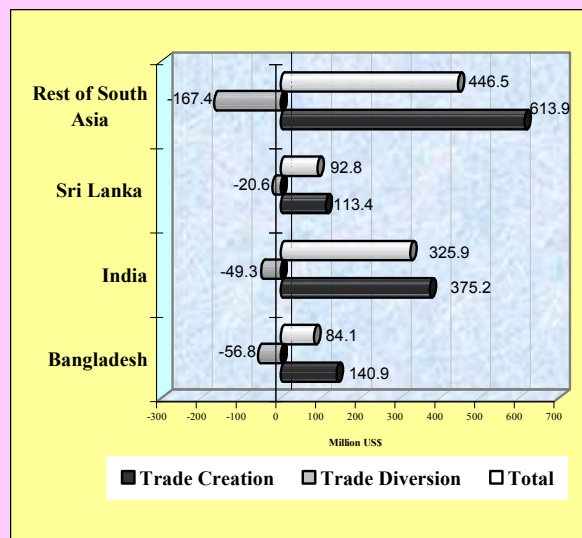
<sup>12</sup> It should, however, be noted that the original GTAP framework does not provide any estimates of trade creation and trade diversion aspects of the total welfare effects. In order to estimate these two effects the authors made some adjustments in the GTAP model. The GTAP model provides a net welfare estimate of the SAFTA simulation which is a sum of the trade creation and trade diversion effects. With a view to isolating the trade creation effect from the total welfare effect a separate simulation was run where necessary adjustments in the GTAP closure were made so that the imports to all the South Asian countries from all over the world (except from the South Asian countries) were held fixed. The welfare effects from this scenario were nothing but the trade creation effects for individual South Asian countries. This trade creation effect was then deducted from the total welfare effect in the original simulation to get the estimate of the trade diversion effect.

**Box 5: Trade Creation and Trade Diversion Effects of SAFTA Simulations**

**SAFTA1 Scenario**



**SAFTA2 Scenario**



SAFTA1 Scenario = Full Tariff removal by the member countries

SAFTA2 Scenario = SAFTA1+ Bangladesh reduces her MFN tariff by 50%

Source: Raihan and Razzaque (2007)

Raihan and Razzaque (2007) also explore the possible reasons for the large trade diversion effects for Bangladesh. From the GTAP simulation results it appears that under SAFTA1, imports from China and other low cost sources (all over the world) would decline while that from India would increase significantly, which indicates, as far as the imports into Bangladesh are concerned, a replacement of low cost import sources by a high cost source (see Box 6). However, two caveats should be kept in mind while qualifying these GTAP simulation results: firstly, the GTAP database does not allow enough dis-aggregation of commodities, and secondly, since the model is a comparative static model, potential new trade (or more precisely the dynamic effects) cannot be captured.

**Box 6: Changes in Imports to Bangladesh from Different Countries under SAFTA1 (in US\$m)**

The high negative trade diversion effect for Bangladesh under SAFTA1 is explained by the fact that imports from India (a relatively high cost import source) increases substantially and imports from all over the world (relatively low cost import source) also declines significantly

|                       | India         | Sri Lanka   | Rest of South Asia | China         | Japan        | Korea         | USA          | EU            | Rest of the World |
|-----------------------|---------------|-------------|--------------------|---------------|--------------|---------------|--------------|---------------|-------------------|
| Agricultural Products | 426.3         | 14.9        | 5.7                | -12.1         | -3.6         | -1.7          | -16.6        | -17.1         | -243.3            |
| Textile               | 279.9         | 3.7         | 291.2              | -96.5         | -5.2         | -38.8         | -2.9         | -4.3          | -111.6            |
| Wearing Apparels      | 13.8          | 1.7         | 8.7                | -0.8          | -0.8         | -0.8          | -1.4         | -3.6          | -6.3              |
| Leather               | 5.0           | 0.0         | 1.4                | -0.2          | 0.0          | -2.0          | 0.0          | -0.3          | -0.9              |
| Chemicals             | 133.0         | 3.4         | 11.0               | -11.6         | -4.3         | -12.9         | -8.0         | -19.4         | -48.5             |
| Machineries           | 114.4         | 2.2         | 6.0                | -17.6         | -16.6        | -6.9          | -6.6         | -32.1         | -31.8             |
| Other Manufacturing   | 517.1         | 8.5         | 22.6               | -28.8         | -60.8        | -59.5         | -16.0        | -53.1         | -162.9            |
| Service               | -0.1          | -0.1        | -0.2               | -0.1          | -0.1         | -0.1          | -1.2         | -1.8          | -2.1              |
| <b>Total</b>          | <b>1489.4</b> | <b>34.3</b> | <b>346.3</b>       | <b>-167.8</b> | <b>-91.4</b> | <b>-122.7</b> | <b>-52.8</b> | <b>-131.6</b> | <b>-607.2</b>     |

*Source: Raihan and Razzaque (2007)*

It appears from the analysis of the studies based on CGE models on SAFTA that most of these studies predict a welfare loss for Bangladesh, which is primarily driven by a large trade diversion effect that dominates over the trade creation effect. The insights, which can be derived from these CGE models, have been very useful since these models take into account the inter-sectoral and inter-regional effects of any regional trading arrangement like SAFTA. However, the major disadvantage with the GTAP model is that the database, it has, is much aggregated in nature. Therefore, it is difficult to identify, at the disaggregated level, the products and the extent to which SAFTA would lead to expansion of exports from Bangladesh to other South Asian countries in general and to India in particular. In addition, being very aggregative in nature, these models, in general, are not capable of capturing RoO aspects in the simulation exercises.

#### **4.2.4. SAFTA and the Expansion of Bangladesh's Exports into Indian Market: A Simulation Exercise using the Partial Equilibrium WITS/SMART Model**

From the Bangladesh perspective, one of the major questions related to SAFTA is whether it would generate substantial exports from Bangladesh to India. In this sub-section, we try to answer this question.

The limitation of the GTAP model in handling dis-aggregated data has already been mentioned. In contrast, a partial equilibrium model, namely the WITS/SMART model, allows analysis at a much disaggregated product level, despite its weakness of ignoring sectoral and regional feedbacks when trade policy instruments are changed either in a given sector or all sectors in a given country. However, given its capacity to allow analysis at high level of dis-aggregation, the partial equilibrium models become indispensable especially where there is interest in establishing sensitive sectors either with regards to industrial or fiscal policies. One special advantage of the WITS/SMART model is that it allows the analysis to be undertaken at the 6-digit level.

Using the WITS/SMART model we simulate the SAFTA scenario (remove all intra-regional tariff for all countries), and our interest is to see what happens to Bangladesh's exports to India. This modelling exercise helps us identify the sectors in which Bangladesh's exports are likely to expand in the Indian market under SAFTA. The simulation results are presented in Table 3. It appears that under SAFTA, Bangladesh's exports to Indian market would rise by an amount of US\$78mn<sup>13</sup>. However, the top 30 products (at the 6 digit HS code), together, account for 83 percent of the increase in export earnings (US\$64.9mn). If products included in the Indian sensitive lists are excluded from tariff reduction, exports increase by US\$64mn.

**Table 3: Exports rise for top 30 products (HS 6-digit) from Bangladesh to India ('000 US\$) under SAFTA**

| HS Tariff  | Description   | Increase in Exports |
|--|---|---------------------|
| 080290   | Other nuts fresh or dried                                     | 5012.20             |
| 150790   | Soy bean oil and fractions                                    | 1878.05             |
| 151620   | Vegetable fats and oils                                       | 2539.79             |
| 220290   | Mineral water   | 908.30              |
| 251710   | Pebbles, gravel or crushed stones                             | 504.48              |
| 252329   | Cement  | 463.48              |
| 281410   | Anhydrous ammonia   | 17039.55            |
| 310420   | Fertiliser (potassium chloride)                               | 566.87              |
| 340111   | Toilet soap   | 814.10              |
| 392690   | Plastic articles  | 3880.31             |
| 410419   | Other tanned or crust hides and skins of bovine               | 576.55              |
| 410449   | Tanned or crust hides and skins of bovine                     | 930.40              |
| 410719   | Leather further prepared after tanning or crusting            | 555.76              |
| 520299   | Cotton waste  | 1234.79             |
| 530310   | Jute textile  | 3314.02             |
| 530710   | Yarn of Jute  | 2742.05             |
| 530720   | Multiple yarn of jute or other textile                        | 923.35              |
| 531010   | Unbleached woven fabrics of jute                              | 1500.70             |
| 560710   | Jute ropes  | 2670.10             |
| 630492   | Other made up of textile (not knitted or crocheted of cotton) | 568.22              |
| 630510   | Jute bags   | 7506.17             |
| 720421   | Ferrous waste of Stainless steel                              | 1121.73             |
| 740400   | Copper waste and scrap  | 704.16              |
| 740811   | Copper wire   | 1296.94             |
| 740819   | Other Copper wire   | 1112.54             |
| 790111   | Unwrought zinc (containing by weight 99.99% zinc or more)     | 765.19              |
| 850680   | Other primary cells and primary batteries                     | 499.31              |
| 850690   | Parts of other primary cells and primary batteries            | 488.07              |
| 850710   | Lead acid electrics   | 1306.81             |
| 850720   | Lead acid electrics   | 1487.20             |
| <b>Total for top 30 products</b>                                 |   | <b>64911.11</b>     |
| <b>Total for all products</b>                                    |   | <b>78130.83</b>     |
| <b>Total excluding the products in the Indian Sensitive list</b> |   | <b>64006.38</b>     |

Source: WITS/SMART simulation results

Note: Products in the shaded rows are included in the Indian Sensitive List for LDCs

<sup>13</sup> It should be noted here that originally the WITS/SMART model simulation results indicate an increase in exports from Bangladesh to India by only US\$24mn. However, the GTAP simulation results for a similar scenario suggest an increase in such exports by US\$78mn. In the current exercise we have considered the GTAP simulation result, and the increase in exports by US\$78mn has been distributed among different sectors in the WITS/SMART model as per their shares in the rise in exports by US\$24mn (the result of the original WITS/SMART model).

An analysis of Table 3 suggests that under SAFTA, Bangladesh may not be able to expand her exports to Indian market substantially. The presence of sensitive lists will further acts as hindrance for export expansion. The WITS/SMART simulation results also suggest that exports of ‘other made up of textiles’ (HS code 630492) from Bangladesh to India would increase only modestly under SAFTA, though Bangladeshi exporters consider India to be a good market for Bangladesh’s RMG. A critical question thus arises whether the model simulation results are correct or the exporters in Bangladesh have some wrong notions about their comparative advantage on RMG exports as far as the Indian market is concerned.

#### **4.2.5. Some Final Observations on the Partial Equilibrium and General Equilibrium Simulation Results**

Despite their limitations both the partial equilibrium and general equilibrium models are useful in assessing the impacts of any RTA on the member countries. If carefully designed, simulation results from these models provide useful insights in analysing the static gains from such PTAs. However, since most of these models are static in nature, they are not capable of capturing the dynamic impacts of such trading arrangements. Also, when trade is restricted (whatever may be the reasons) – both partial equilibrium and general equilibrium models cannot capture the ‘new trade’. Because, if the initial base of trade in any product is very low (or even zero), there would not be any substantial increase (or no increase in the case of zero base) in trade for that particular commodity as far as these model simulation results are concerned. However, as evidences suggest, mutual tariff concessions can lead to trade in new items. In the case of bilateral FTA between India and Sri Lanka, Sri Lanka benefited from exporting *Vanashpati* oil to India (which was almost nil before the FTA) by taking advantage of this preferential trading arrangement..

The aforementioned arguments in no way, however, undermine the usefulness of the partial equilibrium and general equilibrium modelling exercises with respect to RTA analysis. The static gains/losses of any RTA are rather obvious compared to any dynamic gains/losses which are uncertain, and are also dependant on many other ‘uncertain’ factors.

#### **5. Feedback from the Policy Makers and Business People in Bangladesh**

We shared the results of the aforementioned review and simulation exercises with a few key policymakers and representatives of other stakeholders to gather their perception on them.<sup>14</sup> It appears that the policy makers and the business people are aware of these issues, and they, to some extent, agree with many of the concerns raised by a number of empirical studies on SAFTA. However, they have different opinions too.

Discussions with the policymakers and business people in Bangladesh suggest that the benefit that Bangladesh foresees through SAFTA is her substantial market access in India. It has already been mentioned that together with the trade through informal channel, India is by far the biggest source of imports for Bangladesh. However, despite growing huge and sustained trade deficits, India has not yet provided any meaningful trade concessions to Bangladesh. While some insignificant tariff concessions have been offered so far under SAPTA and SAFTA, non-tariff and para-tariff barriers far outweigh the benefits of tariff concessions.

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<sup>14</sup> The people interviewed include, among others, a high official in the Tariff Commission, Ministry of Commerce in Bangladesh and the President of a leading Chamber of Business and Industries in Bangladesh.

Discussions with the policymakers and business people also indicate that there are a number of products which have significant export potentials in the Indian market under SAFTA. These are plastic and melamine products, chemical products, toiletries, copper wire, betel nuts, raw jute, jute products and fertiliser. However, a number of such products, i.e., plastic products, toiletries, betel nuts (included in other nuts: HS 080290) are included in the Indian SAFTA sensitive list, which makes the expansion of exports of these products in the Indian market almost impossible. Bangladeshi exporters also face a number of non-tariff and para-tariff barriers in the Indian market. A list of non-tariff and para-tariff barriers faced by Bangladeshi exporters in Indian market is presented in Table 4.

**Table 4: Non-tariff and Para-tariff Barriers Faced by Bangladeshi Exporters in India**

| <b>NTBs</b>                                     | <b>Description</b>   |
|---|--|
| Classification of Goods                         | Customs authorities in India, in many cases, do not agree with the HS classification declared by exporters. There is a tendency of reclassifying the products in such a manner so that higher duties can be imposed.   |
| Customs Valuation                               | Indian customs authority often does not accept the value declared by Bangladeshi exporters. Arbitrary valuation by of goods makes the products uncompetitive.  |
| Testing Requirements                            | Often each consignment of food products is subjected to certificate from the Port Health Officer. Samples are sent to testing laboratories which are far from the customs stations. Such chemical tests are applicable to leather and leather goods, plastic, and melamine products. For leather goods, NOC from Wildlife Department is also required.   |
| Mandatory Requirement for Labelling and Marking | All pre-packaged products are to carry such information as: name and address of the importers, generic common name of the product, net quantity in standard unit of weights and measures, month and year of packing, maximum retail sales price including all taxes, freight, transport charges, commission payable to dealers.  |
| Special Labelling for Jute Bags                 | Every jute bag carry, 'bag made in -' which must be machine stitched.  |
| Mandatory Standards Requirement                 | Since August 2003 mandatory marking form Bureau of Indian Standards (BIS) is required for import of 159 commodities. These products include, amongst others, cement, steel tubes, stoves, electrical and electronic items, steel products, leather products, helmets, gas cylinder, batteries, and mineral water. Foreign manufactures intending to export these products will have to set up an office in India, with the permission of the Reserve Bank of India.  |
| Sanitary and Phyto-sanitary Measures            | All primary agricultural products are subject to bio-security and sanitary and phyto-sanitary import permits. Determination of eligibility procedure suffers from lack of transparency.  |
| Technical Regulations                           | (1) Import consignment containing textile and textile products shall have to accompany a pre-shipment certificate from a textile testing laboratory accredited to the National Accredited Agency of the country of origin. If such a certificate is not available consignment will be cleared only after testing the same from the notified agencies.<br>(2) All pharmaceutical products must be registered by the Central Drugs Standard Control Organisation headed by the Drugs Controller of India.<br>(3) For jute products a certificate is required from a national testing agency confirming that the content of non-halogenated hydrocarbon (jute batching oil) in the jute bags for packaging purposes shall not exceed three percent by weight. |
| Quarantine Requirement                          | All imports of plants, fruits, and seeds have to obtain an import permit at least one month in advance and all imports shall be subject to inspection by officer in charge of plant quarantine station. Jute and jute products are often subject to such requirement even though they are not living organisms.  |
| Tariff Value                                    | Import of C.I. sheet is subject to a tariff value of US\$590/600, while the price of such product from Bangladesh is not above US\$450.  |
| Countervailing Duty                             | Countervailing duty at a rate of 16 percent is imposed on agro-products, toiletries and cosmetic items.  |

*Source: Based on the information compiled by the Ministry of Commerce.*



The policy makers and business people in Bangladesh are also concerned because it is not clear in the Treaty whether other NTBs will be removed with QRs. The existing Treaty provision is for elimination of only QRs on products included in the trade liberalisation programme (TLP). The Treaty is, however, silent on the removal of para-tariffs and NTBs. Unless these barriers to trade are removed simultaneously with the reduction of tariffs, it will be difficult to exploit the full gains from various phases of tariff reduction, and the objective of preferential tariffs will be defeated. A more serious concern is that in the SAFTA Treaty there is no format for phasing out the negative list over the years. The criteria for designing RoO are not clear either.

It also appears that the Treaty is silent about how SAFTA will integrate the bilateral and multilateral trade arrangements that currently exist between some SAARC countries and between SAARC countries with outside the region. There are concerns that if, for example, the pace of tariff reduction is not accelerated, SAFTA may become irrelevant in light of other agreements. Also, with respect to RoO, there are discrepancies while comparing the SAFTA treaty with the India-Sri Lanka bilateral FTA agreement and also with the BIMSTEC agreement.

A number of suggestions have emerged from the discussions. To minimise its potential adverse effects and maximise its beneficial effects there should be: (i) minimisation of the sectoral/product exceptions, (ii) have 'RoO' that are very liberal, simple, transparent, and remain the same for all products; and (iii) have clear rules against tariff-rate quotas. There should also be regional cooperation in trade facilitation, harmonisation of standards and policies, and infrastructural developments. There could be a Regional Fund for the development of infrastructure, human resources, and improvement of export supply capacity of LDCs.

## **6. The Prospect of Multilateralism with Regionalism for Bangladesh**

As has been mentioned before, the regional market in South Asia has not yet been an important destination for Bangladesh's export products. More than 90 percent of Bangladesh's export products are destined to the North American and EU markets. Therefore, Bangladesh has a vital interest in improving her market access to global markets. While the importance of the larger integrated market of the South Asian countries can hardly be ignored, Bangladesh is also putting serious efforts at the multilateral trade negotiations. Bangladesh's has some offensive interests at the WTO negotiations and these include gaining duty-free quota-free (DFQF) market access of LDCs' products in the developed as well as in the advanced developing countries, and temporary movement of her unskilled labour in the developed countries under GATS's mode IV negotiations. Studies have indicated that Bangladesh is likely to gain significantly if DFQF market access is ensured for her exports in the developed and advanced developing countries.<sup>15</sup> Also, there are importance gains from the migration of unskilled labour as the remittances sent by the migrants contribute much to the eradication of poverty in Bangladesh (Raihan and Khondker, 2007; Annabi *et al.*, 2006).

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<sup>15</sup> Raihan et al (2007) explored, using the GTAP model, different duty-free-quota-free (DFQF) market access scenarios for the products from Bangladesh (as well as from other LDCs) in the economies of developed and advanced developing countries. The simulation results suggested significant gains for Bangladesh in terms of welfare and export rise. The paper called for serious negotiating efforts from Bangladesh at the WTO in order to secure such DFQF market access.

Bangladesh should also try to expand its export outlets outside the region, such as the BIMSTC, D-8, and the IOR-ARC, of which Bangladesh is a member. Bangladesh may also seek to improve its trading relations with the ASEAN. Attempts may also be made to obtain an association status with the ASEAN, which would open enormous opportunities for expanding export to ASEAN countries and also attracting FDI from that region.

### **7. Challenges and policy options for making SAFTA an effective vehicle of trade-led growth for Bangladesh: The Call for a 'SAFTA-Plus' Agreement**

The existing SAFTA Treaty is predominantly centred on 'trade in goods'. Though the strategies suggested in the foregoing sections would be expected to stimulate intra-regional trade in South Asia, it is presumed that Bangladesh cannot hope for too much gain from the existing Treaty to enhance its growth opportunities merely by promoting exports to the regional market. Bangladesh's exports to the South Asian region are very small, and a doubling, trebling, or even a quadrupling of its intra-regional exports will not lead to any significant expansion of its total exports. Therefore, in addition to the promotion of trade a number of areas need to be addressed for making the regional economic cooperation in South Asia an effective vehicle for promoting economic growth in the Member countries in general and in Bangladesh in particular. For that purpose, SAFTA Treaty should go beyond the mere Agreement in 'trade in goods', and there is a need for some kind of 'SAFTA-Plus' agreement which will include regional co-operation mechanism in the areas of investment, finance, services trade, trade facilitation and technology transfer..

The proposed 'SAFTA-Plus' agreement should call for creating an enabling environment to promote intra-regional investment. The creation of a SAARC Investment Area through an intra-SAARC investment agreement could create such an environment (SACEPS, 2002; RIS, 2002). As an example, the trade-investment nexus has come into effective operation in India-Sri Lanka bilateral FTA and the large trade deficits between these two countries have been compensated by the capital account through significant investment flows (RIS, 2004). In the context of investment flows, horizontal and vertical integration of industries of South Asia becomes important to face the global competitive pressures. Even though a multitude of literature is available on these crucial issues, the existing agreement has completely overlooked these areas and solely focused on trade facilitating measures in Article 8.

The 'SAFTA-Plus' Agreement will also enhance Bangladesh's prospects for getting larger investment inflows from the more developed partner countries in the region. These investments, whether 100 percent ownership by regional investors or joint ventures, should help improve the country's export supply capability and boost exports both to the region and to the outside world. It is obvious that without significant structural changes in her production pattern Bangladesh is unlikely to be able to derive the desired benefits from SAFTA. Top priority, therefore, should be given to augmenting Bangladesh's export supply capability.

A major limitation of the existing Treaty is that it leaves out trade in services. A number of empirical literatures have shown that the trade in services can generate substantial gains as against the gains from trade in goods. Considering the sensitivity of this issue, the GEP report (1998) did not recommend the liberalisation of trade in services. But it suggested regularisation of the informal labour movement on the basis of regional norms and mechanisms and evolving rules and procedures to make things easier for the service

providers and consumers in the social sector, particularly health and education. The ‘SAFTA-Plus’ Agreement should assign much importance on promoting services trade in the region.

## **8. Conclusion**

This paper has examined the implications of SAFTA for the economy of Bangladesh. In doing so it has reviewed Bangladesh’s bilateral trade with her neighbouring countries. The paper has also examined the S&DT provision for LDCs under SAFTA. The paper reviewed a number of studies which conducted qualitative and quantitative assessments of SAFTA and its implications on the Bangladesh economy. It appears that there are conflicting arguments on the success of SAFTA as well as on whether Bangladesh would stand to gain from SAFTA. The debate appears to be far from conclusive. However, rigorous economic analysis suggests that Bangladesh may not be able to gain much within the existing ‘trade in goods’ based agreement. The possibility of a large trade diversion for Bangladesh under the full implementation of existing SAFTA Agreement, is high.

However, it is also important to note that trade diversion for Bangladesh and possibly for other LDCs under SAFTA is inevitable. Bangladesh will have to raise the export share into the regional market substantially in order to gain through positive terms of trade effect. Export diversification in this regard is very important. Technical assistance to Bangladesh to diversify her export basket can be a vital agenda. It should also be noted that the S&DT for the LDCs under SAFTA are not sufficient, especially maintaining the sensitive list for some of the critical products produced by India will not help Bangladesh to increase her export share. The paper also calls for a ‘SAFTA-Plus’ Agreement by highlighting the importance of some additional measures like the agreements in intra-regional investment, finance, and trade in services.

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