

ISAS Background Brief

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The South Asian Trade Labyrinth & India's Regional Trade Policies

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Introduction

The process of regional integration has gone hand in hand with multilateralism for several decades. Following the collapse of the Soviet Union and the end of the bipolar cold-war world, the process of regionalism intensified. The EC single market, NAFTA, AFTA and MERCOSUR are evident instances of this process.²

This process has gained momentum in the last couple of years, especially after the failure of the WTO negotiations at Cancun in September 2003. Former United States Trade Representative (USTR) Robert Zolleick launched his series of bilateral agreements under the aegis of what he referred to as “competitive liberalization”, while there was a proliferation of bilateral and plurilateral agreements in Asia.

India has been no exception. While it has officially claimed to support the cause of developing countries at the WTO, its trade strategy has also included building links with regional bodies like the ASEAN, AFTA and IOR-ARC³. In the Indian subcontinent, India has signed the framework agreement for the South Asian Free Trade Agreement (SAFTA) which will enter into force on January 1, 2006.

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² North America Free Trade Agreement (NAFTA), ASEAN Free Trade Agreement (AFTA), Common Market of the South (MERCOSUR).

³ Association of Southeast Nations (ASEAN), Indian Ocean Rim Association for Regional Cooperation (IOR-ARC).

However, the process of regional trade integration has been extremely sluggish in South Asia. India being the leader by default is in good part responsible. The sluggishness of the South Asian regional integration process contrasts with the much greater interest New Delhi has shown in seeking deeper integration with the larger East Asian region. India is now following its “look east” policy in earnest.

If we take a close look at India’s decisions to join regional forums and form bilateral agreements, we will see that, as it is often the case with PTAs (Preferential Trading Agreements) – they are as much, if not more, influenced by strategic and geopolitical motives, rather than by trade alone. India’s trade integration with South Asia has been that of cautious liberalization, and its role in the whole process, as well as the complexities and the future, merit close analysis.

Why Regional Integration in South Asia?

South Asia accounts for 22 percent of the world’s population, 2 percent of the world’s GNP, and is home to about 40 percent of the world’s poor⁴. However, the region’s seven countries contribute only about 1 percent to world trade⁵. Combining this low level of economic development with political and ethnic disparities makes this region economically and politically very sensitive.

These ethnic, geopolitical and economic disparities were the very reasons that the then Bangladesh President Zia took the initiative to establish a regional cooperation forum in South Asia in the early 1980s. This decision was, to a certain extent, also influenced by the formation of ASEAN and enabled the states of South Asia to consider and react collectively to international events. The Soviet attack on Afghanistan and the US’ direct military links with Pakistan to counter the Soviet Union hastened the pace of formation of this regional bloc.

Initially, India and Pakistan did not take easily to the idea. While India thought that it was an attempt by the smaller nations to gang up against India and put collective pressure on it

⁴ Bandara S.Jayatilleke & Yu Wunsheng, How Desirable is the South Asian Free Trade Area?: A Quantitative Assessment, May 30, 2001.

⁵ The South Asian region includes Bangladesh, India, Pakistan, Sri Lanka, Nepal, Bhutan and Maldives.

regarding matters that affect them. Pakistan thought that it would deepen the hegemonic powers of India and hamper Pakistan's integration with West Asia. Nevertheless, in spite of these misgivings, the South Asian Association for Regional Cooperation (SAARC) came into force in 1985 to promote political stability and deal with external developments.

While the basis for the formation of SAARC was to promote peace, harmony and political stability, the countries realized that deeper and stronger economic links were required to overcome the political differences and to boost intra-regional trade. As a result, the South Asian Preferential Trade Agreement (SAPTA) came into existence in 1995 to promote economic integration. One of the core principles of the SAPTA agreement is to provide special treatment for LDCs like Nepal, Bhutan, Bangladesh and Maldives. The alleged intention was to enable smaller and least developed countries to benefit equitably from economic liberalization.

All the same, over the years, the level of intra-regional trade has been extremely low in South Asia, hovering around 5 percent of total trade, as compared to above 60 percent in the EU and 38 percent in ASEAN. The reasons for this include the following:-

1. Lack of trade complementarity: most of the South Asian countries have expertise in the production and export of the same primary products in agriculture, as well as in textile and clothing, and other labour intensive goods. For instance, both India and Sri Lanka export tea and compete to secure overseas markets.
2. Prevalence of informal trade: high tariff and non-tariff barriers coupled with weak transportation links are responsible for the informal/unaccounted trade that takes place between South Asian countries⁶. The cost and time of transportation along with security issues hamper cross-border trade. In order to export from India, an exporter needs to obtain 258 signatures and make 118 copies of the same information, key punching of which takes 22 hours. Likewise all Nepalese export/import is routed

⁶ For instance, India's informal trade with Sri Lanka was \$207.3 million in 2000-01.

through the port of Kolkata in India, and the absence of a direct rail link between Kolkata and Nepal has been a major impediment to trade.⁷

3. Political tensions: The region is bedevilled by intra-state conflicts and border disputes – notably the intractable dispute between India and Pakistan over Kashmir – which goes to show that politics dominate economics in this region. This is in contrast with Southeast Asia, which has largely succeeded in transforming its region from a battlefield to a market-place. These political tensions have also led to the rerouting of trading between the SAARC nations. Of the US\$2 billion informal trade with Pakistan, almost half was traded through third countries like Afghanistan and Dubai⁸.

SAPTA was envisaged primarily as the initial step towards the transition to a South Asian Free Trade Agreement (SAFTA), subsequently leading to a custom union.

India's Journey to Regional Integration

India has treaded the path of liberalization and integration with the South Asian economies very cautiously, which is reflected in its low level of openness. This outlook of India is not restricted to South Asia itself but is manifested in almost all the relationships that India has built whether bilaterally or regionally. This is because for India, trade is not the only criterion for forging an alliance; strategic and political motives are also involved.

The trade policies of India bear the imprint of past history, notably the three and a half decades following independence in 1947. Post-independence concerns over external exploitation resulted in the Nehru government adopting an import substitution, a quasi-autarkic model of development. This resulted in the Indian economy being closed to imports and Indian exports being kept away from the world markets for several decades. However, the serious foreign-exchange crisis in 1990 led to a number of economic reforms in the early 1990s dealing with trade, industrial licensing, and privatization⁹. The Indian government also

⁷ Banerjee Pritam & Sengupta Dipankar, Economic growth, Exports and Issue of Trade Facilitation; An Indian Perspective, Trade Facilitation: Reducing the Transaction Costs or Burdening the Poor, CUTS International, December 2004.

⁸ Taneja Nisha, Informal and Free Trade Agreements, South Asian Journal, April-June 2004.

⁹ According to the WTO Trade Policy Review (TPR,2002), the 1990 reforms resulted in a drastic decrease in peak as well as average tariff rates. Peak tariff rates decreased from 400 percent in 1990 to 50 percent in 1996, while the average tariff reduced from 80 percent in 1991 to 40 percent in 1996.

realized that in order to foster competition and alleviate poverty, it had to be a part of the global system and not sustain its alienated position.¹⁰

As far as intra-SAARC trade is concerned, India has been a forerunner in terms of exports but its share of imports has been low. This is a reflection of its high tariff and non-tariff barriers and protectionist policies as compared to open nations like Sri Lanka.¹¹

Even though India has opened its economy since 1991 and applied tariffs have come down, India's commitment to the WTO (according to the TPR, 2002) suggests that the final average bound tariff in 2005 would be around 50.6 percent, with an average of 37.7 percent in non-agricultural products and 115.7 percent in agricultural products.

Being the largest economy in this regional bloc in terms of GDP, population, area and foreign trade, India affects the functioning of this group in a very big way. For the past decade or more, India has accounted for 80 percent of the region's exports while its imports have been as low as 6 percent in 2001. Besides being the leader by default, India is also important because it is the only country in the region that has the necessary expertise, experience and technology to set up joint ventures.

Political and geopolitical factors have played a very important role in shaping the trade relations of India with its neighbors. The dispute with Pakistan over Kashmir and cross border terrorism, the issue of water sharing with Bangladesh, and the problem of illegal migrants from Nepal, have all aggravated the situation. India and Pakistan have already fought three wars over Kashmir. Trade between India and Pakistan is negligible and, as we have seen, often routed through third countries because of weak trade relations due to political disagreements. Over the decades the relationship between these two neighbors has been very erratic – spurts of activity interspersed with long periods of stalemate. Cross border

¹⁰ India's contribution to world trade was more than 2 percent at the time of independence but dwindled to about half-a-percent by the early 1990s. At the multilateral level also, India has followed a policy of unilateralism which stems from its historic past and from the socio-economic duties and obligations it has for the 260 million people living below the poverty line.

¹¹ India's trade as a percentage of GDP in 2001 was 19.5 as compared to 67.5 for Sri Lanka and 39.5 for Nepal.

terrorism has resulted in relations being strained. In 2001, all transport means were stopped by India after an attack on the Indian parliament by terrorists.¹²

The spring of 2005 has again seen some semblance of optimism between the two neighbors, with the visit of the Pakistani President to India in April. While both the countries could not reach a consensus regarding the Line of Control (LoC), they took measures to boost trade and economic cooperation by agreeing to form a Joint Business Council (JBC). Communication links between both countries have also been resumed by India in order to bridge the cultural gap and bring divided families together.

A détente between India and Pakistan would lead to economic benefits to the broader region in Asia. Pakistan has agreed to consider a gas pipeline between India and Iran, which will transit through Pakistan¹³. The economic spillover of this détente is also manifested in the smooth functioning of the completion of the Asian highway¹⁴, which will facilitate trade among these countries.

Lack of transport links and cumbersome custom procedures have also been responsible for slowing down trade between India and its neighbors. This situation, again, is a result of political differences and the protectionist policies of India, whereby it wants to protect its market from cheap imports. For instance, Nepal, a landlocked state, depends on India for trade with the outside world. All goods have to transit through Kolkata in India. The two countries have signed successive trade and transit agreements, but disruptions have occurred and the transit points have been restricted by India. Nepal even brought up the issue at the UN, but later withdrew the case. India thus needs to be sensitive to the needs of its smaller neighbors and find a common ground¹⁵.

India has signed bilateral trade agreements with Nepal, Bhutan and Sri Lanka which might be seen as an attempt to fill the gaps of regional integration. It is also a member of regional

¹² In a recent report by the National Counterterrorism Centre, USA, 651 serious international attacks took place in 2003, half of which were in South Asia, including on Kashmir.

¹³ India's petroleum minister Mr. Mani Shankar Aiyar will be visiting Pakistan in May 2005 to discuss the India-Iran pipeline and bilateral cooperation in the hydrocarbon sector.

¹⁴ In April 2003, 23 countries signed an agreement to complete a massive Asian highway that will pass through a number of Asian countries like China, North and South Korea, India, Pakistan, Vietnam and Cambodia, among others.

¹⁵ The problem of Maoists in Nepal, the current political upheaval and the influence of China are important concerns for India. Nepal is bordered by India and China.

groupings such as BIMSTEC¹⁶ and IOR-ARC which give India access to Thailand and Malaysia. India along with all the other members of BIMSTEC has signed the framework agreement for the BIMSTEC Free Trade Area in February 2004, with the objective to enhance and strengthen economic, trade and investment cooperation.

India also nurses the ambition of integrating with the larger Asian region and has been actively pursuing the Southeast and East Asian countries. These countries on their side have begun to realize the potential that India has as a market and a political ally. The recent visits of the Chinese Premier and the Japanese Prime Minister substantiate this outlook. There have been talks of an Indo-Japan FTA which will double the existing trade between the two nations¹⁷. China on its part has made a wise strategic move by recognizing Sikkim as a part of India. India is also in the process of signing a Comprehensive Economic Cooperation Agreement (CECA) with Singapore to improve bilateral trade and the movement of natural persons.

In fact the ASEAN+3¹⁸ countries have emerged as one of the major trading partners of India accounting for 19.7 percent of its merchandise trade. The signing of the ASEAN-India Framework Agreement on Comprehensive Economic Cooperation is consistent with the country's "look east" policy and is likely to facilitate trade with this region.

The Road Ahead for the South Asian Giant

It is evident that India has its goals set high and is looking beyond the Indian subcontinent. Nevertheless, its commitment and relationship with the South Asian region will continue. India has benefited from trade in the South Asian region and its exports have shown a continuous increase. However, the same cannot be said for imports¹⁹. India has erected high tariff and non-tariff barriers to imports which make it difficult for smaller countries like Maldives, Nepal and Sri Lanka to gain access to Indian markets.²⁰

¹⁶ Bangladesh, India, Myanmar, Sri Lanka, Thailand economic cooperation (BIMSTEC).

¹⁷ At present, trade flows between Japan and India amount to approximately \$5 billion.

¹⁸ ASEAN plus China, Japan and Korea, form ASEAN+3.

¹⁹ India's exports to the South Asian countries increased by 52.4 percent in 2003-04, while the imports increased by 14.0 percent in the same period.

²⁰ One reason for the high import duties is because these duties are a source of revenue for the government and contribute to more than 40 percent of the net tax revenue of the government. For more information, see www.lancs.ac.uk/people/ecavnb/india.doc;%20trade%20policy%20review.doc.

India needs to be more accommodating and develop open policies towards its neighbors and should formulate regional trade policies that facilitate the huge volume of informal trade. Trade can only increase if the movement of goods is made easier across borders. Tariffs will automatically go down with the enforcement of SAFTA in 2006 and hopefully this will act as a major catalyst to boost trade.

The government also needs to look into the building and maintenance of infrastructure as trade flows increase. A good banking system, proper network of roads and custom reforms are essential for the smooth flow of goods and services.

Intra-SAARC trade would also improve if India is granted the Most Favoured Nation (MFN) status by Pakistan as well as transit access from Pakistan to Afghanistan²¹. The setting up of a JBC should definitely look into these matters and come up with concrete and feasible solutions. Besides political differences, trade relations are also suffering because of the rigidity on both sides. At the multilateral level, rather than just the bilateral, India and Pakistan need to continue to work hand in hand at G-20 to further the cause of developing countries.

India also needs to be cautious, to ensure that the bilaterals that it is signing with its neighbors do not overlap with the benefits and motives of the regional group. Being the leader of the region, it has to promote a balanced growth and encourage exports from smaller less developed countries.

Whether India liberalizes preferentially or unilaterally, it stands to gain because of its dominance of the market in the region. India's trading partners outside the region, like NAFTA and the EU, will also gain substantially if India liberalizes unilaterally. However, all the regions outside South Asia lose if there is preferential trade liberalization due to diverted trade. There is no denying the fact that India has been working on opening its economy and Quantitative Restrictions (QRs) and average tariffs have come down. Even so India's applied tariff rates in both agriculture (36.9 percent) and non-agriculture sector (27.7 percent) remain

²¹ As a part of SAARC, Pakistan expects transit permit through India to get to Bangladesh but denies the same to India since Afghanistan is not a part of SAARC.

much higher than those of other emerging economies like Malaysia (2.1 and 8.1 percent respectively) and Indonesia (8.2 and 6.7 percent respectively)²².

Therefore, India needs to work out the plan for trade liberalization, as far as South Asian countries are concerned, whereby it can reduce tariffs for particular sectors or products where the other country has comparative advantage. For example, India can import jute from Bangladesh because of lower costs, rather than competing with it. This way, India can promote trade in the region by giving some leeway to the less developed and smaller countries, which have a much larger share of trade in their GDP as compared to India.

Importantly, because of the political and economic differences, it is essential for each country to focus on the liberalization of its trade rather than waiting for the SAFTA to work.

It has been 20 years since the SAARC came into being. Despite all the difficulties and roadblocks it has survived and moved on, albeit at a sluggish pace. However, it is time to use trade as an engine to bring about economic growth and development in this region, and India's role in regional trade is well-defined. If economic and political integration is to be achieved in the region, the South Asian nations need to get their act together and learn to "love and respect thy neighbour".

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²² As per the World Trade Report 2004.