The bilateral trade agreements and export performance of South Asian nations with special reference to India Sri Lanka Free Trade Agreement

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The regional trade agreements (RTA) have been one of the important developments in the world trading system in 1990s. There are number of studies on the effects trade agreements in different contexts. This study is an attempt to analyse the effects of bilateral trade agreements in the intraregional trade in the SAARC region with special reference to the Free Trade Agreements (FTA) between India Sri Lanka. The study uses a panel regression analysis by using balance panel data. The study concludes that the FTA between India and Sri Lanka has brought positive results in the trade between these two nations by improving the bilateral trade in goods. The results of the study are important in the context of looking for the prospects of a free trade area in the region by member nations.

Key words: Regional trade agreements, SAARC, regression, panel data, intra regional trade.
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Introduction

One of the most striking development in the world trading system since the mid-1990s is a surge in the regional trade agreements. From about 50 till 1990, the number of RTAs notified to the World Trade Organization (WTO) has crossed 250 in 2003, and according to the latest data (till March 15, 2008) of the WTO, more than 300 RTAs have been notified to WTO. Among these RTAs, more than 200 are currently active. The World Bank (2005) estimates show that about 40 per cent of the total global trade is done among the regional trading partners.

In the beginning the trade agreements were formed among developed countries and then the agreements between developed and developing nations started. It is notable that the surge in RTA is largely driven by advanced countries. Traditionally the advanced nations have always been big markets for exports from developing countries and the prospect of preferential access to such markets has induced many developing countries to seek preferential or free trade agreements with developed countries (Pal 2008).

The effects of trade agreements among developing and developed countries are mostly in favour of developed countries. The developing countries had to compromise so many policy options as a consequence of these agreements. They are not able to reap of neither the benefit market access nor other benefits. In this context the agreements among the emerging countries has become more relevant in the recent time. With growing income in the emerging world may provide the significant markets for other developing countries. The developing countries have diverse export basket to generate sufficient trade among them. Therefore the trade agreements among emerging nations are supposed to reap these benefits.

Prospects of Intra-regional trade in the SAARC region

Asian countries have followed multi-literalism rather regionalism faithfully. In south Asia, while the South Asian

Preferential Trading Arrangement (SAPTA) has been there for some time, the emphasis was on broader issues of regional cooperation rather than concrete measures of trade liberalisation. The stance has now changed. Regional economic integration in the geographical, social, historical and culturally contiguous south Asia is being pursued seriously. The South Asian Free Trade Area (SAFTA) agreement was implemented in July 2006. In this article, South Asia is defined as the seven, South Asian Association for Regional Cooperation (SAARC) member nations comprising Bangladesh, Bhutan, India, Nepal, Pakistan, Sri Lanka and the Maldives. The economic profile of the region is presented in the Table 1.

Table 1

South Asia – Comparative Perspective

Region	Population (Mn)	GNI ($bn)	GNI(PPP)	GNI Per capita ($)	GDP Growth (%) 2002-03
East Asia	1855	1988.2	8542	1070	8.1
Europe and central Asia	472	1216.5	3555	2580	5.8
Latin America	533	1747.4	3801	3280	1.6
West Asia and north Africa	312	744.2	1826	2390	5.7
South Asia	1425	733.2	3761	510	7.5
Sub-Saharan Africa	705	351	1236	500	3.9

Source: World Development Indicators, World Bank 2005

It is evident that South Asia compares reasonably well with other regions in terms of GNI purchasing power parity (PPP) and per cent rate of growth over 2002-03. South Asia has the third largest GNI in PPP terms after East Asia and Latin America and has registered the second highest growth rate next only to East Asia.

Given its growing economic strength, south Asia has the potential to form a regional economic grouping. Intra-regional trade in south Asia has however been very low. As a percentage of total trade volume intra-regional trade has remained around 2 per cent since 1980. Among all regions, south Asia is the least integrated when measured as a share of GDP. Intra-regional trade in south Asia is only 0.8 per cent of GDP, a fraction of east Asia's – nearly 27 per cent of GDP – and is in fact even below that for sub-Saharan Africa. But there are some counter arguments for this which of course should be taken with some caution. Official trade figures understate the extent of intra-regional trade in south Asia. Several studies point to the considerable amount of "informal" trade taking place in the region not only to evade high tariffs prevalent in the region but also to carry out some trade that would not have been permitted at all. Pitigala (2005) reports that once the informal trade is added, intra-regional trade of Bangladesh jumps from 17.7 to 21.8 per cent in 1995 and for Sri Lanka in the same year the increase is from 11.4 to 14.4 per cent.

The success of a regional bloc is also very often considered to be positively related to the diversity in the structure of comparative advantage of member nations. Several earlier studies have analysed the nature and extent of revealed comparative advantage of the south Asian economies. Most of these studies are suggestive of a similarity in the pattern of comparative advantage and export interests across south Asian countries. However, in comparison with other south Asian countries, the range of products over which India has comparative advantage is somewhat broad. According to a Kemal et al (2000) study for the period 1985-95, India has reasonable potential to meet the import needs of countries in the south Asian region. India can export a variety of products ranging from various food items to machinery and transport equipment to other countries in south Asia. The degree of trade complementarities has increased for Bangladesh and India. A reasonable compatibility is also indicated between the trade structures of Sri Lanka and India. Interestingly, relative to other countries in the region, complementarities between India and Pakistan are higher.

Batra and Khan (2005), show that India has comparative advantage in 41 out of 97 sectors of the HS-2 classification. On analysing the correspondence between the structure of revealed comparative advantage for India and imports of the other SAARC member nations, it is evident that India can meet the import demand for the region. There are ample examples to support this – Pakistan imports cereals, milling products, malts, starches, sugars and confectionary, textiles – all commodity groups where India has a high revealed comparative advantage in the global market and Pakistan high imports. However, none of these products are currently being sourced from India.

Gains from regional economic integration are possible through intra-industry trade. Scope for vertical integration of different stages of production among south Asian nations exists in sectors like textiles, leather goods, light engineering, rubber products, automobiles and exploitation of bio-resources. The proportion of intra-industry trade in total trade is however low (Kemal et al 2000). The exception is India-Nepal intra-industry trade that is about 14 per cent of their bilateral trade.

There is potential for efficiency seeking restructuring in south Asia. Illustrative examples of this potential for restructuring in south Asia are available. A recent study by Das (2004) shows how the free trade regime under the India-Nepal bilateral free trade arrangement has facilitated the restructuring of production by certain companies that have shifted production base to Nepal to serve the north Indian market as also for third country exports. Among others, examples include Dabur, India setting up its production unit for fruit juices in Nepal. Evidence towards efficiency seeking restructuring is also evident from the India-Sri Lanka FTA. These include Ceat India, production of automotive tyres in Sri Lanka for the markets in south Asia and beyond. While these cases are an outcome of India's bilateral agreements, they help reveal how an FTA with a liberalised investment regime can induce a spate of efficiency seeking industrial restructuring through intra-south Asian foreign direct investment (FDI) flows. Potential for such flows exists in both the textiles and clothing sector. From these perspectives it is important to analyse whether the Free Trade Agreement (FTA) between India and Sri Lanka has any impact on the export performance of these two nations.

India-Sri Lanka Free Trade Agreement (FTA)

The Commerce Secretary of India and Finance Secretary of Sri Lanka exchanged letters that operationalise the Indo-Lanka Free Trade Agreement (ILFTA) between India and Sri Lanka signed in New Delhi on 28 December 1998 by H.E. the President of Sri Lanka and the Honourable Prime Minister of India with effect from 1st March 2000. The Agreement provides for duty free as well as duty preference access for the goods manufactured in the two countries. Both the countries have listed products for immediate duty free entry into each other's territories. India has agreed to phase out its tariffs on a large number of items within a period of three years. Sri Lanka will likewise do so in eight years. Both the countries have drawn up Negative Lists in respect of which no duty concessions will apply. These Lists include items on which protection to local industry has been considered essential. India has retained less than 400 items in its Negative List. These mainly include garments, petro-chemicals, alcoholic spirits and coconuts and coconut oil. Sri Lanka has around 1200 items in its Negative List. Items in the Negative List do not enjoy tariff concessions. Both the countries intend to reduce the items in the Negative List through periodic consultations.

The Agreement sets out the rules of origin criteria for eligibility for preferential access. Products having domestic value addition of 35% will qualify for preferential market access. Sri Lanka's exports with a domestic value addition content of 25% will also qualify for entry to the Indian market if they have a minimum 10% Indian content.

In respect of a number of sensitive items preferential treatment is accorded with only partial lifting of quantitative restrictions. India will permit the import of Sri Lankan tea to the extent of 15 million kg. per annum at a fixed tariff preference of 50%. Under the initial terms of the Agreement India would permit import of 8 million pieces per annum from Sri Lanka at a fixed tariff preference of 50%. Out of this, 6 million pieces fabric need to be sourced from India. A ceiling of 1.5 million pieces was prescribed for individual categories. In respect of textile items, India's offer is restricted to a maximum of 25%. The agreement was renegotiated following the Commerce Secretary level talks and Joint Ministerial Committee meeting in June 2002 in New Delhi followed by the senior officials' meeting in Colombo in July 2002.

Literature review

Cheng and Tsai (2005) studied the effects of different Regional Economic Integrations including the European Economic Community (EEC), European Free Trade Agreement (EFTA), European Union (EU), Canada-US Free Trade Agreement (CUSFTA), North American FTA (NAFTA), Latin American FTA (LAFTA), and the South American Common Market (MERCUSOR) by using panel data analysis. They have used the data from for the period of 1981 to 1997 comprised of 44 exporting nations and 57 importing countries. The analysis is done by using panel regression model.

In the study the export demand equation has been estimated as a function of GDP of the trading nations, Population of the trading nations, Price of exports, Dummy variables for cultural and language similarities and the dummy for the regional economic integration. The study found out that the regional economic integration has resulted in significant effects on the intra and inter regional trade of those countries in the study period. There are some agreements with positive effects like EFTA, NAFTA and some agreements with negative effects like EEC2 EECM etc.

Sova et al (2008) studied the effect of free trade agreement between European Union (EU 15) and the Central Eastern European countries (CEEC4). The results of the study indicate a positive and significant impact of FTAs on trade flows among these nations. This finding is robust to the inclusion in the sample of a group of control countries (specifically Belarus, the Russian Federation and Ukraine) that did not sign an FTA. Besides, the paper shows that trade growth after the FTA agreement with the EU was signed exceeded trade growth of the control group of countries which did not become members.

Pal (2008) studied the result of regional trade agreements and the improved market access in developed countries. The study focused on the agreements between developed and developing countries. Through studying the effects of agreements like NAFTA the author opined that the effects of trade agreements between the advanced and emerging nations are more in favour of advanced nations. Apart from this the study pointed out that by signing agreements with advanced nations emerging nations have to compromise several trade and commerce related policies. This curbs the freedom of the emerging nations to formulate trade commercial policies independently. In this context the paper analyses the prospects of trade agreements among emerging nations and concludes that there is enough potential for the improvements in trade performance of emerging nations by getting into bilateral multilateral trade agreements among emerging nations.

Banik (2006) studied the prospects of the Bay of Bengal Initiative for Multi-sectoral Technical and Economic Cooperation (BIMSTEC) economies are ready to form a free trade area. The study observes that the BIMSTEC region has many characteristics that would be desirable to form a FTA. They focused their analysis on the basis of few criteria such as price, income, economic and geographical characteristics, and trade, as an indication for forming a FTA. In general, the author found there are favourable indications for the BIMSTEC economies to flourish into a successful RTA. Forming a FTA would be expected to create relative advantage for the member countries. Greater economic cooperation among BIMSTEC member nations has important implications in the form of larger market economies of scale in production, and improved resource allocation.

There are so many trade agreements among Asian countries. South Asia also has sufficient number of bilateral trade agreements between different countries. But most of the literature on the effects of trade agreements is done in developed countries especially in US and European contexts. There is a need for the empirical analysis of the effects and prospects of trade agreements among Asian countries especially in SAARC region.

Objectives of the study

This study tries to analyse the effects of bilateral trade agreements in the intraregional trade in South Asia especially among SAARC nations comprising of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The paper investigates the effects of the free trade agreement between India and Sri Lanka on the export performance of both the countries and infers potential for improvement in trade through regional economic integration. India and Sri Lanka signed the Free Trade Agreement (FTA) in December 1998. The specific objectives of the study can be described as:

Study the effects of India Sri Lanka free trade agreements on the exports of India and Sri Lanka

India has trade agreements with Nepal, Bangladesh etc. but they are of recent origin and data is available only for two three years and that is why this study restricted only with the India Sri Lanka agreement.

Hypothesis

H_0: The free trade agreement between India and Sri Lanka has no effects on the exports performance of India and Sri Lanka.
H_1: The free trade agreement between India and Sri Lanka has positive effects on the exports performance of India and Sri Lanka.

Methodology

A multiple regression model has been used for the analysis. The analysis has been done by estimating the export demand functions for India and Sri Lanka through panel data analysis. The study used the balanced panel data. The export demand is defined as function of the Gross Domestic Product (GDP) of the trading nations, Population of the trading nations, export price or exchange rate of the country (India/Sri Lanka) and the dummy variable for the effect of Indo-Lanka FTA. The export demand functions for India and Sri Lanka have been estimated separately to study the effect of Indo-Lanka FTA on the export of both the countries respectively. The specification of the model is:

$$\ln X_{ijt} = b_0 + b_1 \ln Y_{jt} + b_2 \ln N_{jt} + b_3 \ln P_t + b_4 DTA + u_{it}$$

Variables

X_{ijt} is the exports of India or Sri Lanka (in respective equations) to j^{th} country at t time period
Y_{jt} is the GDP of the j^{th} country at t time period
N_{jt} is the population of the j^{th} country at t time period
R is the price of exports of India and Sri Lanka, and
DTA is the dummy variable for the Free trade agreements between India and Sri Lanka. The dummy variable will be given the value of 1 for Sri Lanka in case of India's export and for India in case of Sri Lanka's exports.
Data
The annual export of India to other six SAARC (Bangladesh, Bhutan, Maldives, Nepal, Pakistan and Sri Lanka) nations has been collected

for the period of 1999-2007. Likewise the GDP, population, import price for the same period have also been collected. But in case of Sri Lanka the data pertaining to Bhutan is not available. Therefore in the estimation Lankan export demand equation the data pertaining to other five nations have been used. The data pertaining to all the variables have been collected from the CD-Rom of The International Financial Statistics (IFS)-2010 published by the International Monetary Fund (IMF).

Empirical results

Export demand equation of India

R^2: 0.76 (0.72-Adjusted)

SE: 0.9767

F: 19.52 (Probability: 0.000)

Details about variables and coefficients are given in Table 2

Table 2

Regression coefficients export demand equation of India

Variable	Coefficient	Probability
GDP	1.132*	0.016
Population	1.602**	0.019
Price	-0.397	0.920
DTA	2.835**	0.006

**Significant at 1% level, * Significant at 5% level

Export demand equation of Sri Lanka

R^2: 0.76 (0.71-Adjusted)

SE: 0.9234

F: 16.04 (Probability: 0.000)

Details about variables and coefficients are given in Table 3

Table 3

Regression coefficients export demand equation of Srilanka

Variable	Coefficient	Probability
GDP	5.51**	0.000
Population	5.48**	0.000
Price	8.479	0.119
DTA	2.016**	0.002

**Significant at 1% level

Note: The star on the coefficient shows significance at 1% level. The R2, adjusted R2 and the F-Statistics show the goodness of fit and the overall significance of the model. In both the equation 76% the variation in the dependant variables have been explained the by model. Among the variables the export price is not significant in the export demand equation of both India and Sri Lanka.

Discussion and conclusions

In the variables GDP and population have positive and significant coefficients as expected. The price is not significant in both the equations. That means price is not significant determinant of the export of India and Sri Lanka. In the export demand equation of both India and Sri Lanka coefficient of the dummy variable pertaining to the Free Trade Agreement between India and Sri Lanka, is positive and significant for India as well as Sri Lanka. That indicates the bilateral trade agreements between India and Sri Lanka has brought positive effects on the export performance of the country.

The trend in the bilateral trade after the agreements supports this result. India's export to Sri Lanka grew from US $ 636 Million in 1999 to US $ 2916 Million in 2008 with a percentage of 458%. Whereas, Sri Lanka's export to India registered a 500% growth in the period from 1999 to 2003. It increased from US $ 48.62Million to US $ 245.05Million in absolute terms. Bilateral trade exceeded US $ 1.7 billion in 2004 and rose to US $ 2.025 billion in 2005. The FTA prompted a 257 % increase in bilateral trade between 2001 and 2004.

At 15% of the total, India is the biggest source of Sri Lankan imports. India held the 14th position in Sri Lanka's Export in 2000 and it improved to the 3rd position in 2005. With FDI approvals of US $ 450 million, India is the 4th largest investor in Sri Lanka. Indian Oil Corporation, Taj Hotels, Apollo Hospitals, L & T, Ambujas, Tatas and Ashok Leyland are among the prominent Indian companies operating in Sri Lanka. Connectivity between the two countries is at an all time high with approximately 100 flights per week, including Indian private airlines, to and from 10 destinations in India.

The study is a preliminary attempt to analyse the effect of bilateral trade agreements on the export of SAARC nations. The study found a positive effect of the agreement between India and Sri Lanka on the intraregional (SAARC) trade of both the nations. This gives an indication that the countries in the region can reap the intra regional potential trough bilateral trade agreements by improving the trade and investment situation in the region. But for quantifying and analysing the prospects of SAARC as a trade block, the detailed study is needed by analysing all such agreements and all countries in the region. The study can be extended in these lines to get a clear picture on the actual trade prospects of the region and the possibility of the region to become a trade block.

While the Free Trade Agreement has worked well; there is scope for significant improvement. Currently the Agreement covers only goods; there are a large number of items in the negative lists (429 items in case of India, 1180 items in case of Sri Lanka as well as quantitative caps on tea and textiles) and implementation of the Agreement has thrown up another set of issues. The two sides are jointly addressing these practical difficulties arising out of the implementation of the FTA. Work is simultaneously going on to move to the next step of economic integration by expediting the Comprehensive Economic Partnership Agreement (CEPA) between the two countries. Rounds of talks in New Delhi on February 2005 resulted in the setting up of a Trade Negotiating Committee and its sub-groups which have since met in New Delhi and Colombo to finalize the Agreement by end-2006. With a small beginning the Free Trade Agreement between the two countries is another feather in its excellent bilateral relationship. It is a huge leap forward but a lot more needs to be done in future to make it a real success story.

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