



***EFFECT OF SOUTH ASIAN FREE TRADE AREA AGREEMENT ON TRADE
AND MACROECONOMICS OF THE REGION***

THELGE USHAN INDIKA PEIRIS

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AND MACROECONOMICS OF THE REGION**

By

THELGE USHAN INDIKA PEIRIS

**Thesis Submitted to the School of Graduate Studies,
Universiti Putra Malaysia, in Fulfilment of the Requirements for the Degree of
Doctor of Philosophy**

April 2019

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Abstract of the thesis presented to the Senate of Universiti Putra Malaysia in fulfillment of the requirement for the Degree of Doctor of Philosophy.

EFFECT OF SOUTH ASIAN FREE TRADE AREA AGREEMENT ON TRADE AND MACROECONOMICS OF THE REGION

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April 2019

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This study investigates the desirability of South Asian Free Trade Area (SAFTA) in attaining static and dynamic efficiencies of trade integration, and in turn, its effect on economic growth of the region. The static efficiency of SAFTA is measured through its potentiality in trade creation and trade diversion. The dynamic time path of static efficiency is also investigated to measure the timely realizations of trade creation and trade diversion. The static analysis of SAFTA is further extended to measure the effect of political factors, because prevailing political tension within the region is appeared to be the main hindrance in expanding trade. In measuring its dynamic efficiency, the potential of SAFTA in improving macroeconomic factors of the region is measured. Six (6) theoretically chosen macroeconomic variables (Macroeconomic Policy Credibility, Price Distortion, Physical Investment, Inward FDI, Technology Transfer, and Human Capital) are considered on this regard. Finally, macroeconomic channels that mediate static efficiency of SAFTA in boosting economic growth are investigated to measure the growth effects of SAFTA.

The desirability of SAFTA is measured over the period 2003 to 2013 considering only seven (07) South Asian countries (Afghanistan, Bangladesh, India, Maldives, Nepal, Pakistan, and Sri Lanka). Bhutan is not taken to the sample due to data constraint. When measuring trade creation and trade diversion effects, a gravity model is augmented to represent both static and dynamic model specifications separately. Static gravity models are measured using linear panel regression models, while two-step GMM and two-step system GMM models are used for the dynamic gravity models. When estimating these models, regions bilateral trade with 87 trading partners is used. To measure the dynamic efficiency, linear panel regression models and two-stage least-squares generalized panel data models are used depending on the model specifications of the macroeconomic variables. When estimating the growth effects of SAFTA, macroeconomic variables used to measure the dynamic efficiency are taken as mediator variables. Thus, a structural

model with seven simultaneous equations, each for the six mediator variables and one for the economic growth, are used to measure the mediation effect of SAFTA in boosting economic growth of the region.

The estimated results for both static and dynamic gravity models confirm the presence of significant intra-bloc and extra-bloc trade expansions following SAFTA. When moving from static to dynamic gravity models a significant trade persistency is reported, however, trade expansions significantly reduced. Also, results further confirm the presence of significant anticipation effects for SAFTA. Meanwhile, this study empirically confirms the existence of weaker governance and inefficient institutions within South Asian political environment that hinder region's trade. The dynamic efficiency of SAFTA is also supported by the results. That is, with the exception of human capital equation all the other macroeconomic equations depict a statistically significant coefficient for SAFTA with the expected signs. Finally, results for the growth effects indicate that SAFTA positively and significantly influences economic growth through two out of six channels: macroeconomic policy credibility and physical investment. This indicates that SAFTA carries its economic growth effects to the region mainly through its potential in stabilizing region's macroeconomic policies and encouraging physical investment. Therefore, with the presence of static and dynamic efficiencies, and significant economic growth effects, it is recommended to bring SAFTA to its full potential by further reducing tariffs and removing other trade barriers.

Abstrak tesis yang dikemukakan kepada Senata Universiti Putra Malaysia sebagai memenuhi keperluan untuk ijazah Doktor Falsafah

**KESAN DARIPADA PERJANJIAN KAWASAN PERDAGANGAN BEBAS
ASIA SELATAN KEPADA PERDAGANGAN DAN EKONOMIMAKRO
WILAYAHNYA**

Oleh

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Kajian ini menyiasat keutamaan Kawasan Perdagangan Bebas Asia Selatan (SAFTA) dalam mencapai kecekapan integrasi perdagangan statik dan dinamik, dan seterusnya memberi kesan kepada pertumbuhan ekonomi rantau ini. Kecekapan statik SAFTA diukur melalui potensinya dalam penciptaan perdagangan dan lencongan perdagangan. Laluan masa dinamik bagi kecekapan statik juga disiasat untuk mengukur realisasi penciptaan perdagangan dan lencongan perdagangan. Analisis statik SAFTA diperluaskan lagi untuk mengukur pengaruh faktor-faktor politik, kerana ketegangan politik yang berlaku di rantau ini terlihat seperti halangan utama dalam memperluas perdagangan. Dalam mengukur kecekapan dinamik, potensi SAFTA dalam meningkatkan faktor makroekonomi rantau diukur. Enam (06) pembolehubah makroekonomi yang dipilih secara teoritis (Kredibiliti Dasar Makroekonomi, Penyimpangan Harga, Pelaburan Fizikal, FDI ke Hadapan, Pemindahan Teknologi, dan Modal Insan) dipertimbangkan dalam hal ini. Akhir sekali, saluran makroekonomi yang memantapkan kecekapan statik SAFTA dalam meningkatkan pertumbuhan ekonomi disiasat untuk mengukur kesan pertumbuhan SAFTA.

Keutamaan SAFTA diukur sepanjang tempoh 2003 hingga 2013 dengan mempertimbangkan hanya tujuh (07) negara Asia Selatan (Afghanistan, Bangladesh, India, Maldives, Nepal, Pakistan, dan Sri Lanka). Bhutan tidak diambil ke dalam sampel kerana kekangan data. Apabila mengukur penciptaan perdagangan dan kesan lencongan perdagangan, model graviti diperluaskan untuk mewakili kedua-dua spesifikasi model statik dan dinamik secara berasingan. Model graviti statik diukur dengan menggunakan model regresi panel linear, sementara 'two-step GMM' dan 'two-step system GMM'

digunakan untuk model graviti dinamik. Apabila menganggarkan model-model ini, rantau perdagangan dua hala dengan 87 rakan dagangan digunakan. Untuk mengukur kecekapan dinamik, model regresi panel linier dan model data panel umum, dua peringkat paling kecil digunakan bergantung pada spesifikasi model pembolehubah makroekonomi. Apabila menganggarkan kesan pertumbuhan pembolehubah, makroekonomi SAFTA yang digunakan untuk mengukur kecekapan dinamik diambil sebagai pemboleh ubah pengantara. Oleh itu, satu model struktur dengan tujuh persamaan serentak, masing-masing untuk enam pemboleh ubah mediator dan satu untuk pertumbuhan ekonomi, digunakan untuk mengukur kesan mediasi SAFTA dalam meningkatkan pertumbuhan ekonomi rantau ini.

Anggaran hasil bagi kedua-dua model graviti statik dan dinamik mengesahkan kehadiran pertukaran intra-blok yang ketara dan pengembangan perdagangan blok-blok yang mengikut SAFTA. Walau bagaimanapun, apabila bergerak dari statik ke model graviti dinamik, keterlibatan perdagangan yang ketara dilaporkan, namun ekspansi perdagangan berkurangan. Selain itu, keputusan selanjutnya mengesahkan kehadiran kesan jangkaan yang signifikan untuk SAFTA. Sementara itu, kajian ini secara empiris mengesahkan kewujudan tadbir urus lemah dan institusi yang tidak cekap dalam persekitaran politik Asia Selatan yang menghalang perdagangan rantau. Kecekapan dinamik SAFTA juga disokong oleh hasilnya. Iaitu, dengan pengecualian persamaan modal manusia, semua persamaan makroekonomi lain menggambarkan pekali statistik yang ketara untuk SAFTA dengan tanda-tanda yang dijangkakan. Akhir sekali, keputusan kesan pertumbuhan menunjukkan bahawa SAFTA secara positif dan signifikan mempengaruhi pertumbuhan ekonomi melalui dua daripada enam saluran: kredibiliti dasar makroekonomi dan pelaburan fizikal. Ini menunjukkan bahawa SAFTA membawa kesan pertumbuhan ekonominya ke rantau ini terutamanya melalui potensinya dalam menstabilkan dasar makroekonomi rantau dan menggalakkan pelaburan fizikal. Oleh itu, dengan kecekapan statik dan dinamik, serta kesan pertumbuhan ekonomi yang ketara, adalah disyorkan untuk membawa SAFTA sepenuhnya dengan mengurangkan tarif dan menghapuskan halangan perdagangan yang lain.

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This thesis was submitted to the Senate of Universiti Putra Malaysia and has been accepted as fulfilment of the requirement for the degree of Doctor of Philosophy. The members of the Supervisory Committee were as follows:

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LIST OF ABBREVIATIONS

APEC	Asia-Pacific Economic Cooperation
ARDL	Autoregressive Distributed Lag
ASEAN	Association of Southeast Asian Nations
CACM	Central American CM
CADC	Southern African Development Community
CAFTA	China-ASEAN Free Trade Area
CARICOM	Caribbean Community
CEEC	Central and Eastern European Countries
CES	Constant Elasticity of Substitution Preferences
CGE	Computable General Equilibrium
CM	Common Market
CMEA	Council of Mutual Economic Assistance
COMESA	Common Market for Eastern and Southern Africa
COMESA	Common Market for Eastern and Southern Africa
CU	Custom Union
CUSFTA	Canada-US Free Trade Agreement
EAEC	East Asia Economic Caucus
EC	European Community
ECO	Economic Cooperation Organization
ECOWAS	Economic Community of West African States
EEC	European Economic Community
EFTA	European Free Trade Association
EI	Economic Integration
ESCAP	Economic and Social Commission for Asia and the Pacific
EU	European Union

FDI	Foreign Direct Investment
FTA	Free Trade Area
GCC	Gulf Cooperation Countries
GDP	Gross Domestic Production
GTAP	Global Trade Analysis Project
HC	Human Capital
HO	Heckscher-Ohilin
IFDI	Inward FDI
IPA	Integrated Programme of Action
LAFTA	Lathing American Free Trade Association
LAIA	Latin American Integration Association
LTTE	Liberation Tigers of Tamil Eelam
MENA	Middle East and North African
MPC	Macroeconomic Policy Credibility
NAFTA	North American Free Trade Agreement
NCPF	Non-Converging Political Factors
OECD	Organization for Economic Co-operation and Development
PC	Physical Investment
PD	Price Distortion
PE	Partial Equilibrium
PTA	Preferential Trade Agreement
R&D	Research and Development
RRA	Relative Rate of Assistance
RRC	Rate of Return to Capital
RRC	Rate of Return to Capital
RTA	Regional Trade Agreement
SAARC	South Asian Association for Regional Corporation

SAFTA	South Asian Free Trade Area
SAPTA	South Asian Preferential Trade Agreement
SATIS	SAARC Agreement on Trade on Services
TC	Trade Creation
TD	Trade Diversion
TI	Trade Integration
TT	Technology Transfer
UDEAC	Central African Customs and Economic Union
UDEAC	Central African Customs and Economic Union
WTO	World Trade Organization

CHAPTER 1

INTRODUCTION

1.1 Introduction

The advent of new information and communication technologies led the world economies, irrespective of their economic and political characteristics, to move away from earlier protectionist stance towards greater liberalization. Indeed, this rapid technological development, particularly in the industries of transportation and telecommunication reduced the economic barriers in exchanging goods and factors of production. Herein, the role of geographical distance emerged as irrelevant for economic transactions. Therefore, the process of globalization became well received. Meanwhile, Regional Trade Agreements (RTA) database of World Trade Organization (WTO) indicates that almost all of its member countries have participated in at least one of RTAs so far. As such, by October 2014, the number of notified RTAs approximately increased to 585. Of these, 379 are in force. As globalization became more popular and persistence, why should countries more often tend to integrate with their neighbors over the trading partners located outside their regions?

Aforementioned empirical question has been addressing with reference to RTA specific economic effects over several decades now. According to Bhagwati and Panagariya (1996) the theory underlying the economic effects of regionalism mainly derives from the Static and Dynamic Theories of trade integration¹. The Canadian-born American economist, Jacob Viner, is regarded as the pioneer of Static Theory. Viner (1950) introduces the Static Theory through the trade creation and trade diversion effects of regionalism. Trade creation is the positive effect as trade shifts from a high cost supplier member country to a low-cost supplier member country within the integrated region. Meanwhile, trade diversion is the negative effect as it leads to shift trade from a low-cost supplier nonmember country to a high cost supplier member country. Thus, according to Static Theory an RTA is considered desirable with the presence of net trade creation effect and undesirable with the presence of net trade diversion effect.

However, Hungarian economist, Bela Balassa, who is regarded as the pioneer of dynamic theory, indicates that Static Theory concentrates only on the resource allocation effect of RTAs and thus, emphasize the requirement of expanding an investigation to study the effect of integration on “dynamic efficiency” as well. The “dynamic efficiency” of RTAs is defined as the expected improvement in the economic development under a given resource use and savings ratio. Further, this can be represented by a movement of production possibility frontier of an economy to the northeast direction. According to Balassa (1961) the influence of trade agreements on “technological progress, allocation

¹ More detailed explanation on these theories and their developments are provided under the chapter two.

of investment, dynamic inter-industry relationships in production and investment, and uncertainty and inconsistency in economic decisions” are some of the factors of “dynamic efficiency”. Schiff and Winters (1998) indicate that though an integration arrangement leads to small or even negative static effects, it may possibly provide dynamic effects. Further, they summarize the dynamics as the potential of integration agreements in improving macroeconomic factors, in turn, that affects to the rate of economic growth of participating countries.

Nevertheless, most of the previous empirical studies that examined the desirability of RTAs limit to the scope of Static Theory, while very little concentration is devoted to Dynamic Theory. Therefore, economic integration literature still fails to provide enough evidences on RTA specific dynamic effects and dynamic channels through which RTAs may affect economic growth of participating countries. On the other hand, empirical literature that concentrates on static effects substantially immersed from RTAs pertaining to the European Union (EU), North America, and Southeast Asia. RTAs in other counterparts of the world, particularly in South Asia, are hardly tested for their efficiencies. Moreover, prevailing literature in this regard on the South Asia context still inconclusive.

This inconclusiveness of static efficiency and reticent dynamic efficiency of South Asian RTAs have generated a misgiving particularly on the desirability of region’s cooperative economic growth model, South Asian Free Trade Area (SAFTA). Moreover, lack of investigations on both static and dynamic fronts of the desirability of SAFTA have shaded its full potential leading it to appear as a dormant RTA. Furthermore, it has restrained policy makers in bringing SAFTA to its full potential.² Therefore, this study seeks to emphasize the potential of SAFTA by investigating whether SAFTA leads in expanding intra-regional trade and boosting economic growth by influencing growth determinants of the region.

The rest of the sections in this chapter are drafted as follows. Section 1.2 provides an overview on South Asian economic background devoting more attention on intra-regional trade. The problem statement of the study is described next in section 1.3. Followed by, the main and specific objectives in section 1.4. A discussion on the significance of the study is provided under section 1.5. Finally, the chapter concludes with a summary in the section 1.6.

² SAFTA is not in its full potential due to failure in reducing tariffs as agreed and the availability of sensitive lists.

1.2 Overview of South Asian Economy and Trade

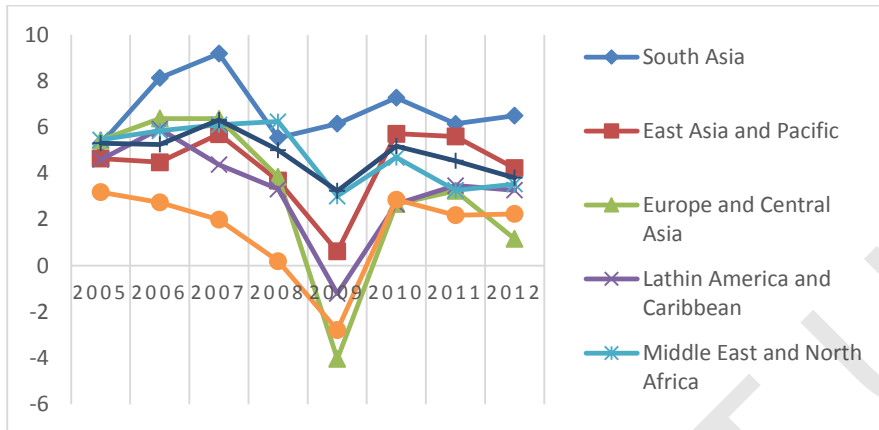
South Asia is the southern region of Asian Continent. The region homes to more than one fifth of the global population, making it one of the densely populated topographical regions on the planet. South Asia comprises of Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. Because these countries were governed over 200 years under the British colony, they share some typical equality in terms of political, social and economic characteristics. As reported in South Asia Economic Report (2006), even the policy reforms of the region depict a similarity and these reforms can be grouped into four general areas, such as; developments in macroeconomic stability, enhancing the environment for economic sector advancement, rejuvenating the banking industry, and abolition of highly protective trade policies by removing trade protection instruments, lowering tariffs, and streamlining the trade regime.

On this background, this section devotes the attention on some key economic and political characteristics of the region. Hence, subsection one briefs the recent economic performances of the region. Subsection two reviews the trade integration arrangements with especial focus on multilateral trade agreements. Subsection three concentrates on some bilateral political disputes that constraint the intra-regional trade. Finally, some recent incentives for deeper integration will be discussed in the subsection four.

1.2.1 Recent Economic Performances

The world bank statistics indicate that South Asian countries have performed well in economic activities during recent years. According to the Figure 1.1, the region's growth rate persisted around 6% while rest of the regions depicted relatively lower growth rate during the period. Especially, in 2009 when almost all the other regions suffer from the global economic meltdown due to global financial crisis, South Asia depicted a positive economic growth rate, except for Maldives (-3.64%). This might have resulted due to macroeconomic policies that showed an expansionary stance in both fiscal and monetary policies of the region (Park, Ramayandi and Shin, 2013).

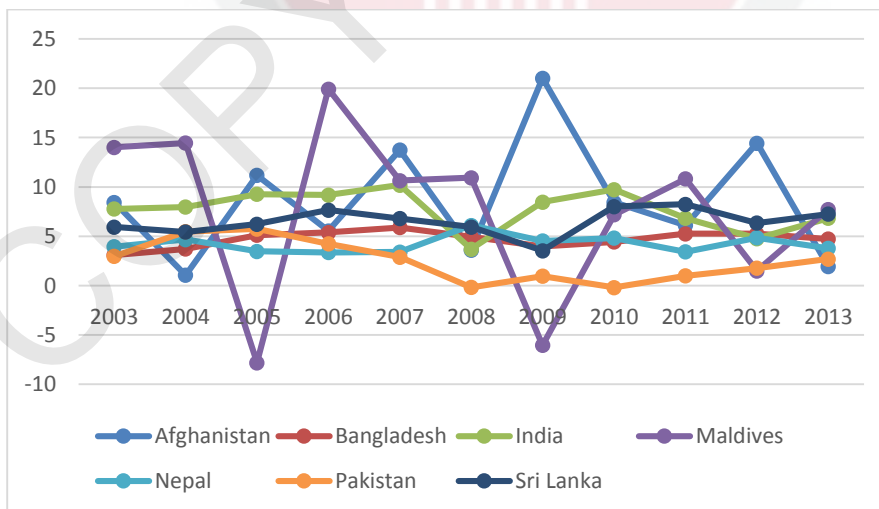
Figure 1.1: Regional GDP Growth (Annual %)



Source: World Bank Database

Figure 1.2 provides an overlook on the growth rates of individual countries of the region. The region's average growth rate reported as 6.00% for the period. This average growth rate ranges from 2.5% (Pakistan) to 8.7% (Afghanistan). Meanwhile, India and Maldives reported an average growth rate of well over 7%. Bangladesh and Sri Lanka also depict profound performances, reporting 4.7% and 6.5% respectively, which is very close to the region's average. Surprisingly, Pakistan (2.5%), being one of the strongest economies in the region, deviates much from region's average.

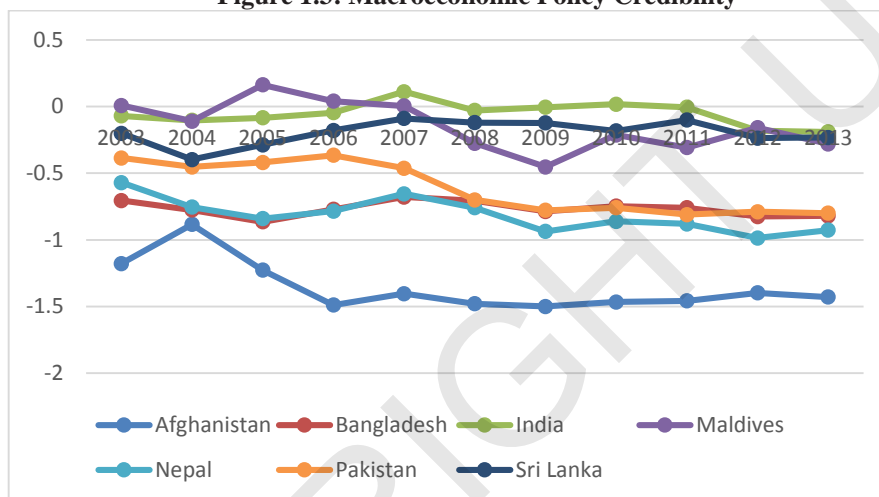
Figure 1.2: GDP Growth Rate (Annual %)



Source: World Bank Database

GDP per capita of the region also improved gradually during the period. Specially, Maldives (6566.6 US Dollars), Sri Lanka (2923.2 US Dollars), India (1489.2 US Dollars) and Pakistan (1256.7 US Dollars) report an impressive progression by 2013. Meanwhile, GDP per capita of the other counterparts of the region remained well below 1000 US Dollars by 2013. Even though the region's economic growth statistics depict a better picture, macroeconomic environment does not portrahit the similar comporment. Therefore, the behavior of several macroeconomic factors is analyzed in the rest of the section.

Figure 1.3: Macroeconomic Policy Credibility



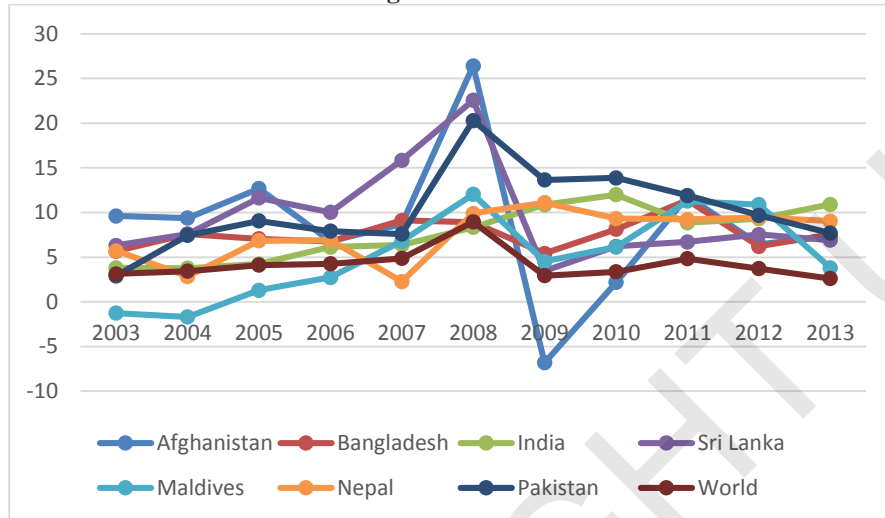
Source: World Bank Database

When studying the macroeconomic environment of the region the behavior of macroeconomic policy credibility is first examined, because unstable macroeconomic policies may lead to slow down the economic growth (Fischer, 1993). According to the figure 1.3, the region has failed to maintain the credibility in their macroeconomic policies because, by 2013, all the countries in the region depict a negative value for the government effectiveness index introduced by Kaufmann, Kraay, and Zoido-Labaton (1999a). India shows a persistency in policy credibility till 2011, while in Sri Lanka it is positive during 2006 to 2011. However, both these countries have not been able continue the policy credibility 2012 onwards. Afghanistan, Bangladesh, Nepal and Pakistan have never reached policy credibility during the period, but further deteriorated.

During the period, South Asia's average inflation is 8.1%, which doubles the World's average 4.2%. Afghanistan, Pakistan and Sri Lanka reported the highest inflation rates in 2008 leading to an average inflation of 8.6%, 10.1% and 9.5% respectively. Bangladesh, Nepal and India also reported inflation rates of around 7.5% during the period. Meanwhile, Maldives showed the lowest average (5.1%), which very close to World's average inflation, 4.2%. As shone in the Figure 1.4, the inflation in the region is significantly fluctuating. Moreover, all the countries reported a higher rate of inflation when compared to the average inflation rate of the World. Because price distortion is

considered as one of the major costs of inflation, these relatively higher inflation rates may significantly reduce the trade potential of the region.

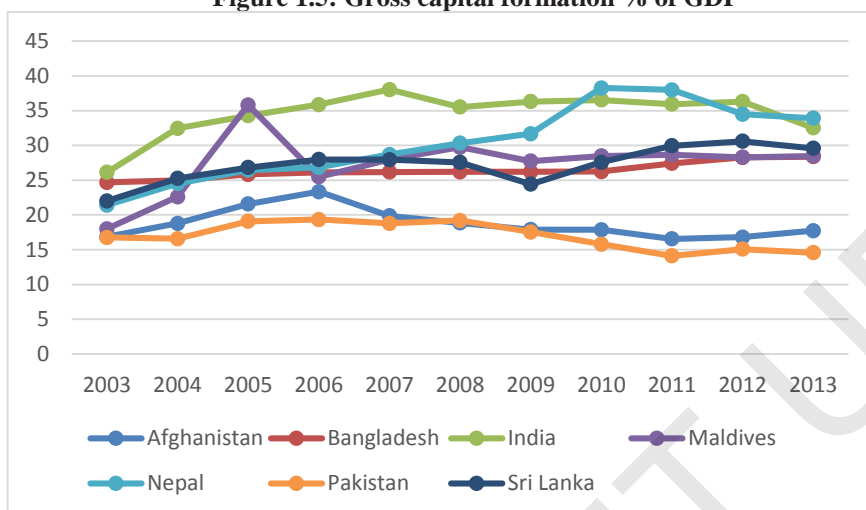
Figure 1.4: Inflation



Source: World Bank Database

Figure 1.5 shows the gross capital formation for the region as a percentage share of GDP for the period, 2003 to 2013. Slight improvement in gross capital formation is observed for India and Nepal. In case of Bangladesh, Maldives and Sri Lanka, it persisted around 20% to 28%. Meanwhile, a declining trend in gross capital formation as a percentage share of GDP is shown for Afghanistan and Pakistan over the considered period. According to the World Bank statistics, capital formation per capita in 2013 for the region was 539.6 billion US Dollars. However, when compared to the other sub regions of Asia, East Asia (3555.1 billion US Dollars); West Asia (2823.4 billion US Dollars); Central Asia (1329.8 billion US Dollars); South-East Asia (1137.4 billion US Dollars), capital formation per capita in South Asia is relatively low.

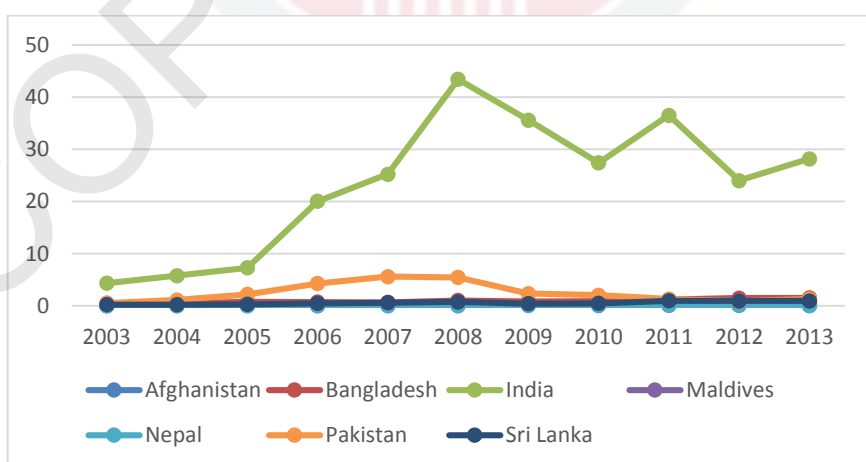
Figure 1.5: Gross capital formation % of GDP



Source: World Bank Database

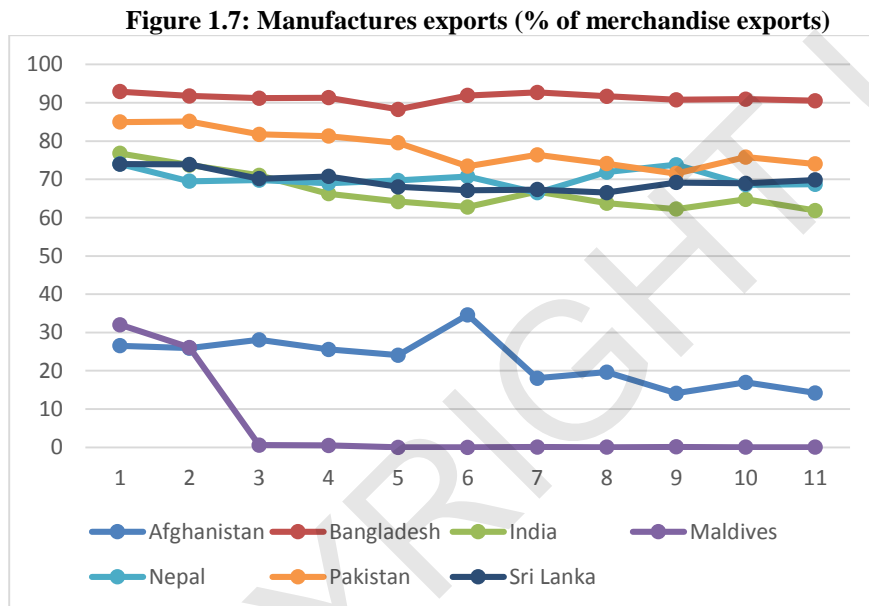
Similarly, according to the Figure 1.6 trends of net FDI inflows to the region do not depict an attractive picture during the period. Most of the countries share of net FDI inflows are less than the region's average (4.3 billion US Dollars) in 2013, because majority of FDIs have flown to India. In 2013, total amount of net FDI flows to India was approximately \$28 billion, which is almost close to the region's total (32 billion US Dollars). Bangladesh and Pakistan have managed to attract approximately 1.5 billion US Dollars and 1.3 billion US Dollars in the same year. Meanwhile, all the other countries altogether reported a net FDI inflow value of approximately 1.4 billion US Dollars.

Figure 1.6: Foreign direct investment, net inflows (\$ billions)



Source: World Bank Database

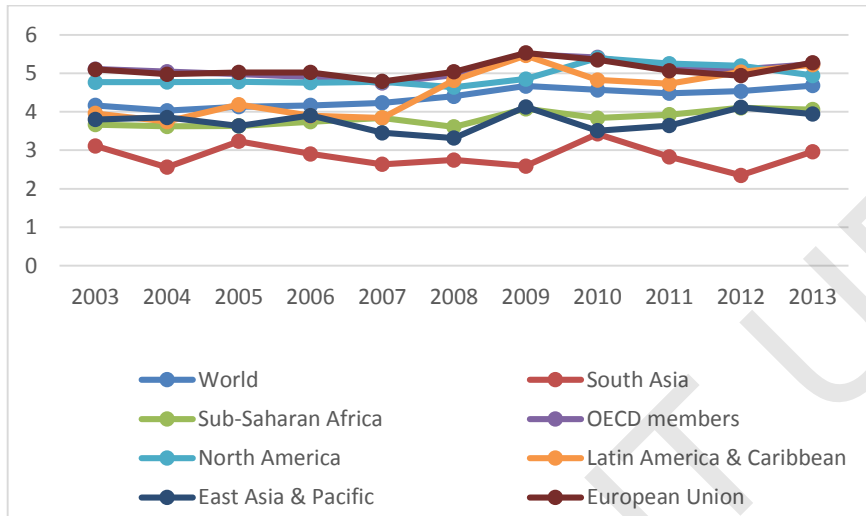
Figure 1.7 shows the distribution of the region's manufactures exports as a percentage of merchandise exports over the period 2003 to 2013. Except for Maldives and Afghanistan all the other countries of the region depict that manufactures exports percentage exceeds 50% out of the total merchandise exports. In case of Maldives the percentage is less than one for most of the years. However, the overall trend is downward sloping for all the countries except for Bangladesh. Because manufactures exports as a percentage of merchandise exports is considered as a proxy for technology transmission, the figure advocates a weaker technology transmission over the period for these South Asian countries.



Source: World Bank Database

Government expenditure on education remained at a very low level in South Asia when compared to the most of the other regions of the world. As Figure 1.7 depicts, South Asia is the lowest expending region on education over the past few years. Most of the other regions' government expenditure on education was approximately 4% to 5% from their GDP in 2013. For instance; European Union 5.3%, OECD members 5.2%, North America 5%, East Asia & Pacific 4%, Latin America & Caribbean 5.2% and Sub-Saharan Africa 4.1%. However, South Asia hardly reached a value higher than 3% during the period.

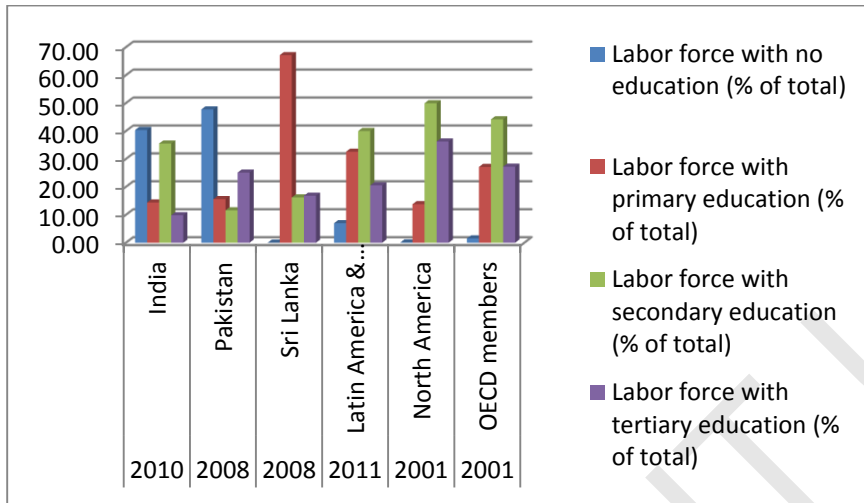
Figure 1.8: Public spending on education, total (% of GDP)



Source: World Bank Database

Prevailing unemployment and human capital issues in the labor force might have resulted due to lack of government expenditure on education. Unemployment is considered as a major issue that these countries are facing at the moment, especially, among the least developed countries in the region. According to the world bank statistics, unemployment in Nepal is the worst. In 2004, it is 42% of the total labor force and it has raised to 48% in 2008. Afghanistan reports an unemployment rate of 40% and 35% in 2005 and 2008 respectively. Maldives depicted relatively persisted, but higher rates. It is 14.4% and 14.5% in 2006 and 2010 respectively. Other countries in the region depicted relatively lower rates of unemployment, reporting 5%, 5.6% and 4.2% respectively for Bangladesh, Pakistan and Sri Lanka in 2011. However, the most prospective country in the region, India, showed relatively high rate of unemployment during the period, which was around 10%.

Figure 1.9: Human Capital



Source: World Bank Database

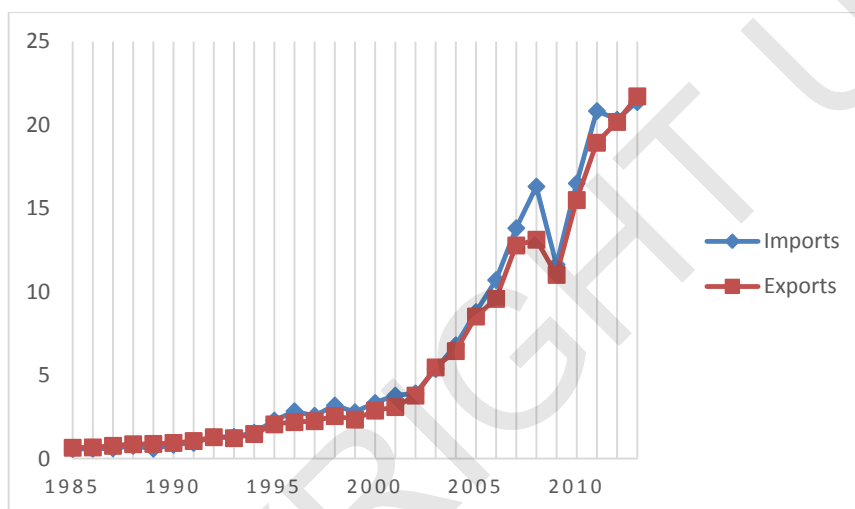
Figure 1.10 above compares the education level of the labor force in three strongest countries of the region with some other selected groups of countries. The majority of the labor force in India and Pakistan are uneducated. The labor force with no education of these two countries accounted as 40.3% and 47.7% respectively due to the lower literacy rates. In Sri Lanka, among the labor force 67.1% represented by those who had only the primary education. The labor force with secondary or tertiary education in these countries is relatively low when compared to other counterparts of the world. In developed countries, like North America and OECD countries, this phenomenon is completely different. The majority of their labor force is represented by those who had secondary education and then by those who had tertiary education.

1.2.2 Intra-Regional Trade in South Asia

Trade among South Asian countries are considered relatively low when compared to other regional blocs in the world. Figure 1.10 shows the total intra-regional imports and exports during 1985 to 2013. In mid 1980s, that is when South Asian Association for Regional Corporation (SAARC) is formed, both intra-regional imports and exports depict a value around 0.6 billion US dollars. This less than one billion US dollar figure in intra-regional trade in South Asia continues until early 1990s. Later, when South Asian Preferential Trade Agreement (SAPTA) is formed, in 1996, total imports and exports among these countries account as 2.84 and 2.20 billion US dollars respectively. During this SAPTA period, 1996 to 2005, intra-regional imports and exports depict a significant improvement in their volumes as imports increased from 2.84 billion US dollars to 8.79 billion US dollars and exports increased from 2.20 billion US dollars to 8.52 billion US dollars. However, as figure 1.10 shows, the rapid expansion in intra-regional trade starts from 2003. That is seven years after the implementation of SAPTA or in other words

three years before the implementation of South Asian Free Trade Area (SAFTA). This might be due to late response of SAPTA (Moktan, 2009) or due to “anticipation effect” of SAFTA. An anticipation effect of trade agreements is expected because according to Frankel (1997) firms may position themselves in advance for the future markets. Several other researchers also confirm the existence of significant positive effects on trade flows even before the implementation of trade agreements due to anticipation effects of firms (Magee, 2008; Freund and McLaren, 1999).

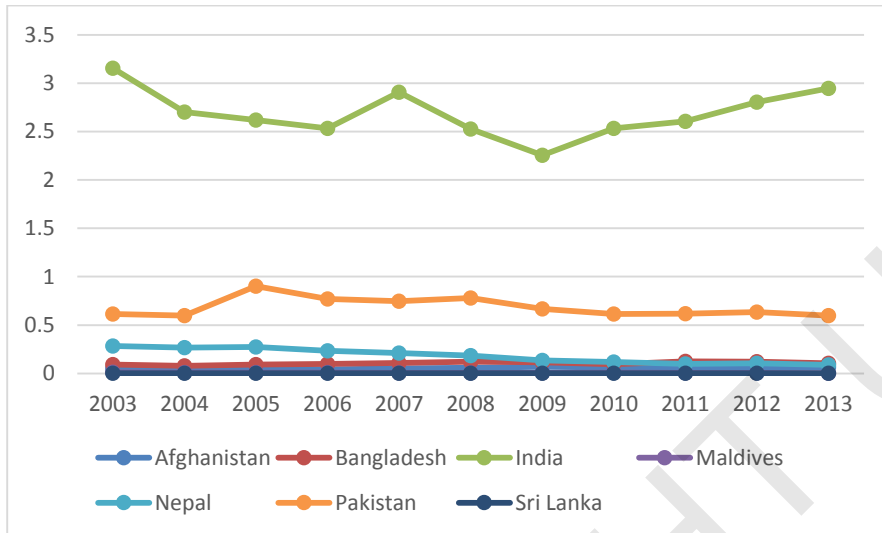
Figure 1.10: Intra-regional Imports and Exports (US \$ billions)



Source: World Bank Database

This increasing trend in expanding the intra-regional trade that started in pre-SAFTA period continues even after the formation of SAFTA except in 2009. Intra-regional imports dropped from 16.30 billion US dollars to 11.62 billion US dollars and exports dropped from 13.12 billion US dollars to 11.01 billion US dollars in 2009. This sudden drop may be due to the global economic meltdown took place as a result of the global financial crisis during that period. However, the region recovered quite quickly as the trade comes to its normal trend from the subsequent year itself. Except this 2009 incidence, trade among South Asian countries grew at an increasing rate during this entire SAFTA period. This rapid expansion in intra-regional trade would certainly indicate a trade creation effect of SAFTA. Rapid expansion in Sri Lankan imports of automobiles from India can be considered as one of the good examples on this regard. However, the level of intra-regional trade with compared to total South Asian trade is still very low. It is approximately 2.4 percent in 1990 and increases up to 4.3 percent by 2001 and at present it is about 4.8 percent. Figure 1.11 and Figure 1.12 further explain this be more specific to the imports and exports.

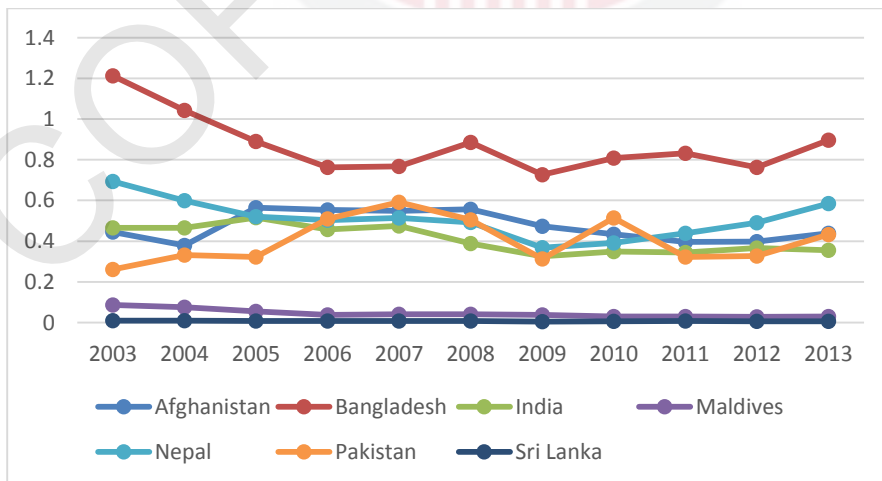
Figure 1.11: Intra-regional exports % in total exports



Source: World Bank Database

Figure 1.11 depicts the intra-regional exports for the individual countries as a percentage of region's total exports. India being the dominant country in the region depicts the highest share of exports to the region. India's export percentage have persisted around 3% during the period, while all the other country's share of exports to the region is less than 1%. Even though the region experienced a significant intra-regional export expansion, when compared to the total exports the share of intra-regional exports depicts a declining trend.

Figure 1.12: Intra-regional imports % in total imports



Source: World Bank Database

The trend of intra-regional imports shares in the total imports of these countries almost analogous to the exports. As depicted in the Figure 1.12, all the country's import share from the region is less than 1% during the period. Moreover, the trend is negatively sloped for most of the countries as in the case of intra-regional exports. This indicates that the intra-regional trade in the region, both imports and exports, has not increased in parallel to the total trade expansions. However, it evidences for strong trade relations with other counterparts of the world and thus, less potential for trade diversion effect of SAFTA.

1.2.3 South Asian Trade Policy Reforms

South Asian countries were under the British nest and were ruled for around 200 years before the independence. After the independence, these countries embrace a Soviet-type model, which reveal the attributes of import substituting policies, a dominant public sector and consequently positioning numerous constraints on private sector. Later, during late 1970s and 1980s these countries began the process of trade policy reforms. Sri Lanka initiated the policy liberalization process in late 1970s, followed by the other nations in the region (Devarajan and Nabi, 2001). Though, the region made a late arrival to the phenomenon of trade integration several bilateral and multilateral trade agreements were launched, especially after the establishment of SAARC.

SAARC is formally established in 1985 comprising Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka and hold the first summit in December, 1985 in Dhaka, where Charter of the SAARC is signed. Later in 2007, Afghanistan joined SAARC as the eighth registered member state. The objectives and the aims of the association as specified in the Charter are:

“to promote the welfare of the people of South Asia and to improve their quality of life; to accelerate economic growth, social progress and cultural development in the region and to provide all individuals the opportunity to live in dignity and to realize their full potential; to promote and strengthen selective self-reliance among the countries of South Asia; to contribute to mutual trust, understanding and appreciation of one another's problems; to promote active collaboration and mutual assistance in the economic, social, cultural, technical and scientific fields; to strengthen co-operation with other developing countries; to strengthen co-operation among themselves in international forums on matters of common interest; to co-operate with international and regional organizations with similar aims and purposes; and, to maintain peace in the region”.³

The Integrated Programme of Action for SAARC initially came with five agreed areas of cooperation namely; Agriculture, Rural Development, Telecommunications,

³ Charter of the South Asian Association for Regional Cooperation, Article 1.

Meteorology, and Health and Population Activities⁴. Later, according to the SAARC charter, these areas of cooperation were improved as “Agriculture Rural Development, Biotechnology, Culture, Economic and Trade, Education, Energy, Environment, Finance, Funding Mechanism, Information, Communication and Media, People to People Contact, Poverty Alleviation, Science and Technology, Security, Social Development and Tourism”. In South Asia, the regional trade integration process started to take off when SAARC initiated a framework for region-wide integration under SAPTA in 1995. Later, SAFTA and SAARC Agreement on Trade in Services (SATIS) are launched with the intention of deepening the trade integration process in the region.

SAPTA is an arrangement of trade, where SAARC member countries offer each other the advantageous therapy by means of reducing import tariffs on qualified products. The heads of the states of member countries at the sixth SAARC Summit held in Colombo in December 1991, accept to liberalize their trade policies in a step by step method, in such a way that nations in the area share the benefits of trade equitably. Later, SAPTA agreement is signed on April 11, 1993 and comes into force on December 7, 1995. Main goals of SAPTA are: promoting regional cooperation; and stimulating national economic growth, national employment levels, and living standard of South Asian nations. Four rounds of trade arrangements are conducted under SAPTA covering over 5,500 products. Each round contributes an additional number in the product coverage and deepens the tariffs concessions. The last round of trade negotiation is concluded at the second meeting of inter-Governmental group on trade liberalization held at the SAARC secretariat on October 30, 2002 to November 1, 2002.

SAFTA is motivated by the requirement to boost intra-SAARC economic cooperation to maximize the realization of the region's potential in trade and development for the benefit of people who live in the region⁵. The main objective of SAFTA is to promote and enhance mutual trade and economic cooperation among contracting states by, inter-alia⁶: removing barriers to trade in and providing facilities to speed up the cross-border exchange of goods and services among the territories of the contracting states; promoting unbiased competition in the free trade area, and making certain of fair gains to all contracting countries, taking into account their particular degrees of economic development; establishing an effective system specially for the joint administration and for the resolution of disputes to ensure proper execution of SAFTA agreement; and developing a structure for additional regional cooperation to broaden and boost the shared benefits of this arrangement.

SAFTA was signed on January 1, 2006, whereby the contracting states agreed to have a gradual tariff reduction process. Members of the association will bring down tariffs to 0

⁴ Jang Media. "[History and Evolution of SAARC](#)". Jang Media Research Unit. Jang Media Group. Retrieved 11 November 2013.

⁵ SAARC Secretariat, Agreement on South Asian Free Trade Area (SAFTA), SAARC Secretariat, Kathmandu, 2004, P. 1.

⁶ Ibid, P. 3.

to 5 percent from 25 to 30 percent over the period 2006 to 2016. It sets deadlines for developing countries like India, Pakistan and Sri Lanka to reduce their initial tariff rates to 20 percent and the least developed countries like Nepal, Bhutan and Bangladesh to 30 percent within the first two years. The subsequent tariff reduction by the developing countries is from 20 percent or below to 0 - 5 percent within next five years' period, that is 2008 to 2012. The least developed countries agree to bring down their tariff rates to 0 - 5 percent during the next eight years' period, that is 2008 to 2015.

SATIS is signed at the sixteenth SAARC Summit on April 2010 and came into force on 29th November 2012. The Governments of SAARC member states enter into the SATIS recognizing the fact that regional trading arrangements both in goods and services shall function as opportunities for attaining goals of economic growth and development in the region. The objective of this agreement is "to promote and enhance trade in services among the contracting states in a mutually beneficial and equitable manner by establishing a framework for liberalizing and promoting trade in services within the region in accordance with Article V of General Agreement on Trade in Services"⁷.

Bilateral trade agreements have been burgeoning globally since the early 1990s. Like elsewhere in the world, a particularly increasing trend of signing both intra-regional and trans-regional bilateral FTAs emerge in South Asia. For instance, the India-Bhutan Trade Agreement; the India-Nepal Trade Treaty; the India-Sri Lanka FTA, the India-Afghanistan Free Trade Area (FTA) and the Pakistan-Sri Lanka FTA are the region's intra-regional bilateral agreements. The Comprehensive Economic Partnership Agreement between India-Japan; Chile-India; India-Malaysia; India-Singapore; Korea-India; Pakistan-China; Pakistan-Malaysia; are the region's trans-regional bilateral agreements. Table 1.1 provides a brief description about these bilateral trade agreements in the region.

Table 1.1: Bilateral Trade Agreements in South Asia

Date/Year	Contracting States	Agreement Type/Title
Intra-regional		
Jan 1972. Renewed March, 1995	India and Bhutan	Agreement on trade, commerce and transit between the Government of the Republic on India and Royal Government of Bhutan.
March 28, 1972. Renewed March 26, 2006.	India and Bangladesh	Trade Agreement between India and Bangladesh.
April 2, 1976.	Nepal and Bangladesh	Trade and Payment Agreement between His Majesty's Government of Nepal and the

⁷ SATIS Agreement:

<http://commerce.nic.in/trade/saarc%20agreement%20on%20trade%20in%20services%20sats.pdf>. Retrieved on 3rd March 2014.

		Government of People's Republic of Bangladesh.
April 3, 1979.	Nepal and Sri Lanka	Trade Agreement between His Majesty's Government of Nepal and Government of Democratic Socialist Republic of Sri Lanka.
1980. Renewed September 2000.	Bangladesh and Bhutan	Trade and Transit Agreement between the Government of People's Republic of Bangladesh and Royal Government of Bhutan.
March 31, 1981.	India and Maldives	Trade Agreement between Government of the Republic of India and Government of the Republic of Maldives.
July 28, 1982.	Pakistan and Nepal	Trade Agreement between Government of Islamic Republic of Pakistan and His Majesty's Government of Nepal.
December 6, 1991.	Nepal and India	Free Trade Agreement between His Majesty's Government of Nepal and the Government of India.
December 28, 1998.	India and Sri Lanka	Free Trade Agreement between Republic of India and Democratic Socialist Republic of Sri Lanka.
March 2003	India and Afghanistan	Free Trade Agreement between Government of the Republic of India and the Transitional Islamic State of Afghanistan.
January 12, 2005	Pakistan and Sri Lanka	Free Trade Agreement between Government of Islamic Republic of Pakistan and Democratic Socialist Republic of Sri Lanka.
Trans-regional		
March 8, 2006	India and Chile	Preferential Trade Agreement between the Republic of Chile and the Republic of India.
February 2011	India and Japan	Agreement on Commerce between India and Japan.
February 2011	India and Malaysia	Comprehensive Economic Cooperation Agreement between the Government of the Republic of India and the Government of Malaysia.
January 2005	India and Singapore	India-Singapore Comprehensive Economic Cooperation Agreement.
August 2009	India and of Korea	Trade Agreement between the Government of the Republic of India and the Government of the Democratic People's Republic of Korea.
March 4, 2004	Pakistan and Iran	Preferential Trade Agreement between the Islamic Republic of Pakistan and the Islamic Republic of Iran.
November 24, 2006	Pakistan and China	Free Trade Agreement between the Government of Islamic Republic of Pakistan and the Government of People's Republic of China.

February 2012	Pakistan and Indonesia	Preferential Trade Agreement between the Government of the Islamic Republic of Pakistan and the Government of the Republic of Indonesia.
July 30, 2007	Pakistan and Mauritius	Preferential Trade Agreement between the Republic of Mauritius and the Government of the Islamic Republic of Pakistan.

Source: Moktan (2008) and Author's complications from various sources.

Apart from these bilateral agreements, some of South Asian countries join with several other multilateral trade agreements. India-MERCOSUR PTA: this is signed between India and MERCOSUR in New Delhi on January 25, 2004. The aim of this PTA is to expand and strengthen the existing relations between MERCOSUR and India and promote the expansion of trade by granting reciprocal fixed tariff preferences with the ultimate objective of creating a FTA between the parties; India-ASEAN Agreement: recognizing the vital role and contribution of the business sector in boosting investment and trade among the parties and the requirement to have further cooperation and utilization of greater business opportunities, this agreement is signed in August 2009 and came into force in January 2013; Asia Pacific Trade Agreement: recognizing the requirement in implementing a trade expansion program among the developing member countries of the Economic and Social Commission for Asia and the Pacific (ESCAP) the Governments of the People's Republic of Bangladesh, the People's Republic of China, the Republic of India, the Lao People's Democratic Republic, the Republic of Korea and the Democratic Socialist Republic of Sri Lanka are entered into this agreement; Economic Cooperation Organization (ECO): ECO is an intergovernmental regional organization established in 1985 by Iran, Pakistan and Turkey for the purpose of promoting economic, technical and cultural cooperation among the member states. Current membership includes: Islamic State of Afghanistan, Azerbaijan Republic, Islamic Republic of Iran, Republic of Kazakhstan, Kyrgyz Republic, Islamic Republic of Pakistan, Republic of Tajikistan, Republic of Turkey, Turkmenistan and Republic of Uzbekistan. Over the past 12 years the member states have been working together to speed up regional development process through their common endeavors and launch several projects in priority sectors of their cooperation including energy, trade, transportation, agriculture and drug control.

1.2.4 Barriers to Intra-Regional Trade in South Asia

South Asia is regarded as a region engulfed with various kinds of intra-state political disputes and inner-state conflicts. When compared to other regional blocs, South Asia depicts very high number of intra-state political conflicts, which probably stands as the main barrier to intra-regional trade. The conflict between India and Pakistan over Kashmir is the most influential within the region. India and Pakistan engaged in at least three fights over this issue, including the India-Pakistan war of 1947, 1965 and 1999. Next, Sri Lanka's accuse on the state government of Tamil Nadu on supplying arms and providing trainings to Liberation Tigers of Tamil Eelam (LTTE) and on the end of Sri Lankan civil war against LTTE, the India's decision to vote against Sri Lanka on the issue of accountability and violations in the civil war at the United Nations Human Rights Council led to some political incoherence also between India and Sri Lanka. The

territorial dispute between India and Nepal over the Kalapani area was also another significant intra-state political dispute. Moreover, Nepal's decision to allow China to build Lhasa-Kathmandu road following India-China war in 1962 influenced India to concentrate more on security issues when dealing with Nepal. India and Bangladesh were also politically dismantled for some extent on the claims of both parties over Boraibari and Daikhata-Dumabari falls, demarcation of boundaries involving fertile islands and over the enclaves (Bhatta, 2004). Finally, Afghanistan's claims on Pakistan over federally administered tribal areas had led to some political disputes between these two countries as well.

Divergence through religion and its influence on politics is also significant in the region. As reported by Bhatta (2004), specially, the opposite intentions of various religious groups, like Pakistan's deep commitment on making India an Islamic state and Bharatiya Janata Party's commitment to make it a purely a Hindu state, have also negatively affected Indo-Pakistan political relations. In addition, he indicates that the influence of religion on politics in Pakistan and Bangladesh is really high while, in other states it is relatively low. Differences in political systems adopting also have led to disintegrate the region. Bhatta (2004) indicates that both Pakistan and Bangladesh "have yet to institutionalize democracy and confirm the capability of political system to keep the military out of politics. Nepal's transition to democracy is at the crossroad following the Maoist movement. Bhutan retains the authority of monarch as the dominant institution", while Maldives just recently experiences the multiparty political system. However, the democracy in India and Sri Lanka establish well with compared to other countries (Bhatta, 2004). These differences in political systems probably influence governance and statecraft of each country to follow different values and principles making harder for the region to settle in to a common trade policy.

However, RTA specific literature provides several arguments on the likely effect of RTAs in promoting peace among politically disintegrated countries. RTAs may lead to increase the opportunity cost of hanging on these political disputes due to its potential in expanding bilateral trade and related welfare effects (Martin, Mayer, and Thoenig, 2008; Oneal and Russett, 1997, 1999; Barbieri, 2002). In addition, implementation of supranational institutions following RTAs would also lead to have settlements over these inter-state disputes (Bearce, 2003; Bearce and Omori, 2005; Haftel, 2007). Meanwhile, the pressure from other countries within the RTA on politically disintegrated countries may also significantly affect these countries to have peaceful solutions.

Apart from these intra-state disputes, political complexities within individual countries are also significant in the region. For instance, in India, the Kashmir problem has turned into an internal conflict, because some Kashmir insurgent groups fight in favor of accessioning the area to Pakistan and some seeking the complete independence. Despite this, India is having its own issues in ethnicity, separatist demands, terrorism and subversive activities, communalism, religious problems and so on. In Nepal, widespread

corruptions, crisis of governance, threats of Maoists and mainstream political parties led to fail a series of democratically elected governments. Sri Lanka experienced a civil war against LTTE over three decades causing serious issues on democracy, economic and social factors of the country. In Pakistan, beside the military governance, the issue between ethnic Sindish and those residents who migrated from India caused major problems within the country. The activeness of Taliban terrorist groups in Afghanistan caused various democracy and security issues. Similarly, in Maldives, the coup attempted in 1987 did affect the unity of the country. Meanwhile, Bhutan is also having some serious internal political issues leading to an unstable political environment within the country.

All in all, these political factors would indicate the presence of serious institutional and governance issues within the region. Therefore, these factors may lead to hinder international trade due to several reasons. They may increase the uncertainty causing higher transaction costs. That is by reducing the security of properties and level of trust in the transaction process. Transaction process become more difficult in these situations due to complexities in understanding legal environments and tax policies, and in setting new links in communication, financial and shipping activities. Anderson and Marcouiller (2002) regard price mark-ups as another major trade barrier that appears as a result of weaker governance practices. Price mark-ups may increase the costs of traded goods with compared to domestic goods leading to higher insecurity. Further, they indicate that the relative insecurity mark-up of traded goods is also higher due to lack formal procedures to protect property rights in weaker governance environments (cited from De Groot, and Linders, 2004).

1.2.5 Recent Incentives for Intra-Regional Trade in South Asia

Despite above stated issues that constraint the intra-regional trade relations over the years, some recent country specific and common incentives towards enhancing region's integration can be identified. India's commitments on this regard are significant, especially, the announcement of Indian Prime Minister on contraction in the sensitive list for least develop countries from 480 to 25 items and reduction of peek tariff rate to 8% for non-least developed countries at the SAARC Summit in 2011. Moreover, realizing the importance of India-Pakistan relations in enhancing the region's integration, Pakistan's decision to grant India the most favored nation status by the end of 2012 and to reduce items from Pakistan's sensitive list are also considered as significant moves towards further regional integration. Bangladesh is also playing a descent role on this regard in the recent past. As reported by Kher (2012), "the government of Bangladesh since January 2009, has been bridging the gap between India and Bangladesh. War crime trails are initiated against those who collaborated with Pakistan Army in its atrocities during the 1971 war. The 5th amendment of the constitution, which gave legitimacy to military dictatorships and removed secularism from state policy, has been repealed. Article 12 of the constitution proscribing religious parties has also been deleted".

Further, the recent agreement on the establishment of South Asian standards organization have the potential in reducing administrative burden on national customs and standards setting for the SAARC countries. Upon successfulness of this South Asian standards organization most of informal intra-regional trade can be reduced. For instance, informal trade that exists in between India, Nepal and Bhutan due to present complex customs and transit procedures can be eliminated (Kher, 2012; and Pohit and Taneja, 2000). Further, well established common standards and upon harmonization with international standards would increase international acceptance of region's products and thereby guarantee a larger market and an accommodative environment for FDI's.

Meanwhile, the tendency of entering into extra-regional RTAs by member countries also creates a potential indirect market for other members of the region. Especially, integration arrangements between South Asia and other sub regions of Asia will possibly beneficial for the region. In this regard, India is playing a major role with its increasing relationships with ASEAN, China, Japan and Republic of Korea. This increase integration with other regions of Asia would provide smaller countries in the region an opportunity to access a wider market through India. Further, India-MERCOSUR preferential trade agreement (PTA) and Pakistan's agreement with Iran and Turkey should enhance the potentiality of wider market for other countries. In addition, Afghanistan's participation to the corporation, entail the region in exploring the central Asia quite easily. Therefore, South Asian countries would need to have more open policies towards each other in order to gain from this potential wider market (Francois, and Wignaraja, 2008; Rana, Wignaraja, and Francois, 2009; Kher, 2012). Moreover, the accessibility to intra-regional market is becoming more essential as most favored export destinations (Japan, North America, and Western Europe) increase their protectionist tendencies in the post financial crisis era (Kher, 2012) and, on the other hand, further intra-regional integration would guarantee a greater bargaining power for the region. Greater bargaining power is essential for the region as 95% of region's trade take place with other counter parts of the world.

1.3 Problem Statement

South Asian countries have been implementing significant policy reforms over the last two decades. Abolition of highly protective trade policies by dismantling trade protection instruments, lowering tariffs, and streamlining the trade regimes is one of the commonly implemented policy reforms in this regard. Therein, the formation of South Asian Free Trade Area (SAFTA) is considered as a central outcome, because it intends to grab both static and dynamic efficiencies of trade integration, and in turn, boosting the economic growth of the region. Existence of higher tariffs prior to SAFTA, unexplored trade opportunities, abundant factors of production (labor), similar demand structures, huge consumer base, implementation of SAFTA with gradual tariff reductions, and continually improving terms of trade illustrate the potential of SAFTA in succeeding as a viable trade bloc. However, the ability of SAFTA in achieving the region's policy interest is still suspicious and yet to answer empirically due to dearth of investigations.

According to the Static Theory of trade integration, a trade agreement is efficient if and only if intra-regional trade intensifications (trade creation) exceed extra-regional trade abatements (trade diversion) subsequent to the agreement. In this regard, an expansion of intra-regional trade following the trade agreement is essential. However, intra-regional trade in South Asia is currently very low. It was approximately 2.4 percent in 1990 and at present it is only about 4.8 percent. Prevailing bilateral political disputes and some inner state political conflicts have been the major issue in expanding the region's intra-regional trade. Due to India-Pakistan political disputes, Pakistan imports from other countries about 50% of the products that India exports, despite India being the low-cost supplier. Similarly, India imports about 32% of the products that Pakistan exports from other countries relatively at a higher price (Kher, 2012). Existence of such a lower intra-regional trade exceedingly questions the potential of SAFTA in attaining static efficiency. However, a trade agreement may dynamically efficient, even though it is inefficient within the scope of Static Theory (Balassa, 1961). According to Dynamic Theory, SAFTA can be considered dynamically efficient if it leads to advance the macroeconomic environment of the member countries. But, even the macroeconomic environment of the region is not so attractive at present. Lower investment rates, lesser confidence on macroeconomic policy credibility, lower FDI inflows, inflation, lower manufactured exports, and over-burdened education system are some of the characteristics of macroeconomic environment of the region. Thus, the potentiality of SAFTA in supporting the regions policy interest even by way of dynamic efficiency is ambiguous.

In spite of that, some previous researchers have focused on the effectiveness of SAFTA as a viable trading bloc. However, several gaps continue to exist. This thesis fills the gap in literature in three ways. It considers the effect of political factors in measuring the static efficiency of SAFTA. This would indicate to what degree have political factors given weight over economic factors by the region, particularly when implementing the trade strategy. Further, it measures the dynamic efficiency of SAFTA, which is often overlooked by the previous studies. Therefore, the empirical question what macroeconomic factors are auspiciously influenced by SAFTA will be answered. Moreover, because dynamic efficiency tied with the macroeconomic factors, its attentiveness would help policy makers to come up with decisions that bind the trade strategy with the macroeconomic factors of the region. Finally, this thesis enlightens the literature by investigating economic growth mediators of trade integration with reference to SAFTA. Although some past studies have investigated the growth effects of trade policies the indirect effect of trade agreements on economic growth were left unaddressed.

1.4 Objectives of the study

The main objective of this study is to investigate the desirability of SAFTA in attaining static and dynamic efficiencies of trade integration, and in turn, its effect on the economic growth trajectories of the region.

The specific objectives of the study can be described as:

- (a) To examine the trade expansion effect of SAFTA through trade creation and trade diversion (static efficiency).
- (b) To examine for what extent the macroeconomic factors of the region are influenced by SAFTA (dynamic efficiency).
- (c) To investigate dynamic channels that mediate static efficiency of SAFTA in boosting economic growth of the member countries.

1.5 Significance of the study

RTA specific economic effects evolve from the two basic theoretical streams of Static Theory (Viner, 1950) and Dynamic Theory (Balassa, 1961) of trade integration. Investigating the effectiveness of an RTA through only one of the theories above is considered as insufficient, because the existence of these economic effects is mutually independent. According to the very best knowledge of the researcher, studies that cooperatively test the static and dynamic effects of RTAs are yet to come. Moreover, RTA specific growth effects are also very rare in the literature. Herein, a broader and in-depth study covering all above aspects is required in order to fill the gap in RTA specific literature, and to provide a comprehensive knowledge for policy makers and the wide community.

1.5.1 Contribution under Static Efficiency

The literature survey of the study evidences for a substantial amount of investigations on static effects of RTAs worldwide. Yet still, the effects of South Asian trade integration have not been investigated as extensively as other regions. While there are many qualitative studies on SAARC, SAPTA and SAFTA, quantitative studies are few and far. Theoretically, South Asian trade integration arrangements do have a huge potential in generating static gains because, on the one hand, the existence of several theoretical welfare determinants and, on the other hand, the potential of trade diversion is relatively low due to strong trade relations with other counter parts of the world. Beside these potentials, the present intra-regional trade is relatively low. Presence of several non-converging political factors might have significantly caused this lower intra-regional trade. Prevailing bilateral political disputes, inner state political conflicts, lack of political commitment for integration and instability in political democracy are the main political obstacles that stand against the region's further integration. Although trade openness

literature confirms these as deleterious factors to international trade, RTAs may deteriorate the influence of these factors due to precise terms and conditions. However, RTA specific literature on this regard is still scarce. Thus, in one end, this study fills the above literature gap by investigating the effectiveness of SAFTA under the static efficiency, especially after controlling for political factors.

1.5.2 Contribution under Dynamic Efficiency

When compared to the substantial amount of literature on static effects, empirical concentration on dynamic effects of RTAs still unsatisfactory. Trade integration arrangements may significantly influence economic attributes like economies of scale (Balassa, 1961), rate of return to capital (Schiff and Winters, 1998), policy credibility (Whalley, 1996) of participating countries and thus, provide a better platform for inward FDIs (Egger and Michael, 2002). Subsequently, the expertise of FDIs may spillover to other growth determinants like human capital, technology transfer, international trade and knowledge/ know-how (Feils and Rahman, 2008). On the other hand, increased trade due to RTAs may itself lead to enhance more technology transfer, knowledge/ know-how, private sector involvement, competition, and more and more investment on research and development. Because empirical literature on this regard is still developing, one is unaware about specific dynamic effects of RTAs. Therefore, it is essential to fill the existing literature gap on dynamic efficiency of RTAs being more explicit about dynamic channels. Further, it is required to extend the concentration deeply in to trade integration and its effects on economic growth. Beside the limitedness of studies that examined the RTA specific growth effects, on the one hand, most of the available studies concentrated on very limited growth channels of trade integration. Ben-David (1993 and 1996) examined the growth rate convergences and income convergences; Walz (1997) employed the endogenous growth models of Romer (1990) and Grossman and Helpman (1991) in to a three-country model in order to assess the growth effects; Nabende, et al. (2001), among others, examined the influence RTAs in attracting FDI and subsequent spillover effects on economic growth⁸. On the other hand, the growth effects of RTAs have never been tested through both static and dynamic theories jointly. Moreover, dynamic effects of RTAs in South Asia have never been investigated. Thus, the present study improves the RTA specific literature by investigating more explicitly the effect of static and dynamic channels on economic growth of South Asian countries.

1.5.3 Contribution to Stakeholders

Apart from the aforementioned significant contribution to the integration literature, this study would immensely helpful to the stakeholders of these countries in several ways. Policy makers keep on launching trade integration arrangements for the region with the intention of establishing South Asian Custom Union in another half a decade time. However, due to the lack of knowledge on the desirability of South Asian trade

⁸ Majority of studies that examined the dynamic efficiency of RTAs comes under the literature that concentrates on FDI and Economic Growth relationships.

integration arrangements the stakeholders might confuse on the present liberalization strategy of the region, because even after a series of RTAs for the region, present intra-regional trade is unsatisfactory. As this study analyses static and dynamic economic effects of SAFTA, especially by covering a wider range of macroeconomic channels like macroeconomic policy credibility, price distortion, physical investment, inward FDI, technology transfer, and human capital, would disseminate significant information on the desirability of SAFTA. Further, policy makers would benefit in planning their future policies towards further integration in a way that it would enhance economic growth and development of the region.

1.6 Summary

The empirical question, why countries often tend to integrate with their neighbors over the trading partners located outside their regions, is investigated in the literature both using static and dynamic theories of trade integration. Static Theory addresses the trade creation and trade diversion effects, while Dynamic Theory examines the effects of RTAs on growth determinants. Although this phenomenon is greatly researched, some significant yet undiscovered knowledge still demands further in-depth studies. The empirical knowledge is still inconclusive on several areas: whether non-converging political factors hinder intra-regional trade or vice versa; what are the specific macroeconomic factors that the effects of RTAs may spillover; what are the specific channels through which a RTAs may influence economic growth of member countries; and moreover, whether South Asian trade integration arrangement, SAFTA, depicts aforementioned economic effects. Therefore, this study attempts to fill the above literature gap by more explicitly investigating the effects of SAFTA subject to both static and dynamic theories of trade integration.

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