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# Regional Trading Arrangements (RTAs) in the World and Asia: Options for India

Regional trading arrangements (RTAs) and bilateral free trade agreements (FTAs) have become an important aspect of a country's trade policy. Over 300 RTAs or FTAs are currently in different stages of negotiations. An overwhelming proportion of world trade is now conducted on preferential basis within the FTAs and not on MFN basis any more. In this context, this Brief discusses the global trends in the regional economic integration, their motivations and implications for other countries. It then summarizes the emerging trends in regional economic integration in Asia and options for India.

## The Global Trends

The decade of 1990s is widely seen as the decade of globalization. However, a more striking trend of the 1990s was the emergence of strong RTAs in different parts of the world led by Single European Market by European Union in 1992 and North American Free Trade Agreement (NAFTA) in 1994.

These RTAs pursued a deeper type of integration covering preferential free trading arrangements complemented by strong rules of origin and mobility of capital (and some times even labour) across the region. The level of economic integration was progressively deepened and coverage of RTAs expanded over time. Thus EU progressively evolved into an economic union and then a monetary union with a single currency while expanding the membership to cover 25 countries. NAFTA is expanding southwards into a Free Trade Area of the Americas (FTAA).

## Motivations for RTAs

The trend of 'new regionalism', as the phenomenon is described to distinguish it from the earlier wave of shallow regional economic cooperation, was motivated by the desire of major developed countries to strengthen the competitiveness of their industries in the context of completion of the Uruguay Round of trade negotiations. The major motivation was not promotion of intra-regional trade as is commonly understood. The deeper regional economic integration was to facilitate restructuring or rationalization of industry across the region on the most efficient basis so as to exploit the economies of scale and specialization. The Cecchini Report commissioned by the European Commission which provided the basis for the White Paper on the Single European Market had empirically established that the European economies were losing substantially in welfare terms by not cooperating between themselves.

The formation of RTAs in the developed world has led to a substantial restructuring of industry. For instance, Unilever decided to make all its dishwasher powder meant for European market at its Lyons (France) plant and all its toilet soap for Europe at Port Sunlight (UK) following the formation of Single European Market in preference to smaller plants catering to each individual market in the entire range of products. Regionalism also helped the member countries to protect their industry from external competition by imposing common external tariffs and strong rules of origin. Japanese companies supplying to the EU and NAFTA markets had to shift their production to the respective regions in order to comply with the 'screw driver regulations' or the strict rules of origin.

The studies on the existing RTAs have shown that in the deeper type of integration pursued by them the biggest beneficiaries are relatively poorer or lesser developed economies because of migration of industry to them helping their economy converge with those of more developed ones. It is evident that poorest economies of EU, viz. Spain, Portugal, Greece and Ireland have rapidly converged with more developed economies of the region such as Germany, France or

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the UK. The other benefits of RTAs are political coherence arising from the growing interdependence.

## Implications for Non-member Countries

The formation of region wide trading blocs by major trading nations of the world has implications for all other countries. Studies show that RTAs have emerged as major factors in determining the patterns of trade and investments. They make RTA members more attractive destinations of investments and more competitive partners in trade at the disadvantage of non-members. Therefore, non-member countries have to respond by building their own RTAs lest their competitiveness for trade and investment is eroded. Therefore, RTAs have become an important part of a country's strategic trade policy. The countries which are vigorously pursuing RTA/FTAs policy are also the ones which keep preaching to others the virtues of multilateralism to keep their edge gained by regionalism. Having built up their strong RTAs, the western countries are now trying seek a moratorium on RTAs to protect their edge.

The prescription of the conventional trade theory that multilateral or unilateral trade liberalization is the most optimal policy response is not valid any more if your major trading partners are pursuing preferential regionalism. Therefore, other regions responded by forming their own RTAs such as MERCOSUR and Andean Pact in South America, and COMESA and SADC, SACU in Sub-Saharan Africa. Currently some 300 RTAs or bilateral FTAs are at different stages of implementation in the world.

As a result of the emergence of these RTAs, more than 50 per cent of the world trade is now conducted on preferential and not on MFN basis. Therefore, any region can ignore formation of its own scheme of regional integration only at its peril as its exports would face discrimination against those of trade bloc partners. The developing countries do not need to be defensive in pursuing regionalism as they are only reacting to a trend started by developed countries which are their major trade partners. Furthermore, in so far as it leads to trade liberalization, regionalism by developing countries should be viewed as a building block of multilateralism rather than a stumbling block.

## Some General Principals for RTAs/ FTAs

RTAs/FTAs are most fruitful when the partner economies have complementary economic structures, factor endowments and capabilities. Attention also needs to be paid to the potential of the partner country for expanding a country's exports.

In general, RTAs involving more than two partners are more fruitful than bilateral FTAs. This is because range of complementarities is extended and they present broader opportunities for industrial restructuring. However, RTAs are generally less ambitious and take longer to take off compared to bilateral FTAs because of involvement of countries at different levels of development.

Generally, FTAs are more fruitful for relatively poorer partners than the richer ones. For this reason, economically it is better (for to engage richer countries India) such as the East Asian countries that can benefit India rather than with poorer countries who will benefit from integration with India. However, political considerations may justify some FTAs with poorer countries.

In any FTA/RTA, there will always be certain sectors that may be adversely affected. However, safeguards are available for protecting these interests such as negative lists, tariff rate quotas, rules of origin. Some time longer phase out may also be agreed to give time to the local industry to adjust.

## RTAs and Trade Policy in Asia

Asian countries that had continued to follow multilateralism all along very faithfully had begun to respond to the trend of regionalism towards mid-1990s. The East Asian Crisis of 1997 provided a much needed stimulus for regional economic integration in the region. The ASEAN countries expedited the programme of implementation of ASEAN Free Trade Area (AFTA) from 2008 to 2002 and moved on to further deepen the economic integration. The crisis also led to launch of several regional initiatives such as the Chiang-Mai Initiative which brought together ASEAN plus three (Japan, Korea and China). Japan and China began to look at the RTAs more seriously as a part of their trade policy. Japan signed a bilateral FTA with Singapore in 2002. China signed a Framework Agreement for FTA to be implemented within ten years with ASEAN in 2002. ASEAN plus three countries began to explore formation of an East Asian Economic Community besides many bilateral arrangements. Asia has therefore finally woken up to the importance of regional economic integration for its development and to respond to the challenge thrown by the worldwide trends.

## India's Approach to RTAs in Asia

India's first brush with new age preferential trade arrangements was a bilateral free trade agreement signed with Sri Lanka in 1998. Initially it attracted a lot of resistance from different pressure groups such as domestic tea industry, copra industry, garments industries, among others. However, safeguards in the form of tariff rate quotas were built in the Agreement. The Agreement which became effective from April 2000 has led to a healthy expansion of mutual trade in a more balanced manner. More significantly it has prompted a significant wave of Indian investments going to Sri Lanka to exploit synergies. For instance, an Indian tyres company set up a large export-oriented tyres plant in Sri Lanka to cater to its growing markets in Pakistan, Middle East and other countries taking advantage of abundant supply of natural rubber in the country. Sri Lanka attracted Indian investments of US$ 145 million in a very short period making India as the third largest source of investments for the island. The encouraging experience has prompted Sri Lanka and India to consider expanding the scope of the FTA to cover investments and services in a comprehensive economic partnership agreement (CEPA). The apprehensions that existed at the time of signing of the Agreement have all but vanished.

## SAFTA and BIMSTEC FTA

Prompted by the worldwide trends and the successful experience of India-Sri Lanka bilateral FTA, South Asian countries have signed the Agreement on South Asian Free Trade Arrangement (SAFTA) in January 2004, setting aside their earlier reservations. The outlook for regional free trade brightened further with the signing of the Framework Agreement for BIMST-EC FTA in Phuket in February 2004 at the Ministerial Meeting of the grouping combining initially Bangladesh, India, Myanmar, Thailand, Sri Lanka and now Bhutan and Nepal as well.

Regional economic integration in South Asia is desirable as it has the potential to exploit their considerable synergies and complementarities for their mutual advantage. The economic interdependence and prosperity that it will generate also has the potential of fostering lasting peace in the region. SAFTA or BIMSTEC could create great market access opportunities for other South Asian countries by giving duty free access to much larger market of India. For India, which constitutes about 70 per cent of the combined SAARC market, the gain in terms of market access arising from SAFTA or BIMSTEC may not be substantial, however. A country of India's size and aspirations has to look beyond its immediate neighbourhood to seek economic opportunities while consolidating the South Asian economic integration. It was with this objective perhaps that India adopted the Look East Policy in 1991.

## Look East Policy and ASEAN

India's Look East Policy adopted in 1991 has involved increasing engagement with ASEAN and other East Asian countries. With rapid growth sustained over the past decade East Asia were emerging as the most dynamic region in the world. Besides geographical contiguity, we had shared centuries old cultural bonds with the region. The economic structures of East Asia with substantial hardware and manufacturing prowess and India's emerging strengths in services and software seemed complementary. This complementarity is evident from a one and half times rise in East Asia's share in India's trade since 1991 to about 33 per cent making it India's biggest trade partner is nothing short of a revolution. East Asia became an increasingly more important source of FDI for India as well. China, South Korea and ASEAN countries have emerged among India's most dynamic trade partners in the world. Therefore, East Asia is the obvious choice for economic integration.

As a part of the Look East Policy, India started to engage ASEAN and became its sectoral dialogue partner in 1992. With the entry of Myanmar, ASEAN also became a contiguous neighbour of India. ASEAN also seemed to be like a bridge for India's economic dealings with the East Asian countries given its vibrant economic relationship with Northeast countries of Japan and South Korea. The Partnership with ASEAN evolved steadily to full dialogue partnership in 1995 and an annual Summit-level interaction since 2002. In 2003, India signed a Framework Agreement for Comprehensive Economic Cooperation involving an FTA to be implemented over a ten-year period. India's Framework Agreement with ASEAN is usefully complemented by bilateral and sub-regional attempts towards economic cooperation including bilateral agreements with Thailand and Singapore, subregional initiatives such as BIMST-EC and Mekong-Ganga Cooperation (MGC). India is jointly studying feasibility of FTAs with China, Japan, Korea, and Malaysia. As a part of the same Look East Policy, India had also tried, unsuccessfully though, to seek membership in Asia-Pacific Economic Cooperation (APEC) in the mid-1990s.

## Asian Economic Integration: Options for India

East Asian countries are also moving ahead to form an East Asian Community (EAC) with Japan taking a lead role. An East Asian Summit has been planned in late 2005 to launch EAC. EAC has the potential of evolving into a trade bloc comparable to EU or NAFTA and is thus likely to be the third pole of the world economy. India needs to actively participate in this process of East Asian economic integration while consolidating the plans of integration with South Asian and East Asian countries bilaterally or sub-regionally under different initiatives. Inability to be a part of a major regional grouping emerging in the neighborhood can be detrimental to India's interests by diverting trade and investments away from it.

ASEAN Foreign Ministers at their April 2005 meeting in Cebu, have paved the way for India's participation in the first East Asia Summit (EAS) to be held in December 2005 in Malaysia. EAS is likely to launch the process of formation of an East Asian Community (EAC) combining the ASEAN10, Japan, China, India and S. Korea with possible participation of Australia and New Zealand as well, combining 14 (or 16) major Asian economies of Asia, half of world's population, two thirds of world's reserves and combined output larger than EU and trade greater than NAFTA.

With the Cebu mandate, the proposed EAC combining ASEAN+3+India would be close to the vision of the Prime Minister Dr Manmohan Singh of building an Asian Economic Community (AEC) to begin with Japan, ASEAN countries, China, India and South Korea (JACIK). EAS can eventually evolve into an even broader Asian Economic Community combining other South Asian, West Asian and Central Asian countries in a phased manner. Seen this way, the EAS will be an important building bloc or an intermediate stage of the AEC as envisioned by the Indian PM.

India's participation in EAS fits well with the Look East Policy vigorously pursued by India since 1991. A conscious strengthening of economic links with ASEAN and the East Asian countries over the past decade has led to the emergence of East Asia as India's largest trading partner. There are many reasons why a greater economic integration with East Asia would be mutually beneficial for India. East Asia combines some of the world's largest and fastest growing economies and is widely seen as the emerging center of gravity of the world economy. A number of these economies such as Japan and Korea, are facing increasing shortages of working age trained manpower due to demographic transition taking place. India with its vast pool of trained work force will be well placed to take advantage of these opportunities. On the other hand, India could bring its own synergies and dynamism to the grouping. A number of ASEAN+3 countries also want India to play an active role in formation of EAC and make it more balanced.

EAC is also likely to bring substantial benefits for the region and the participating countries. By bringing all the major countries in a single bloc and increasing their economic interdependence, the Community is likely to promote peace and stability in the region. It can also become an engine of growth. RIS studies have shown that economic integration among JACIK countries has the potential to generate welfare gains of upto US$ 210 billion. In addition, monetary and financial cooperation in Asia designed to mobilize the foreign exchange pools of Asian countries for development of regional commons or regional infrastructure has the potential of creating hundreds of billions of dollars of additional output. Therefore, as the Indian Prime Minister has argued, such a grouping could really be 'an arc of advantage' and 'an anchor of stability and prosperity for Asia and beyond.'

All the major countries of Asia are also busy evolving preferential trading arrangements between themselves. For instance, all the full dialogue partners of ASEAN namely China, India, Japan, and Korea are evolving FTAs with ASEAN. Japan, Korea and China are studying a trilateral FTA besides a study of the ASEAN+3 FTA conducted by East Asia Vision Group. It has been shown by RIS studies that these bilateral FTAs are sub-optimal and do not allow the region to reap the full benefits of regional economic cooperation which could be substantial. There is a need for building a broader regional architecture coalescing these sub-regional and bilateral attempts. This broader regional trade and investment architecture could facilitate efficiency-seeking industrial restructuring of the industry and take advantage of their synergies for mutual advantage. The synergies or complementarities between Asian countries are obvious from a high share of intra-regional trade that has approached 45 per cent. Since India has already started evolving an FTA with ASEAN and has agreed to study FTA type arrangements with other three members of EAS viz. China, Japan, and Korea we should favour a broader East Asian preferential trading arrangement covering trade in goods, services and investments. In any case a broader trading arrangement covering 14 economies at diverse levels of development would necessarily evolve slowly and less ambitiously than bilateral deals giving to Indian industry time for adjustment.

For India, participation in EAC could have significant strategic spin-offs as well. For instance, participation in a much larger and dynamic grouping would reduce dependence on South Asian countries for economic integration. SAARC (and BIMSTEC) tend to move slowly due to resistance in the immediate neighborhood against perceived domination of the groupings by India. In fact, emergence of EAC may prompt South Asian neighbors to hasten their economic integration with India and eventual entry into a broader AEC.

In the current age of regionalism, different countries are signing multiple agreements and are vying with each other to emerge as hubs. With its excellent trading and transport links and emerging preferential trading arrangements with South Asian countries, GCC and West Asian countries, India could emerge as a hub between East Asia on the one hand and South, West and Central Asian countries on the other.

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