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Trade Liberalisation as an Instrument for Regional Co-operation

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South Asia is home to nearly 1.4 billion people, a vast part of humanity. The countries in the region vary widely in the size of the population as well as area and physiography. On one side of the scale is India with a population of more than a billion while on the other side is Maldives with a population no more than half a million. There is Bangladesh which is essentially a flat delta, island countries such as Sri Lanka and Maldives and countries full of high rise mountains such as Nepal and Bhutan. In between are India and Pakistan with some of everything. While there are several such external differences among the countries in the region and their people, these are literally only skin-deep. The people in the region share, by and large, the same basic culture. In many cases the same or a similar language is spoken across the borders. There are, of course, local variations in the general pattern. But that diversity makes it all the more interesting and attractive. It is only natural that the countries of the region will band together to show a united face to the world. This is yet to happen, though.

The legacy of colonial rules and history and politics since the departure of the British, have created a kind of gulf among the South Asian nations. To be sure there are certain beneficiaries of the present tension in each country who would want the state of mistrust to continue to profit from it. However, the interest of the vast citizenry in all these countries is little served by this atmosphere of conflict, explicit or hidden. And they, by and large, want this state of tension to be replaced by one of harmony. This is the reason why the leaders of the countries in the region have finally agreed and established the SAARC, the regional political framework, to work towards the creation of a harmonious relationship through regional cooperation.

There are various spheres of activity for fostering regional cooperation. SAARC has been working, with different degrees of success, in some of them. The degree of success depends among others on the interest of the countries involved as

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well as their institutional and resource capabilities to manage the issues in a coordinated manner. On the other hand, whether or not a country is interested to resolve an issue in association with others depends on their perceived benefit from such collaboration. One area where success so far had been limited is economic integration through trade liberalisation.

There had been attempts to first create a preferential trading arrangement and later to create SAFTA, South Asian Free Trade Area. The latter was expected to come into effect in 2002. But the “entrepreneurs” in the region are apparently so scared of competition from each other that they are more interested in perfecting or lengthening their negative (euphemistically called the “sensitive”) lists when the negotiations take place. The recent meetings of the officials of the SAARC countries and the members of their chambers had been no exception. The original launching date has been missed since long and the count down to a revised launching date of SAFTA in 2006 has begun. But there will be more meetings between now and then to smoothen the wrinkles (such as the rules of origin and of course the “sensitive” lists) that still exist. We, the ordinary citizens, keep our fingers crossed and can only wait for a positive outcome.

Of course, not all the arguments raised about this or that proposal by this or that country against or for its inclusion in the SAFTA statutes are without valid reasons. Many of you know about this very well and I do not wish to repeat those here. What I would like more to point out is the several directions regarding trading arrangements that the South Asian countries are being pulled to at the same time creating a situation of confusion in finding the optimal mix of policy actions for most, if not all, of them. This I shall discuss in a short while.

There is another issue which so far, according to my limited knowledge, has received apparently little attention either at the academic or policy circles, at least in my country. There is little understanding about how domestic policies may interact with the efforts at trade liberalisation and regional cooperation to strengthen their perceived positive impacts. I would argue that it is the optimal mix of domestic and external policies such as trade liberalisation which can provide the greatest benefits to the countries in the region. Each one standing alone can only result in limited positive impact.

Returning now to the issues related to trade liberalisation, we first observe that globally there is the WTO framework, its rules and procedures which are still evolving and some times have become a bone of contention between various groups of countries. South Asian nations are not immune from them. While SAARC predated WTO, its trade-related initiatives such as SAFTA are now circumscribed by the wider WTO rules. How do these compare with each other in their potential impact on the countries concerned?

There are now also the bilateral free trade agreements between some of the pairs of countries while at the same time some of them are also members of other

regional trade arrangements (apart from that under SAARC). In addition, some of them are also members of powerful lobbies (such as G 20) created to influence and/or amend WTO rules. Such a situation resembles a spaghetti-bowl of tangled interests.¹ How do these fit in with either the South Asia's own regional framework of trade initiatives, or the WTO?

In South Asia, there is an added complexity. Three of the SAARC countries are LDCs. Within the SAFTA agreements that have been worked out so far, these countries are expected to have a much longer time frame to liberalise their trade within the region. Also, under WTO rules, they are exempt from many of its strictures. How are their (LDCs) interests to be protected when some other countries within the region become members of groups (such as India and Pakistan in G 20) whose demands, if met, may not be entirely in the interests of the LDCs in the region? And we now also hear of India offering preferential access to products from LDCs in general. Untangling the web of interests and their net impact on any one of the economies in the region becomes a policy-maker's as well as a trade analyst's nightmare. But unless this is done, we may not know where a country's best interests lie, now or in the medium to long run. At the minimum what needs to be done is to find a common denominator/premise from among all these complex agreements and talks towards agreements to make life somewhat simpler.

The differences in perceived impact on the South Asian countries of the regional cooperation in trade emanate among others from the fact that the levels of development in the SAARC nations are not similar, nor are they growing at the same rate. India's GDP, for example, had grown at just about 6 percent per year over the decade of the nineties while that of Pakistan had grown at a far slower rate of 3.7 percent. Bangladesh GDP over the same period has grown at rates of around 5 percent. In more recent years, the smaller economies of Sri Lanka, Nepal and Bhutan have grown at rates above 6 percent. Furthermore, their economic policies over time have been quite different making the benchmark situations from which they are beginning the attempted cooperation are also substantially at variance with each other. Such differences in the initial conditions may mean that the impact of regional cooperation, even when positive for every nation, are not going to be shared equally by all.

Allow me to elaborate a little on this last issue. I will focus here more on agriculture as this has become the most contentious issue in the WTO deliberations including issues related to agricultural trade liberalisation as well as support to agriculture which are also partly responsible for the emergence of groups such as G 20. In doing this, I shall confine myself mostly to Bangladesh, India and Pakistan. In Bangladesh the reform measures encouraged by the Breton Woods Institutions started in the mid-1980s in agriculture. Subsidies on agricultural inputs were more or

¹Bhagwati, J. and A. Panagariya (eds.) (1996) *The Economics of Preferential Trade Agreements*. Washington, D. C.: AEI Press.

less completely withdrawn over years, privatisation of inputs supply was introduced and in general prices were deregulated. Furthermore, many of the restrictions related to import and purchase of irrigation equipments were withdrawn. By the beginning of the 1990s, this process of withdrawal of support from agriculture was by and large completed. Such a withdrawal of support to agriculture has not, to my understanding, happened in any large measure in India till now. In Pakistan, too the process has been much slower. It must be noted here that under the present WTO rules Bangladesh is under no obligation, as an LDC, to withdraw input price support from agriculture. Yet, even the allowable support under the so-called Green Box was rather insignificant in recent years, 1-2 percent of the value of agricultural output. Of late, however, some of these supports that fall under the WTO's Amber Box (i.e., restricted under its rules) such as subsidy for fertiliser and cheaper fuel for irrigation pumps have been reintroduced in a small way.

Similarly, Bangladesh has initiated large scale reforms to liberalise trade. She slashed her tariffs drastically during early 1990s. Since then the pace has slackened but still the trend remained downwards. For example, over 1991-92-1995-96, the unweighted average customs duty adjusted for tariff exemption and concessions fell from 57.5 percent to 22.6 percent. By 2004-05, the rate further fell to 13.5 percent. When the degree of openness is considered, both Bangladesh and India have become more open by the turn of the century while Pakistan appeared to have faltered. By and large, the countries in the subcontinent mainland have still quite some way to go to make the whole system transparent and as little distortive as possible.

Now let us take a look again at agriculture. In all the countries the share of agriculture has fallen substantially. Yet, even now more than one-half of the labour force is employed in agriculture. The highest is for Nepal at nearly 97 percent followed by India at 61 percent. The lowest share is for Sri Lanka which is 40 percent. It is thus very likely that agriculture will remain the source of livelihood for the largest single group of people in these countries for many years to come. With the livelihood of so many millions at stake, policy-makers have to be pro-active when it concerns agriculture.

There are two types of issues related to agriculture. How agriculture may grow will determine to a considerable extent the future food security in the developing countries and certainly in much of South Asia.² Ensuring victory in the war against hunger will necessitate continued technological progress in agricultural production. The mid-sixties saw the beginning of such a war but its outcome so far remains inconclusive as millions upon millions of people still go to sleep every night with empty stomachs in South Asia.

²Of course, the issue of food security is not simply about national aggregate availability, but more about its distribution between regions, between households and within the household. The ultimate food security of an individual is an outcome of a complex interaction among economic, social and cultural factors as well as of individual preferences.

The second issue relates to the impact of trade liberalisation on livelihood of peasants. While trade liberalisation may cheapen the cost of food to consumers through imports, it may also lead to loss of livelihood and consequent misery to millions of marginal and small peasant households. The imports also have to be paid for in foreign exchange. A better strategy would therefore be to support agriculture as much as possible or allowable and thus minimise the costs of adjustment. What support to provide domestically to agriculture to help it grow and withstand the pressure of competition from others within the region and outside thus has a bearing upon the outcome of attempts at trade liberalisation. The issue of domestic support to agriculture assumes particular importance because of the heavy protection given to agriculture in one way or other by the OECD countries which never tire in preaching the virtues of free market to others. The playing field consequently is globally quite uneven.

The total support provided to agriculture in the OECD countries in 2001 was a whopping US\$ 311 billion. Support provided to producers was US\$ 231 billion. In 2000, it was somewhat higher at US\$ 241 billion. Of this, Aggregate Measure of Support (AMS) was 63 percent. EU tops the list in providing the farm support. Of the total producers support, EU provided 40 percent of the total. The respective shares of USA, Japan and Korea had been 21, 20 and 7 percent.

The support to farmers in these countries is such that in Switzerland, Norway, Korea and Japan for every one hundred dollars of farm earning, 60-70 dollars is a hand out from the government. In EU, it is 35 dollars while in the USA and Canada these are lower at around 20 dollars. In some countries such as Norway, Japan and South Korea the level of support provided to agriculture more or less matched its (agriculture) contribution to GDP in those countries.

Naturally in such a situation, the farmers in developing countries including those in South Asia expect tremendous unfair competition from OECD agricultural producers in selling their goods in the export market as well as in the domestic market. No wonder that much of the present global debates related to trade, and even violent street demonstrations have taken place over the issue of dismantling the support structure to agriculture in the OECD countries.

Question now is what happens when trade is liberalised under such a condition? Does it result in net additional welfare for the people?

To answer some of these questions certain general equilibrium modeling exercises have been carried out in our Institute. While models do only imperfectly capture the reality, they have the advantage of highlighting its (reality) essential features. Then again a general equilibrium model can indicate factors that can compound or negate the initial effects of a policy measure. The exercises were, of course, done to find out the impacts of policy shifts mainly in Bangladesh, not elsewhere within the region. But for some of the exercises, the results are also shown for all the countries in the region.

The very first exercise was what happens if the trade all over the world is carried out at zero tariff and all non-tariff barriers are absent. This, of course, according to neoclassical theory, would be the most welfare-raising situation. And indeed it is so. The net additional welfare of Bangladesh over the present situation is estimated at US\$ 2 billion. SAFTA alone with complete removal of trade restrictions is not much helpful as the change in welfare (US\$ 111 mn) is only 5 percent of that under completely free global trade. But if SAFTA is combined with a uniform tariff (of 15 percent) against the rest of the world i.e., a kind of South Asian customs union is formed, this results in substantial positive welfare change (US\$ 953 mn). This is still only one-half as much as that under global free trade, though. However, if Bangladesh and India forms a bilateral free trade area, the gains in welfare (US\$ 120 mn) is somewhat more than that under normal SAFTA (i.e.; without the customs union).

These results assume that SAFTA ultimately leads to complete free trade within the region. This is not going to happen even if SAFTA is launched next year. That means that its impact will be much less than what the model results indicate.

Consider now what would happen if Bangladesh provides fertiliser subsidy to the tune of 1 percent of the value of her agricultural output. This results in a boost to agricultural exports and fall in agricultural imports, and rises in output and employment. For SAFTA (without customs union arrangements) the welfare change is doubled to almost US\$ 257 mn. Even for the globally free trade, provision of subsidy results in an additional US\$ 100 mn gain. Again for bilateral trade with India, the welfare changes are doubled. So are for employment changes. In case of GDP change, the effect is much stronger, almost 3 times.

Since Cancun, the Group of 20 which includes India and Pakistan from the region has been pressing for withdrawal of agricultural subsidy by the OECD countries for creating a level playing field. This apparently does not take into account the possibility of harm to countries which may have to import food or essential agricultural commodities from some of these OECD countries. Indeed, one of the simulations in the model which assumed 50 percent reduction in subsidy in the Quad (EU, USA, Canada and Japan) results in a net welfare loss for all countries in South Asia, a substantial part of which was due to terms of trade effect.

The loss to Bangladesh accrues mainly due to liberalisation by EU. Of the total loss 70 percent is due to EU liberalisation. The breakdown of the welfare loss into its components shows where it bites. One half of the loss is due to lower employment of unskilled labour while about a third is attributed to terms of trade effect that is higher import prices compared to export prices of farm products. And here, if Bangladesh provides a little subsidy, as explained above, it can do wonders. In this case where Bangladesh provides a little subsidy, farmers get a boost from two sides. The prices rise for their products due to a withdrawal of support in the Quad while domestically support by the government lowers their costs of production. The

over-all results are thus all positive and the country takes part more vigorously in trade.

Consider now another experiment. What would happen if technological change takes place in Bangladesh agriculture? If factor-neutral technological change takes place, up to 10 percent in 10 years time, the gains to the country becomes twice as much as that under globally free trade. If the technological change is 20 percent over 10 years which is quite plausible given the country's historical experiences, the net welfare gain is US\$ 9.3 bn or almost 4 times that under globally free trade. Note that we have assumed here the present pattern of trade. If there is freer trade, the net positive effect is likely to be further enhanced.

Where do all these simulation results leave us? Given the caveat against model-building, and that the assumptions may not always hold, these results tell us a very clear story. Free trade, regional cooperation, trade facilitation measures are all good and beneficial. Trade liberalisation and regional cooperation alone, however, will not be able to ensure income, food security and quality livelihood to the millions of deprived human beings in South Asia. The efficacy of these measures are, however, enhanced substantially, some time dramatically, by the adoption of suitable domestic policies and their implementation such as providing support to agriculture where these are needed in a judicious manner as well as appropriate technology policy. Indeed, without the bedrock of sound domestic policies, the edifice of regional cooperation through freer trade will bring only limited benefit to the people in South Asia. Regional cooperation therefore will also mean harmonisation of these national domestic policies so that these do not conflict with each other and negate their positive effects. I wonder whether South Asia is ready for such a change!