The Presidential Address

Exploring Pakistan's Regional Economic Cooperation Potential

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Free trade benefits are not well-harnessed despite the WTO because of the regional groupings. Such groupings have, in fact, resulted in a chaos. Pakistan has been a member of the SAARC and the ECO. In both the groups, intra-regional trade accounts for only four percent of total trade. The present study briefly reviews and identifies constraints to intra-regional trade and other modes of economic cooperation in the region. The SAFTA agreement and the possibilities of greater economic cooperation are also examined. Comparative advantage and low trade complementarity are found to be the main impediments to trade. Other obstacles such as limited capacity to generate exportable surpluses, restrictive trade policies, and political problems have also inhibited the growth of intra-regional trade. Higher trade levels can be achieved through intra-industry trade, vertical specialisation, joint export marketing of competing regional export products, deepening trade liberalisation, promoting monetary cooperation, and encouraging joint industrial ventures. It is imperative for the success of SAFTA that the negative list is kept quite small and the countries are prepared for closure of a few industries. Thus the SAFTA has great potential and South Asian countries should accept short-term costs for long-run benefits. Expansion of trade as well as efficiency and improved quality of exports would benefit the countries participating in the regional co-operation effort.

I. INTRODUCTION

Despite the GATT and now the WTO, regional trade arrangements have proliferated, resulting in what Bhagwati (1995) calls a "Spaghetti Bowl" of tariffs. The member countries apply different rates of tariffs on products imported from member and non-member countries and deny the advantages of free trade to the non-member countries. Free trade intentions of the regional trade arrangements, therefore, may have resulted in a chaos and thus the impact of regional arrangements on the welfare of member countries and the world at large has been widely debated [see for example, Viner (1950); Meade (1955); Lipsey (1957);

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Corden (1972); Kemp and Wan (1976); Kowalczyk (1990); Bhagwati (1971, 1993); Melo and Panagariya (1993); Anderson and Blackhurst (1993); Baldwin and Venables (1995); Bhagwati and Panagariya (1996); Srinivasan (1993, 1997); Vamvakids (1998); Bhagwati, Krishna and Panagariya (1999); Clausing (2001) and Panagariya (1999, 2000)].[1]

Pakistan is a member of two regional groupings, viz., the South Asian Association for Regional Cooperation (SAARC) and the Economic Cooperation Organisation (ECO), but none of the two has been successful in promoting intra-regional trade in a significant way. Despite the preferential treatment, intra-regional trade has been around 4 percent of the total trade in both the ECO and the SAARC. The Islamabad SAARC Summit Declaration promises the South Asian Free Trade Area (SAFTA) by 2015, and is expected to promote economic cooperation amongst the South Asian countries. The ECO has also taken important initiatives for the promotion of economic cooperation.

The lack of success in promoting trade in both the regions despite the agreements and pronouncements at highest levels reflects the ambivalent attitude of the member countries towards regional cooperation. While South Asian Preferential Trade Agreement (SAPTA) and Framework Agreement for Trade Cooperation (FAT) were signed during the last decade, most of the member countries are still reluctant to grant preferential treatment to the products of export interest to the member countries.

The success of regional integration, preferential treatment, free trade area or a custom union, depends on a number of factors, and most important of which are the pattern of comparative advantage, extent of trade complementarity within a regional trading bloc and tariff rates on the products of export interest of the member countries.

Intra-regional trade is promoted in situations where members have comparative advantage in diverse products and exhibit strong trade complementarities. On the other hand, prospects of regional trade expansion are likely to be limited if the production and trade structures of member countries are characterised by identical pattern of comparative advantage and low trade complementarities.[2] However, various constraints may not allow the trade to flourish despite the comparative advantage and low transport costs. The constraints to possibilities of trade expansion and other modes of economic cooperation, therefore, need to be identified and resolved.

The present study briefly reviews intra-regional trade both in the SAARC as well as ECO and identifies constraints to intra-regional trade and other modes of

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[1]For an excellent survey of regional trade arrangements, see Panagariya (2000).

[2]Obviously if trade is opened up, there are possibilities of changes in comparative advantage and a large number of products not traded now may be traded.

economic cooperation. Brief review of the literature of regional cooperation and its implications is presented in Section II. The levels and patterns of intra-regional trade are examined in Section III. Constraints to intra-regional trade especially the trade complementarities, revealed comparative advantage and intra-industry trade are analysed in Section IV. The possibilities of investment and joint ventures are analysed in Section V. SAFTA agreement and possibilities of greater economic cooperation are examined in Section VI. Main conclusions are summarised in Section VII.

II. REGIONAL COOPERATION AND ECONOMIC WELFARE

Regional arrangements may take various forms including:

(i) *Preferential Trade Area:* Preferential treatment is granted to the member countries in the form of reduction in the import duty on their exports.

(ii) *Free Trade Area:* Imports are allowed duty-free from the member countries, but each country individually determines the level of tariffs on the non-member countries.

(iii) *Custom Union*: Besides allowing duty-free imports from the member countries, uniform tariff is imposed on the imports from the non-member countries.

(iv) *Economic Union*: Besides the duty-free tariffs on member countries and uniform tariff for the non-member countries, factors of production move freely across the member countries. Moreover, it has uniform competition policy and all other measures aimed at strengthening of market mechanism; common policies for structural change and regional development; and macro-economic policy considerations including binding rules for budgetary policies. The countries may have the same currency as well.

Viner (1950) was the first one to examine the impact of regional groupings on the welfare and introduced the concept of trade creation and trade diversion. However, he made restrictive assumptions of zero demand and supply elasticities. Subsequently Meade (1955) relaxed the assumption of zero price elasticity of demand and Lipsey (1957) relaxed the assumptions of zero supply elasticity as well. The main conclusion of these studies has been that if trade creation and trade expansion exceeds the trade diversion, regional integration would be welfare-promoting and vice-versa. The analysis presented by Viner, Meade and Lipsey has been static and it has been argued that dynamic advantages are much higher than the static advantages.[3]

[3]See for example, Bhagwati (1993); Helpman (1995); Baldwin and Venables (1995); and Srinivasan (1997).

Changes in the welfare due to preferences granted to member countries[4] depends to a large extent whether the most efficient producer of a particular product in the world is part of the group or not. If the efficient producer is part of the group, economic integration would always be welfare promoting. However, if the efficient producer is outside the group the impact on welfare will be uncertain and depends on a number of factors. Firstly, the trade diversion would result in lower level of welfare. Second, even when the most efficient producer is not part of the regional group, trade creation possibilities still exist. If prior to the forming of regional block, tariff was prohibitive, trade would be created as long as preferential tariff is not prohibitive. Third, the static analysis underestimates the benefits and it is generally believed that the major benefits of forming trade blocs are dynamic. Regional grouping results in specialisation in accordance with comparative advantage and the scale economies would result in reduction in costs of production and that is welfare improving. During 1980s and 1990s, most of the work in this area has been towards examining the dynamic effects of trade blocs. See for example, Bhagwati (1993); Bhagwati and Panagariya (1996); Levy (1997); Krugman (1993) and Srinivasan (1991). Fourth, Wonnacott and Lutz (1989); Summers (1991) and Krugman (1993) have espoused "Natural Trading Partner" hypothesis and conclude that more the two countries trade with each other relative to the outside world, the less likely that a union between them will be harmful.

Do the regional groupings bloc movement towards free trade? Bhagwati (1993) and Bhagwati and Panagariya (1996) examine the issue on the basis of two alternative assumptions, viz., regional and multilateral processes do not interact and proceed independently and formation of regional blocs makes the success of the multilateral process more, or less likely. They conclude that regional blocs are an unnecessary nuisance in the way of trade. Similarly, Levy (1997) suggests trading blocs make the multilateral trade less feasible. Moreover, it is suggested that feasible multilateral liberalisation becomes infeasible in case of differentiated products through if there are homogeneous products regional grouping do not block a previously feasible multilateral accord.

Various studies have examined impact of trade policies on the basis of changes in the trade share of intra-regional trade before and after the formation of regional blocs. Such studies implicitly assume that the share of trade with partner countries would not have changed in the absence of the agreement [see Krueger (1999); Cline (1978); de la Torre and Kelly (1992); Drysdale and Garnaut (1993);

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[4]Whether or not the partner countries and the world gains or loses depends on the pre- and post-tariff rates and the nature of agreement. Some authors, such as Krugman (1991, 1994), believe that preferential arrangements between natural trading partners are likely to be welfare inducing, the others, including Bhagwati (1994), fear that preferential trading arrangements may lead to trade diversion.

Robertson (1970); Saxonhouse (1994)]. However, the assumption may not be very realistic and, therefore, a more sophisticated counterfactual is necessary to assess the effect of an agreement on extent of trade creation relative to trade diversion.

Brown, Deardorff, and Stern (1992); Brown and Stern (1989); Haaland and Norman (1992) have used CGE simulations for the counterfactuals. However, CGE models are very sensitive to the assumptions, parameters, and data used to estimate them, and have to be interpreted accordingly. Simulations that provide the counterfactuals have suffered from manipulation of the structure of the model, functional forms and parameter values in these models [see Vamvakidis (1998) and Clausing (2001)].

For counterfactuals, gravity equations have also been estimated to assess the impact of preferential arrangements on trade flows. These equations have the advantage of including several variables that are affecting trade flows, such as income changes and exchange rate variables. A dummy variable is used to assess the impact of various preferential trading agreements on trade flows [see Frankel and Wei (1995); Frankel and Kahler (1993); Frankel (1997); Krueger (1999); Aitken (1973); George, *et al.* (1977); and Willmore (1976)]. However, the gravity model also suffers from various problems. Firstly, the dummy variables may not be capturing the effects of preferential trade liberalisation only and may reflect the impact of certain other variables. Second, they fail to distinguish the extent of trade creation relative to trade diversion. Third, trade flows are examined at a highly aggregative level and fail to examine the extent of trade liberalisation across goods or industries.

III. INTRA-REGIONAL TRADE IN THE SAARC AND THE ECO

Pakistan is part of both SAARC and ECO and despite the South Asian Preferential Trade Agreement (SAPTA) and Framework Agreement for Trade Cooperation (FAT) in ECO, the intra-regional trade in both the groups is around 4 percent (see Table 1). The preferential treatment has led to only a marginal increase in the share of intra-regional trade due to a number of factors. Firstly, negotiations under SAPTA and FAT have been conducted mainly on a product-by-product basis, which though allows some flexibility to each member country, is time consuming. Second, the depth of tariff cuts offered under the two has not been very substantial. For example, India has offered the preferences on a large number of products and the margins have been the maximum but its MFN rates have been higher than those of its partners, and as such concessions had very little impact. Third, actual trade coverage of the preferences has been limited; most of the products to which concessions were given are not widely traded in the region. Fourth, confining solely to the tariffs and leaving para-

Table 1

Intra-SAARC Trade

($ Million)

	Intra-SAARC Trade	World Trade of SAARC Countries	Share of Intra-SAARC Trade in World Trade of SAARC Countries
1980	1210	37885	3.2
1985	1054	44041	2.4
1990	1584	65041	2.4
1995	4228	104159	4.1
1996	4914	111479	4.4
1997	4390	115961	3.8
1998	6073	121331	5.0
1999	5640	129738	4.4
2000	5884	141978	4.1
2001	6537	139585	4.7

Source: Weerakoon and Wijayasiri (2003).

tariff and non-tariff measures out of the purview of negotiations has also been one of the factors in constraining the growth of intra-regional trade. Fifth, high local content criterion has also acted as one of the constraints.

Whereas intra-regional trade on an average in SAARC is rather low, the shares differ both across countries and for the import and exports. Shares of intra-regional imports were 33.2, 11.7, 10.1, 2.3 and 0.7 percent of the total imports of Nepal, Bangladesh, Sri Lanka, Pakistan and India respectively in 2000. Moreover, share of the regional imports in case of Bangladesh quadrupled, that of Sri Lanka increased by almost one half, those of India and Nepal have marginally increased, and that of Pakistan shows some fluctuations but there seems to be an increasing trend over 1985-2000 period (see Table 2). Trends in intra-regional exports reveal a different picture (see Table 3). For instance, share of Bangladesh has gone down from 7.7 percent in 1985 to 1.6 percent in 2000, of Nepal from 38.3 percent to 30.0 percent, of Sri Lanka from 3.8 to 1.8 percent and of Pakistan from 5.3 percent to 2.9 percent. However, that of India increased from 3.3 percent in 1985 to 4.4 percent in 2000. [For details see Kemal, *et al.* (2002)].

Table 2

Percentage Shares of Intra-regional Imports in Total Imports

Year	Bangladesh	India	Nepal	Pakistan	Sri Lanka
1985	3.46	0.69	32.43	1.59	6.17
1986	3.57	0.49	32.44	1.75	7.64
1987	4.28	0.5	18.8	1.61	6.49
1988	5.28	0.48	18.09	1.86	7.79
1989	4.48	0.28	12.11	1.75	5.79
1990	6.84	0.41	11.7	1.64	6.74
1991	7.47	0.54	13.76	1.42	6.88
1992	10.13	0.83	17.4	1.48	11.89
1993	11.88	0.45	17.23	1.55	10.11
1994	12.76	0.49	18.37	1.55	10.58
1995	17.66	0.53	17.53	1.46	11.08
1996	16.29	0.5	28.55	2.41	12.59
1997	12.91	0.45	26.76	1.96	10.7
1998	17.26	1.11	31.66	2.42	10.09
1999	13.47	0.80	31.99	1.94	9.78
2000	11.68	0.73	33.15	2.32	10.11

Source: PIDE (2003).

Table 3

Percentage Shares of Intra-regional Exports in Total Exports

Year	Bangladesh	India	Nepal	Pakistan	Sri Lanka
1985	7.65	3.25	38.32	5.28	3.8
1986	6.06	3.01	38.11	3.2	4.52
1987	4.1	2.82	27.84	3.92	3.58
1988	5	2.78	17.63	5.04	5.76
1989	3.9	2.43	2.69	3.51	5.21
1990	3.62	2.71	7.19	3.97	3.3
1991	4.7	1.78	7.86	3.33	2.6
1992	2.21	3.83	13.07	4.93	1.97
1993	2.42	4.00	4.69	3.21	2.17
1994	2.3	4.13	3.87	3.25	2.37
1995	2.65	4.98	8.7	3.13	2.28
1996	1.82	4.92	12.99	2.54	2.27
1997	2.26	4.36	25.44	1.75	2.05
1998	2.69	5.46	36.49	4.08	1.53
1999	1.92	4.82	28.85	3.27	2.03
2000	1.57	4.43	26.95	2.92	1.81

Source: PIDE (2003).

It has been observed that relatively smaller countries of SAARC have the pro-regional bias in their trade structure while larger countries, both Pakistan and India, have an anti-regional bias in their trade structure. Moreover, India's trade has not only an anti-region bias, the index of trade balance[5] for India falls short of unity as well; her exports to the region have invariably been higher than her imports [see Kemal, *et al.* (2002)]. Unless the benefits of trade liberalisation accrue to all the trading partners, possibilities of trade expansion in SAARC would be rather limited.

The Framework Agreement on ECO Trade Cooperation (FAT)[6] calls for progressive elimination of non-tariff barriers as well as gradual reduction of tariffs in the region with a view to promoting trade. The intra-regional exports in the ECO region is not only low, it has fallen over time (see Table 4). The shares of intra-

Table 4

Percentage Shares of ECO Intra-regional Exports in Total Exports

Country	Years				
	1995	1996	1997	1998	1999
Afghanistan	n.a.	n.a.	n.a.	n.a.	n.a.
Azerbaijan	49.0	51.2	33.1	35.3	12.9
Iran	19.0	15.4	19.4	24.3	3.4
Kazakhstan	8.5	8.8	7.8	7.4	6.1
Kyrgyzstan	39.7	51.7	37.4	29.7	26.5
Pakistan	3.3	2.5	2.0	2.5	3.0
Tajikistan	20.6	31.6	28.9	27.7	26.4
Turkey	4.2	4.9	4.9	4.2	3.3
Turkmenistan	22.5	11.9	40.5	65.2	15.7
Uzbekistan	20.1	11.8	11.7	15.4	n.a.
Share of Intra-regional Exports in Total Exports to the World	11.34	8.71	10.55	10.61	4.15

[5]The index of trade balances (TB) is

$$TB = \frac{Share\ of\ the\ country\ in\ intra\text{-}regional\ Imports}{Share\ of\ the\ country\ in\ intra\text{-}regional\ Exports}$$

If TB exceeds unity, the country runs deficits;

If TB is equal to unity, trade is balanced; and

if TB is less than unity, the country runs surpluses. It should be noted that the trade balance indices are reported here only to highlight the existing pattern of intra-regional trade, and not to argue for balanced trade within the region.

[6]It was signed on March 6, 2000 by all the Member States (except Turkmenistan and Uzbekistan).

regional imports in the total imports have declined from 11.1 to just 4.2 percent and that of exports from 11.3 to 4.2 percent over 1995-99 period. There are wide variations across various countries; intra-regional imports is 3.3 percent for Pakistan, 2.8 percent for Turkey, 3.6 percent for Iran, 4.6 percent for Kazakhstan, 12.5 percent for Turkmenistan, 12.5 percent for Azerbaijan, 22.6 percent for Kyrgyzstan and 28.3 percent for Tajikistan of their total imports (see Table 5). The shares of intra-regional exports also vary significantly and are the lowest in case of Turkey and Pakistan, i.e., 3.3 and 3.0 percent respectively. Kyrgyzstan, Tajikistan and Turkmenistan show the maximum intra-regional trade. While Pakistan's trade within ECO accounts for only 3 percent of its total trade, Turkey, Iran and Afghanistan and to some extent Uzbekistan and Kazakhstan account for bulk of Pakistan's intra-regional trade. It is low with Azerbaijan, Kyrgyzstan, Tajikistan and Turkmenistan [Kemal (2003)].

Table 5

Percentage Shares of ECO Intra-regional Imports in Total Imports

Country	Years				
	1995	1996	1997	1998	1999
Afghanistan	n.a.	n.a.	n.a.	n.a.	n.a.
Azerbaijan	44.9	34.8	36.6	31.4	22.6
Iran	32.8	34.5	25.9	24.2	3.6
Kazakhstan	13.5	8.4	5.4	5.8	4.6
Kyrgyzstan	35.1	41.5	39.6	31.6	28.3
Pakistan	2.7	2.4	3.3	2.3	3.3
Tajikistan	42.9	46.3	48.1	46.9	59.3
Turkey	3.2	2.7	2.3	2.1	2.8
Turkmenistan	25.2	18.7	30.0	25.9	12.5
Uzbekistan	18.1	15.7	14.9	13.3	n.a.
Share of Intra-regional Imports in Total Imports from the World	11.13	9.58	8.51	7.82	4.18

IV. ECONOMIC COOPERATION: IMPEDIMENTS

There have been various attempts to foster mutually beneficial economic relations both in SAARC and ECO including SAPTA in SAARC and FAT in ECO. The weak trade linkages may be attributed to several structural as well as policy-

induced factors including identical comparative advantage, lack of complementarities, low intra-industry trade, lack of exportable surpluses, lack of communication links, restrictive trade policies, and lack of finances. Besides, lack of political commitment has been the major stumbling block in the way of economic cooperation.

Identical Comparative Advantage

Both the SAARC and to a lesser extent ECO are characterised by an almost identical pattern of comparative advantage in a relatively narrow range of products, and consequently they have weak complementarities in their bilateral trade structures. It is generally believed that the economies of South Asia are quite similar and therefore they have similar comparative advantage. The revealed comparative advantage, ratio of the share of a given product in a country's exports to its share in world exports, may be used to determine the comparative advantage.

Balassa (1965) defines the relative comparative advantage as

$$R_{ih} = \frac{X_{ih} / X_{it}}{X_{wh} / X_{wt}}$$

where

R_{ih} = Revealed comparative advantage ratio for country i in product h
X_{ih} = Country i's exports of product h
X_{it} = Total exports of country i
X_{wh} = World exports of product h
X_{wt} = Total World exports.

A country is said to have a revealed comparative advantage (disadvantage) in a product if the ratio exceeds or falls short of unity. However, it may give misleading results in the presence of distortions in the market. Therefore the pattern of "true" comparative advantage may differ from the one suggested by the revealed comparative advantage ratios.

The Revealed Comparative Advantage at three digit classification reported in Kemal, *et al.* (2002) show that

- The pattern of revealed comparative advantage is quite similar across the South Asian countries;
- With the exception of India and Sri Lanka, the South Asian countries enjoy comparative advantage in a relatively narrow range of products. Bangladesh, Nepal and Pakistan out of 71 commodity groups have revealed

comparative advantage in only 7, 5 and 12 commodity groups while India and Sri Lanka have comparative advantage in 26 and 21 product categories; and

- Not surprisingly, none of the countries has comparative advantage in capital intensive and high value-added products.

Lack of Trade Complementarities

It is generally presumed that success of regional integration depends largely on the extent of trade complementarities. The complementarity indices[7] estimated in Kemal, *et al.* (2002) are reproduced in this section. Trade complementarity index is defined below:

$$C_{ij} = 1 - \left(\sum | m_{hi} - x_{hj} | \right) \div 2$$

Where

C_{ij} = Trade Complementarity index for trade between countries *i* and *j*
m_{hi} = Share of good *h* in total imports of country *i*
x_{hj} = Share of good *h* in total exports of country *j*.

The trade complementarity index is zero when no good exported by one country is imported by the other, and equals one when the shares of one country's imports correspond exactly to those of the other's exports.

There is a lack of strong complementarity in the bilateral trade structures of South Asian countries. Similarities in the trade structures, together with absence of comparative advantage in capital intensive and high value-added products, i.e. the products that are normally imported by countries in the region, may have played a role in constraining the growth of intra regional trade in South Asia.

Intra-industry Trade

Whereas the comparative advantage on the basis of factor endowments suggests that the trade would take place only if there are differences in factor endowments, Grubel-Lloyd (1975) argue that differences in the level of technology and human capital can lead to intra-industry trade even in products with identical factor input requirements. Krugman (1981) argues that industries in which increasing returns are achieved at a fairly low level of output can accommodate many producers, with each producing differentiated products. Under these circumstances, each country will specialise in different varieties of the product and

[7]Because of the non-availability of disaggregated data on most of the ECO region, the complementarity indices cannot be estimated. However, the indices are expected to be larger.

engage in intra-industry trade. Regional integration schemes involving cross-country production sharing arrangements[8] have also resulted in increased intra-industry-trade. Yeats (1998) points out that production sharing has become a major factor in regional trading arrangements.

The Grubel-Lloyd intra-industry trade helps in determining the intra-industry trade. The index is defined as:

$$G_h = \frac{(X_h + M_h) - |X_h - M_h|}{(X_h + M_h)}$$

Where

G_h = Grubel-Lloyd index of intra-industry trade in industry h
X_h = Exports of industry h
M_h = Imports of industry h.

The Grubel-Lloyd index ranges between 0 and 1 with larger values indicating a greater degree of intra-industry trade. The Grubel-Lloyd indices for SAARC countries reported in Kemal, *et al*. (2002) lead us to conclude:

- Historical pattern of intra-industry trade amongst the South Asian countries is highly erratic, and there are only a few products in which intra-industry trade has occurred on a sustained basis;
- With few exceptions, leather products, textiles and clothing, and some basic machinery and tools dominate the intra-industry trade profiles of the South Asian countries; and
- The proportion of intra-industry trade in total trade has been very low for most of the products, implying a low intensity of intra-industry trade in the region. This is also reflected in the average bilateral Grubel-Lloyd indices of intra-industry trade.

Lack of Export Diversification

All the countries belonging to SAARC and ECO are deficient in capital, and the industrial base is hardly diversified. The regional exports largely consist of raw materials and traditional products, and where they have comparative advantages, are competitors in the world export market rather than trading amongst themselves. Given the scenario, both the SAARC as well as ECO trade is tilted towards developed countries. If this pattern is to change trade sharing arrangements and vertical integration may be necessary which besides provision of intra-regional trade

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[8]Under the production sharing arrangements, various stages of the production process for a specific product are undertaken in different countries, giving rise to intra-industry trade.

would also help in the realisation of dynamic advantage.

Lack of Transport Communication Links

Because of the poor communication links production, consumption, and trade patterns of potential trading partners sometimes are unknown to the partner countries. The inadequate trade facilitation mechanisms such as high handling and transportation charges and delays in delivery, implies that potential of intra-regional trade cannot be fully utilised. The land route and railway links in SAARC depend on the transit facilities provided by India; Pakistan, Bangladesh and Nepal have to pass through India. In ECO, seven of the ten countries are landlocked and Afghanistan is the key to trade between Pakistan and Central Asian Republics. The shipping facilities are also inadequate and many a products could not be traded in SAARC due to lack of such facilities.

Monetary Cooperation

These countries have generally faced severe foreign exchange constraints due to persistent imbalances in their current accounts. The paucity of foreign exchange may have been an impediment to intra-regional trade. Monetary cooperation such as the Asian Clearing Union (ACU) can facilitate intra-regional trade by obviating the need for hard currencies for settling regional trade balances.

Political Problems

Apart from problems on the economic front, political differences have undermined efforts to foster regional economic cooperation especially in SAARC. Political differences between Pakistan and India have been the main constraining factor towards trade expansion within SAARC. In general the smaller countries in the region have been generally skeptic towards regional economic cooperation initiatives. The political conflicts as well as differences in economic outlooks have been strong impediments to intra-regional trade.

V. PROMOTION OF INTRA-REGIONAL TRADE AND INVESTMENT

Intra-industry trade can flourish even in situations where the trade and production structures of the trading partners lack strong complementarities. The trade expansion helps in reaping dynamic scale economies. Therefore, trade linkages among the South Asian countries need to be strengthened by devising mechanisms to promote intra-industry trade within the region. One way to

accomplish this is through regional production sharing arrangements that involve the initiation of part of a manufacturing process for a specific good in one country and the transfer of the activity to another for further processing.[9] The South Asian countries can achieve greater economic cooperation and integration by evolving a vertically integrated regional production structure in sectors that are of economic significance in the regional context.[10] This would allow the South Asian economies to specialise in different lines of production within a particular industry and thus achieve benefits of specialisation and scale economies. The regional production sharing arrangements generally emerge in response to a combination of factors including low tariffs, wage differentials, low transportation costs, and favourable policies.

Since the basic objective of any economic grouping is to liberalise and expand trade within the region, removal of tariff and non-tariff barriers in the region, regulatory and enabling environment for trade are essential. Moreover, increasing the inter-connection of private sector in various product groups would be rather helpful in promotion of trade, establishment of joint ventures, and the visits of businessmen across countries. In this regard, visa policy of the regional economies can play an important role in promoting trade. The institutional and human resource capacity of the private sector to deal with the complexity of regional and multi-lateral trade agreements needs to be enhanced.

Joint ventures can be important instruments for pooling regional resources to promote industrialisation and economic growth. In view of the fact that these countries have collectively gained substantial experience in agro-based industries, textiles and clothing, paper and pulp, and light engineering, there seems to be a scope for joint ventures in these areas. It may be pointed out that the establishment of joint ventures will particularly benefit the small countries because they generally lack the resources to undertake industrial investment on an efficient scale.

VI. THE SAFTA AGREEMENTS AND POSSIBILITIES OF INTRA-REGIONAL TRADE

The Islamabad Declaration promises the South Asian Free Trade Area (SAFTA) coming into force on January 1, 2006, with full implementation by 2015. The SAFTA calls upon India, Pakistan, and Sri Lanka, relatively more developed countries in the region, to reduce tariffs to 20 percent by 2006 and Nepal, Bhutan,

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[9]For instance, electronic components may be produced in country A, shipped to country B for assembly, and then re-exported back to country A.

[10]Some of the potential areas where regional production sharing systems can be developed are leather products, textiles and clothing, and basic machinery.

Bangladesh and Maldives, relatively less developed countries, are required to reduce tariffs to 30 percent by 2006. Following that Pakistan and India in five years, Sri Lanka in six years and other SAARC countries in 8 years shall have to reduce tariffs to 0–5 percent level. Moreover, India, Pakistan, and Sri Lanka will reduce their tariffs on imports from the relatively less developed countries to 0-5 percent by January 1, 2009. Tariff reductions, rules of origin, safeguards, institutional structures, and dispute settlement will be sorted out by various committees.[11] It also calls for adoption of various trade facilitation measures, such as harmonisation of standards and customs procedures, and transport infrastructure cooperation.

The agreement calls for elimination of all quantitative restrictions, though it allows a sensitive list of products on which preferences may not be accorded. However, such a list is not expected to be more than 20 percent of the total number of potentially traded products. The products on the sensitive list are to be reviewed at four-year intervals with a view to reducing the list and expanding the free trade coverage of the Agreement.

The six broad factor that result in success of regional groupings has been enumerated in the World Bank (2004). Firstly, a regional trade agreement does not automatically result in increased trade and growth. This is because a large number of interest groups emerge who on the grounds of injury to their industry, call for exemption from reduction in the import duties. Experience with SAPTA has been disappointing for that reason. SAFTA allows a sensitive list and if the list is large, then SAFTA may not result in higher intra-regional trade. Agreements that keep high trade barriers to protect inefficient activities undermine the competitiveness.

Second, those trading arrangements which were preceded or accompanied by unilateral efforts among members to reduce external protection have been more successful. Reducing trade barriers *vis-à-vis* the rest of the world creates an incentive for all members to export. It augments competition that drives domestic productivity [see Muendler (2002)]. As is quite well known, when external protection is generally low, trade creation usually dominates trade diversion, and so the risks that regional agreements will be a drag on growth is substantially reduced. Indeed regional agreements where members have had low external protection have enjoyed greatest success [see Baldwin and Venables (1995) and Burfisher, *et al.* (2003)].

Third, regional groupings between the countries with different factor endowments allow opportunities to exploit differentials in wage rates, capital

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[11]With a view to ensuring that agreement is implemented, it establishes the SAFTA Ministerial Council, the regional body's highest decision-making authority, and a Committee of Experts responsible for monitoring implementation and resolving disputes. The Committee of Experts is required to update the Ministerial Council every six months on the progress of the Agreement.

availability and technological levels [Schiff and Winters (2003) and Lederman, *et al.* (2003)]. However, this conclusion runs contrary to the success of EU. The promotion of intra-industry trade would result in higher growth even if factor endowments are similar.

Fourth, a regional integration framework that helps in trade creation and competition amongst regional countries would help in lowering domestic prices and providing new technology. It is impossible to have the benefits of a regional agreement without exposing the member economies to new competition [Hoekman and Schiff (2002)].

Fifth, competition in services also results in successful integration. Lowering the cost of telecommunications, finance, business services, and retail and wholesale commerce would result in productivity gains.

Finally, there is a need to streamline border transactions through trade facilitation. Increase in efficiency within the region often spills over into trade outside the region as well, because improving customs or improving efficiency of ports helps both intra-regional trade and international trade.

To ensure success of SAFTA, the member countries have to take a number of initiatives. Firstly, all countries must have very small sensitive list and simple and transparent ground rules should be laid for putting a product on the sensitive list. Second, keeping rules of origin simple and transparent, and ensuring that they must not become devices of protection and impediments to trade. Third, since some of the SAARC members may dump their products and/or provide subsidies to exports resulting in unfair competition, the transparent anti-dumping and countervailing methods would be necessary. Fourth, intra-industry trade can play an important role in bolstering economic and trade relations within the region. An increased level of intra-industry trade in the region can only be achieved if the regional countries are able to develop the technological capacity to produce different product varieties at declining average cost. Fifth, joint ventures can be important instruments for pooling regional resources to promote industrialisation and economic growth in the South Asian region.

What would be the impact of the SAFTA? RIS (2004) reports results of studies conducted in the framework of the gravity model. It suggests that complete elimination of tariffs under SAFTA may increase the intra-regional trade by 1.6 times the existing level. It further suggests that in the dynamic framework the gains from liberalisation are at least 25 percent higher than the static gains. However, these gains are grossly understated in view of SAARC's large trade potential; it exists both in terms of trade diversion from traditional sources towards SAARC countries by removing the constraints and in terms of trade creation and trade expansion by

easing import restrictions on products which, are in general, not being traded amongst SAARC countries but are the major exports of South Asian countries. It needs to be underscored, that while more than half the exports of manufactured goods from South Asia consist of textiles and leather products, they are subject to very high rates of import duties and/or quantitative restrictions and even outright bans in South Asia. Similarly, rather limited trade in engineering goods is due to a number of factors including reliance on foreign aid to finance the import of capital goods, poor quality of goods and heavy import duties on capital goods even by the countries who are themselves exporters of capital goods.

VII. CONCLUSIONS

Regional economic cooperation is increasingly being viewed as a vehicle for expediting the process of economic development through trade expansion, improvement in productivity, specialisation in accordance with comparative advantage and improved quality of products. Pakistan has been a member of SAARC and ECO but in both the groups, intra-regional trade accounts for only 4 percent of total trade.

Similar comparative advantage and low trade complementarity are the main impediments to trade. Nevertheless, other impediments such as limited capacity to generate exportable surpluses, restrictive trade policies, and political problems have also inhibited the growth of intra-regional trade. However, through intra-industry trade; achieving vertical specialisation; joint export marketing of competing regional export products; deepening trade liberalisation, promoting monetary cooperation; and encouraging joint industrial ventures can result in higher trade. But regional economic cooperation is unlikely to succeed without political harmony and convergence in economic perceptions, which are essential pre-requisites for forging an economic and trade alliance.

The signing of SAFTA has created euphoria in the South Asian countries. However, there are at least two possibilities which may make it redundant. Firstly, all the countries are members of WTO and would reduce the tariff levels. If their MFN tariffs are close to preferential tariffs under SAFTA, intra-regional trade may not grow at a rapid rate. Though one could argue that at lower rate of import duty, with or without SAFTA, the intra-regional and trade outside the region would flourish. Second and more importantly, if the sensitive list is large and includes most of the products of export interest of South Asian countries, then the trade would not flourish. For the success of SAFTA it is imperative that the negative list is quite small and the countries must be prepared for closure of a few industries. Similarly, the rules of origin should be so formulated that they do not constrain the growth of intra-regional trade. Moreover, anti-dumping and countervailing duties, though

necessary for fair trade, should not be used for protective measures.

The SAFTA has great potential and South Asian countries should accept the short-term costs for long-run benefits. Nevertheless, SAARC countries must make an effort to make SAFTA a success, because that would expedite the process of economic development, mainly because of the problems in global market access and the higher transaction costs of producing for the world market. Expansion of trade, efficiency and improved quality of exports would hopefully benefit the countries participating in the regional co-operation effort.

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