

**Regional Cooperation in Trade, Finance and Investment
Among SAARC Countries: The Bangladesh Perspective**

M. Kabir Hassan, Ph.D.

LREC Chair Professor of Economic Development and Finance
Department of Economics and Finance
University of New Orleans
New Orleans, LA 70148
Phone: 504-280-6163
Fax: 504-280-6397
Email: mhassan@uno.edu

Rock-Antoine Mehanna, Ph.D.

Assistant Professor of Business and Economics
Wartburg College
Waverly, Iowa 50677
Phone: (319) 352-8315

Syed Abul Basher

Ph.D. Candidate
Department of Economics
York University
Toronto, Canada

Regional Cooperation in Trade, Finance and Investment Among SAARC Countries: The Bangladesh Perspective

Abstract

Intra SAARC trade seems to be quite of a small order of magnitude. This might be because of normal outcome or because of unexplored trade opportunity. If the latter is the case, then increased trade within this region might be welfare improving. This study attempts to make a formal analysis of these issues, and estimates a gravity model of international trade to examine whether intra SAARC is lower or higher than what is predicted by economic model. This gives an idea about the structure of comparative advantage in the SAARC countries that help us to explain why intra SAARC trade is low and how trade among them can be increased. It also helps us to understand the possibility of trade creation and trade diversion effect resulting from SAPTA among SAARC countries. Liberalization of trade in SAARC countries offers significant gains for all the economies in the region. Efforts should be made to liberalize border trade and strengthen bilateral trade relations through separate sets of trade concessions in the general framework of SAPTA.

Regional Cooperation in Trade, Finance and Investment Among SAARC Countries: The Bangladesh Perspective

I. Introduction

The issue of regional economic cooperation is drawing a burgeoning interest in the arena of international economics and politics. Regional economic cooperation typically have been taking the form of free trade areas and other special regional trading arrangements. South Asian Association for Regional Cooperation (SAARC) was born in 1985 by the initiative of late president Ziaur Rahman with the broad objectives of economic, cultural and social cooperation among seven countries in South Asia. Like most of the other regional cooperation in Asia, SAARC's activity in economic cooperation is still limited. This research aims at assessing the feasibility of economic cooperation from the perspective of regional trade. Like the EC countries, the SAARC countries share a lot of similarity in culture and socio-economic condition, but as opposed to EC countries they are all poor countries. Another interesting feature of SAARC is that there is one large country (India) and all others are relatively small. Hence feasibility of economic cooperation among SAARC countries can be a unique case study about the potential of South-South Cooperation. This study attempts to broadly analyze the feasibility of economic cooperation in terms of potential for free trade among these nations.

Intra SAARC trade seems to be quite of a small order of magnitude. This might be because of normal outcome or because of unexplored trade opportunity. If the latter is the case, then increased trade within this region might be welfare improving. This study attempts to make a formal analysis of these issues. This paper estimates a gravity model of international trade to examine whether intra SAARC is lower or higher than what is predicted by economic model. This enables to have an idea about the structure of comparative advantage in the SAARC countries that help to explain why intra SAARC trade is low, and how trade among them can be increased. It also enables to have an impression about the possibility of trade creation and trade diversion effect out of any preferential tariff agreements among SAARC countries.

Liberalization of trade in SAARC countries offers significant gains for all the economies in the region. A very close look at the existing structure of trade reveals that, in the context of trade liberalization among neighboring SAARC countries, the interaction between policy-determined barriers (eg. tariffs, quotas and other non-tariff barriers) and natural barriers (eg. transport costs, linguistic and institutional differences) is important. Integrating all these issues together will provide a comprehensive analysis of feasibility and prospects of economic cooperation in terms of enhanced trade within SAARC region. The study will have important implications for policy making about the future course in economic cooperation among the SAARC countries.

This paper is divided into seven parts. Section II describes the benefits of free trade. Section III analyzes the concept of regionalism, free trade and the role of history in trade relations among nations. Section IV provides a synopsis of Bangladesh's recent international trade. Section V discusses the methodology and data. Section VI analyzes the empirical results. Section VII concludes the paper with a future research guide.

II. The Benefits of Free Trade

Economic theory provides us with a number of reasons to believe that international trade can enhance growth. The example of rapidly growing east Asian countries demonstrate that growth in trade has contributed both to economic growth and to the structural transformation of these economies. The advantages a country derives from international trade are many. Every person can enjoy the technological and geographical advantages that exist in any other places in the world. For example, a villager in Bangladesh may listen to local broadcasts on a Japanese made Sony radio running on batteries produced in India. Americans or Europeans enjoy their tea or coffee breaks, using Bangladeshi tea or South American coffee.

Some observers consider trade deficits bad and this notion stems from the misconception that a country with the biggest trade surplus to be the most competitive and efficient nation on earth. This concept is flawed because trade deficits or surpluses today are consequences of a country's current and historical position in the international flow of capital. Trade deficits or surpluses simply reflect consumption and investment decisions over time: they are not inherently good or bad. There is no clearcut empirical evidence that imports cause systematic unemployment or that exports create systematic employment. International lending or borrowing allow countries to buy now and pay later. What must be true is that the imports of goods or services now must be paid for by exports of goods and services later.

For example, in 1992 the U.S. had a merchandise trade deficit of \$96 billion and net unilateral (mostly government) transfers to foreigners of \$31 billion. To finance this outflow of \$127 billion, the U.S. received about \$10 billion in net investment income from foreigners, had a \$55 billion surplus in service transactions (travel, license fees, insurance, and so forth), and borrowed approximately \$62 billion. The reason the US has a trade deficit is because it earns large amount from foreign direct investments abroad, has a comparative advantage in selling services, and is considered by many foreigners to be a good place to invest capital.

The most fundamental argument for international trade is that it enables a country to expand the quantity of goods and services it consumes. Through imports, a country can acquire goods and services that it either cannot produce at home or can produce at home only at a cost that is greater than the cost of obtaining them indirectly by exchanging them for the exports it produces. In other words, a country can obtain goods and services with greater efficiency by specializing in those activities in which the country has a comparative advantage. David Ricardo developed the principle of comparative advantage in 1817. It says that every country, no matter how inefficient its overall production structure is, can always profitably export some goods to pay for its most desired imports.

A country's wages reflect its general productivity level and its overall standard of living, but they do not determine its competitiveness or which goods it ultimately exports. Countries with high overall productivity level will have high wages, and countries with low overall productivity level will have low wages. Each country has industries with both higher than average and lower than average productivities. A country's high productivity industries will have lower relative costs and will be able to compete in world markets.

In the 1950s and 1960s, many developing countries adopted the import substitution industrialization policies. The idea is that if the poor countries want to develop, they will have to start producing manufactured goods rather than continue to rely on imports of these goods from developed countries in exchange for exports of primary products. As the demand for manufactured goods increase relative to primary products with an increase in national income of developing countries, the terms of trade for developing countries fall. The last thirty years of experience shows the relative failure of highly protected import substitution trade regimes and the success of outward-oriented open trade regimes. The evidence shows that countries that have pursued highly protectionist policies, such as Tanzania, Nigeria and Ghana grew much more slowly than the relatively open economies of Southeast Asia, such as Hong Kong, South Korea, and Singapore. The evidence also shows that growth increased in both the manufacturing and agriculture sectors in countries after they have adopted a trade liberalization policy.

The basic problem with the import substitution strategy is that it assumes development can only occur through manufacturing and that it is only possible to develop manufacturing by protecting it. Regardless of the economic sectors- manufacturing, agriculture or mining- countries have done best by exploiting their natural comparative advantage. The evidence also shows that after moving toward a more liberalized trading environment, most countries increase productivity and growth in agriculture as well as manufacturing. Moreover, in highly protected regimes, resources are attracted to industries that do not reflect the comparative advantage of the country. Protected industries, because they lack the incentive to innovate, produce high cost, poor-quality products.

III. Regionalism, Free trade and Role of History

With the creation of European Community (EC) four decades ago, the first wave of regionalism spread across the world. Then after laying dormant during most of the 1970s, it took off again in the mid 1980s. All the major players in the world are involved. There is a growing concern that a three-block world (the US, the EC and Japan) of multilateral trading system will evolve in the future. Since 1985, six substantive regional agreements and innumerable proclamations on intent to integrate have been signed. This second wave of regionalism differs from the first one on the following grounds. First, whereas past arrangements were generally viewed as either benign (pacts among developing countries) or complementary (the EC) to multilateralism, there is reason to worry that current ones may work at cross-purposes with multilateralism. Second, the US is no longer exclusively committed to multilateralism and is actively pursuing regionalism. Moreover, regionalism is now being pursued on a much larger scale. Finally, there are now fewer trade restrictions in developing countries. In addition, in a dramatic shift, developing countries are seeking partnerships with developed countries rather than solely with each other.

The classical literature on the subject of preferential trading arrangements as developed by Viner (1950) concludes that a regional arrangement is more likely to be welfare-improving if: (1) there is a broad scope for production specialization among countries within a bloc; (2) tariffs and non-tariff barriers to intra-trade are substantially reduced; (3) tariffs and non-tariff barriers with third countries are lower after the formation of trade agreements; (4) in order to expand the scope of net welfare gains, trading agreements should allow accession by any interested country, regardless of

geographical location; (5) trading agreements should support member countries to introduce and expand unilateral liberalization measures; and finally (6) trading agreements should restrict the use of unfair trade policies, and minimize the protectionist effects of rules of origin, and whatever policies undermine trade competition.

In a familiar model of trading blocks, Krugman considers a symmetric world in which there is a large number of identical countries. Individuals consume a differentiated good with many potential varieties. Each nation specializes completely in one variety and imports all other varieties. At one extreme, with as many blocks as there are countries, each block is too small to have any market power. Therefore, Nash tariffs are zero and competitive behavior maximizes world welfare. At the other extreme, with one trading block, there are once again no trade restrictions and welfare is maximized. In between, welfare is lower. Starting with one block, if we divide the world into two blocks of equal size, each block exercises monopoly power over its products and imposes a Nash tariff on imports from its rival. There is trade diversion and each block suffers a loss of welfare. Next, suppose we divide the world into three equal blocks. This leads to only one third rather than half of the goods being subject to free trade and there is further trade diversion. But the reduced size of each block also reduces its market power and the Nash tariff declines. This generates a trade creation effect. With both trade creation and trade diversion taking place simultaneously, welfare may now rise or fall. As the number of blocks rises, the Nash tariff continues to decline and at some point must become sufficiently small to yield a larger trade-creation than trade-diversion effect.

Krugman finds that for a variety of parameters, the number of blocks for which a declining welfare begins to rise again is three. Taken seriously, this implies that the number of blocks into which the world is most likely to divide- three- maximizes welfare. This finding remains robust to alternative tariff-formation process. Krugman also argues that trading blocks are in principle bad, but in practice good. They are bad in principle because the world divides into a small number of large blocks and they fail to cooperate, they will exercise their market power, leading to a world of "fortresses" with free trade within each block, but high barriers to trade between blocks. In practice, however, trading blocks are formed among countries that are "natural" partners, so the trade diversion aspect of block formation is exaggerated. He argues that as the number of players become small, a cooperative solution is more likely.

Rodrick argues that regional arrangements might require harmonization of industrial and tax policies, coordination of environmental policies, and above all, a commitment to a stable foreign exchange and monetary policies. A regional arrangement entails a larger political community and hence a smaller role for politically important groups in each country. This should render decision-making less responsive to factional interests, unless politically powerful lobbies can form alliances across countries.

Countries with a history of trading with one another-- whether for reasons related to politics, policies or other factors-- generally continue doing so. Producers, having set up market-specific sales, distribution and service networks that allow them to generate a level of exports greater than would be predicted by the scale and geographical distance of the destination market, should continue to generate a disproportionate level of exports over time. Thus, passing historical events that allow costs to be sunk can be associated with persistent increases in the level of trade. The events in question can be anything from a history of colonialism (in which case military means were

used to install the infrastructure needed to support bilateral trade) to a history of migration (one thinks of Japanese migration to Brazil and Peru, which provides Latin America with linguistic and cultural capital that supports extensive trade with Japan) to purely chance events (Eichengreen and Irwin, 1996).

Traditional trade theory provides little guidance on the question of how past trade patterns should affect current trade flows. Typically, current trade is related to current factor endowments and current technologies. There is no reason in these models why earlier endowments and technologies, much less earlier trade flows, should influence trade patterns independent of current factor endowments and current technologies. The recent theoretical and empirical literature suggests the possibility of hysteresis in trade. Hysteresis refers to the case where a passing shock to trade has permanent effects, and hence trade does not return to its previous value after a temporary shock. The existence of economies of scale and scope in the production of goods and services can cause trade to flow in particular geographical channels for historical reasons.

Baldwin (1988), Dixit (1989), Baldwin and Krugman (1989) and others have focused on how a large but temporary real exchange rate shock could have permanent effects on the pattern of trade. These effects hinge on sunk costs of market entry and exit for domestic and foreign firms. Sunk costs, it is suggested, are associated with the need to set up distribution and sales networks in the foreign markets prior to initiating export sales. For example, a temporary appreciation of a country's currency can make the entry of foreign firms profitable, leading them to undertake a one-time investment in distribution capacity in the domestic market. Even if the currency depreciates back to its initial level, they have no incentive to exit, the up-front costs of distribution and marketing having been sunk. Thus, a temporary exchange rate shock can alter the structural relationship between imports and the exchange rate, permanently affecting the pattern of trade. Any temporary disruption to current trade patterns-- due to war, depression, or temporary tariffs, for example-- could provide an incentive for exporters to sink the fixed costs of penetrating foreign markets.

IV. Bangladesh's International Trade

Tables 1 shows the country-wise export of Bangladesh from 1994-95 to 1997-98. The increasing importance of the USA as the major export destination and the structure of exports to the USA (in FY 1997-98, export share accounted for 40% of total exports to the USA which was 35% in FY 1994-95) would suggest that along with the growth in commodity concentration there has also been a corresponding market concentration over the past years. USA, Germany, and France collectively accounted for over half of Bangladesh's total exports, whilst top 10 countries account for almost 85% of our exports based on the FY 1997-98 figures. In spite of efforts to widen Bangladesh's export market base there has not been any significant breakthrough in recent years in the diversification of our market. The share of countries such as India, Russia and Hong Kong have been in secular decline in recent years. The fall in the share of India, Bangladesh's principal source of imports, is particularly noticeable. Outside of the USA and the EC markets, Hong Kong and Japan's share in total exports has registered sharp decline in the late 1990s - exports to these countries registered a decline of 67.7% and 25.5% respectively over 1994-95 to 1997-98. While, exports to the USA increased by 12% over the same period.

Table 2 presents the structure of imports into Bangladesh by major countries. A review of Bangladesh's import market structure indicates that, import sources have undergone some important changes in recent years, with the emergence of India as the major source of imports in to Bangladesh and the decline in importance of such major import sources as the USA, Singapore and Pakistan. India has, over the years, remained in the top position of the most important import source for Bangladesh. India supplied about 15% of total imports to Bangladesh in FY 1997-98, thereby increasing its share by more than double from 6% registered in FY 1990-91. In contrast, Singapore's share declined from a high of 8% in FY 1994-95 to 0.64% in FY 1997-98. On the other hand, China, Japan, and Hong Kong have remained important import sources in the late 1990s, together contributing more than 20% of the global imports coming into Bangladesh (Bangladesh Bureau of Statistics, 1999).

The emergence of India as the major import source and the resulting negative balance of trade however conceals the fact that a significant part of the imports from India go to export oriented industries as inputs, which in turn results in a positive balance of trade with other trading partners such as the U.S.A. For example, cotton yarn and fabrics accounted for about one-third of Bangladesh's imports from India in FY 1995. However, as is known, the official trade of Bangladesh with India does not reflect the actual traded volume between these two countries. According to the findings of a recent survey, the volume of unofficial exports to Bangladesh is estimated to be about 2528.2 crore taka or \$ 630 million (Bakht, Z. 1995). If this unofficial trade is taken into account India's share in total imports will go up from 12.1% to about 21.1%.

Table 3 presents the export of principal commodities of Bangladesh from the FY 1994-95 to FY 1997-98. Ready made garments remained as the top export item of Bangladesh contributing about 75% of total export alone in 1997-98 followed by prawns and shrimps and jute manufacturing. This excessive dependence on garments products alone may jeopardize the future export revenue especially after the (MFN Most Favored Nation) clause to be phased out by 2005. Bangladesh, thus, seriously needs to diversify its export basket in order to hedge from any possible uncertainties.

Table 4 shows the imports by broad commodity group of Bangladesh from FY 1994-94 to 1997-98. Among the importing commodities, textile and textile articles alone share 27% of the import payment followed by transport equipments (item 17) and machinery and mechanical appliance (item 16) in FY 1997-98. These three items together accounted for 60% of total import payments. Items 1 to 4, which basically represent consumption goods, contribute 15% of total import payment in 1997-98 and have remained steady from 1994-95.

Table 5 shows Bangladesh's export to SAARC member countries. Among the 7 SAARC countries, our major trading partners within South Asia remain India and Pakistan which together account for more than 95% of our imports from SAARC countries and 80% of our exports to the SAARC countries.

Table 5 reveals an interesting outcome. Bangladesh's total export to SAARC countries amounts only US\$ 102.66 million in 1998-99 which is only 2% of her total export with all the countries. This signifies the need for further enhancement of trade of Bangladesh among SAARC countries with more attention to other member countries than India and Pakistan.

V. Methodology and Data

5.1. Methodology: Gravity model offers a systematic framework for measuring the normal pattern of trade. International trade flows are determined by comparative advantage, possibility of intra industry trade, transport cost etc. Trade policy may revise the normal trade flows. A gravity model of international trade estimates the trade flow as a function of variables that directly or indirectly affects the determinants of normal trade flow. We can use the gravity model to examine whether a lower magnitude of intra-SAARC trade is a normal outcome or not. The gravity model has long been used for empirical studies of the pattern of trade. Specifically, the volume of trade between two countries should increase with their real GDPs (the so-called gravity variable), since large countries should trade more than small ones, and with per capita incomes, since rich countries should trade more than poor ones. It should diminish with geographical distance because proximity reduces transportation and information costs. Since the dependent variable in the gravity model is bilateral trade between pairs of countries, each variable (other than distance) is entered in product form. Researchers then add dummy variables for participation in various preferential arrangements. If one finds a positive coefficient on the dummy variable indicating that two countries, both of which participate in the same preferential arrangement, trade more with one another than predicted by their incomes and distance, then the conclusion drawn is that the arrangement is trade creating for its members. If there is a negative coefficient on the dummy variable indicating that only one member of the pair participates in a particular preferential arrangement, this is taken as evidence of trade diversion vis-a-vis the rest of the world.

Results obtained using this approach can be questioned on several grounds. One is that the coefficients on dummy variables for subgroups of countries will pick up all respects in which those countries differ in their trade performance that are not controlled for in the gravity equation. To take an example pursued by Frankel and Wei (1993), if all the countries in a region share a common language, then including a dummy variable for that region but not a measure of language will tend to spuriously attribute the effects of the shared language in encouraging economic links to commercial policy measures. More generally, dummy variables for preferential arrangements serve as a catch basin for omitted factors.

Related to this is the difficulty of measuring economic distance independent of the trade flows that the investigator seeks to explain. The underlying theory appeals to transactions costs to trade, and in empirical implementation it is posited that such costs should rise with distance. But economic and geographic distances are not the same. Insofar as economic distance is mismeasured, its effects may be loaded into the dummy variables intended to capture the effects of regionalism.

A further problem with the gravity model is the omission of third country effects. It is generally assumed that bilateral trade depends only on economic conditions in the two countries considered. In practice, however, bilateral trade will also depend upon competitiveness relative to other countries and markets. More generally, insofar as economic variables in third countries affect trade flows between other country pairs, gravity equations suffer from omitted-variables bias.

A final problem arises from the practice of pooling data for industrial and developing countries. While this maximizes degrees of freedom, the relationship between trade and economic characteristics may vary between the two groups of countries. The income elasticity of trade may be different at high and low levels of income or for different types of goods, for example. Transactions costs may have very different structures in countries with more and less articulated

markets. Results based on heterogenous cross sections may therefore suffer from subsample instability and heteroskedasticity.

The typical gravity model specification relates bilateral trade to income, population (or per capita income), distance and congruity between the trading partners:

$$\log(\text{TRADE}_{ijt}) = a + B_1 \log(\text{GDP}_{it}\text{GDP}_{jt}) + B_2 \log(\text{PCI}_{it}\text{PCI}_{jt}) + B_3(\text{DISTANCE}_{ij}) + B_4(\text{BORDER}_{ij}) \quad (1)$$

where TRADE_{ijt} is bilateral trade between countries i and j at time t (measured in U.S. dollars), GDP is real gross domestic product (the so-called gravity variable), PCI is per capita income, DISTANCE is distance between two countries, and BORDER is dummy variable which takes a value of 1 if two countries have common border and 0 otherwise. As trade is expected to increase with size of domestic economy (GDP), per capita income (PCI) and common border (BORDER) and to decline with distance (DISTANCE), B_1 , B_2 and B_4 should be positive, and B_3 negative.

5.2. Data: Annual data on bilateral trade flows among SAARC countries has been collected from IMF's Direction of Trade Statistics. The UNCTAD and the United Nations COMTRADE data base has also been used to compare import and export trade flows of SAARC countries. Disaggregated data on Bangladeshi imports and exports have also been collected from Bangladesh Bureau of Statistics. A substantial amount of data has also been collected by hand from different government documents. Interviews and surveys with important government policy makers, researchers and politicians have also conducted to supplement the quantitative research with qualitative answers.

VI. Analysis of Empirical Results:

A more systematic way of adjusting for the natural determinants of trade is by means of the gravity model. The assumptions of the model are that trade between two countries is proportionate to the product of their GNPs and the product of their per capita GNPs. An increasing function of adjacency (when two countries share a common land border), and inversely related to the distance between them. Dummy variables are added when both countries in a given pair belong to the same regional grouping. This provides a means of determining how much trade within each region is due to factors common to trade throughout the world and how much remains to be explained by regional effects.

We present the gravity model results for the year 1995. Tables 6 and 7 provide the correlation and descriptive tables, while Table 8 presents the regression estimates of the gravity model. Hassan (2001, 2000) examined the gravity models for the year 1994 and 1997 respectively.

Let us now analyze the gravity model results in details. We use regional block variables in our analysis in three ways. First, we use seven regional blocks of countries-- SAARC1, SAARC2, ASEAN1, ASEAN2, NAFTA, EEC1, and EEC2-- with which Bangladesh has regular and significant trade. SAARC1 block consists of Bangladesh, India, Nepal and Bhutan, whereas SAARC2 block consists of all seven members (the remaining members are Pakistan, Sri Lanka and Maldives). ASEAN1 consists of Indonesia, Malaysia, Philippines, Thailand, Singapore and Laos, whereas ASEAN2 consists of ASEAN1 countries plus Korea, Japan, and China. NAFTA block consists of U.S. and Canada. EEC1 consists of Germany, Italy, UK, Netherlands, Spain, Belgium,

France and Denmark, whereas EEC2 consists of EEC1 plus Brazil. Second, we form hypothetical trading blocks among Bangladesh and ASEAN1, ASEAN2, NAFTA, EEC1 and EEC2 countries to examine the likely effects of such grouping if they were to materialize. Third, we add a term for each grouping in order to capture trade-diversion effects. These terms are indicated by a suffix "N", standing for trade with non-members of the grouping in question.

We present the regression results for the year 1995 in Table 8. To check the robustness of our results, we perform three regression runs: first, with the existing and hypothesized trading block countries; second, with existing trading block countries; finally, with the hypothesized trading block countries.

We have 27 countries in our data set, so that there are 351 data points $[(27*26)/2]$ for a given year. We find all three standard gravity variables (GDP, GDP per capita and distance) to be highly significant statistically at the 1% level of significance. While the BORDER variable retains its sign, it is not statistically significant. All variables except GDP PER CAPITA have their expected signs. The unexpected negative sign for GDP per capita variable suggests that as the GDP per capita of a country improves, it trades less with its block member. While this result may be plausible with the members of SAARC countries because most of them have similar per capita income, it is not conceivable why it may be so with other trading partners.

VII. Conclusions and Future Research:

For economists, the usual presumption is that the national goal is to maximize national economic welfare, most conveniently measured by GNP. For political scientists, the usual presumption is that the goal is to maximize the relative standing of the country vis-a-vis competitors. GNP is important as one of the determinants of power along with other determinants such as the size of one's military, the possession of colonies or a sphere of influence, the state of one's technology, etc.

Economists continue to believe that worldwide free trade is the first-best strategy. Arguments are made that in the presence of imperfect competition, increasing returns to scale, and endogenous technology, an individual country can theoretically raise economic welfare by imposing just the right tariffs or subsidies. But the introduction of imperfect competition does at least as much to strengthen the arguments for free trade as to weaken them. Even in the presence of imperfect competition, intervention works only if the foreign country fails to retaliate. An equilibrium in which all countries are prevented from intervening—for example, by means of the GATT or the World Trade Organization—is better for all than the noncooperative equilibrium in which everyone intervenes.

Although the multilateral system has made large strides toward freer trade, political constraints inevitably prevent the immediate attainment of the economist's nirvana. Since influential producer interest groups in each country typically stand to lose from free trade, unilateral liberalization rarely occurs and the world must instead await the outcome of step-by-step multilateral negotiations, in which countries trade concessions with each other in such a way that at each step the percentage of the population that stands to gain is sufficiently high to overcome the political opposition.

The increasing complexity of international relations and consequent problems with global economic institutions appear to be economic facts of life at the end of the 20th century. Notwithstanding the creation of the World Trade Organization and the effort to establish commercial rules of the road at the global level, this gives grounds for thinking that regional economic arrangements, whose negotiation involves fewer transactions costs, will be the wave of the future. The rise of regionalism has understandably raised the specter of exclusionary blocs and concern over the danger of trade diversion. This paper has asked whether there are grounds for drawing such inferences from the history of regionalism in the SAARC countries. A striking feature of the SAARC economies is that the volume of intra-regional trade is very low and the dependence on the industrialized countries considerable. To the extent that regional trade is limited by the absence of complementarity in production and resource base and financing difficulties, immediate benefits from trade creation within SAARC are not likely to be significant. However, trade in the region is also inhibited by structural rigidities created by political conflicts. Removal of such rigidities under the SAARC can open up some profitable intra-regional trade channels. In the long run, structural change through regional planning can create new vertical and horizontal linkages through regional planning can create new vertical and horizontal linkages to generate dynamic benefits from integration. In addition, there is room for mutually profitable cooperation within the SAARC in the areas of trade cooperation in external markets and regional water management with regard to the problems of floods and irrigation. A precondition for successful integration among the SAARC countries is a diffusion of political tensions so that regional complementarities and scale economies can be exploited and at the same time, mutually agreeable mechanisms for equitable distribution of benefits and costs of integration can be put in place.

The economies of the SAARC countries are similar in factor endowments and cost structure. Therefore, inter-industry trade based on comparative advantage is unlikely to be significant in the SAARC countries. The modern theory of international trade suggests that countries with similar patterns of demand are likely to trade more among themselves because goods which have achieved economies of scale can more easily be sold in another country having a similar preference pattern. Therefore, economies of scale can trigger profitable trade flows even in the absence of comparative advantage.

Expanded regional markets within the SAARC should make it possible for many consumer good industries to achieve significant scale economies thus boosting regional trade. However, to the extent that the region's comparative advantage is going to lie in the production of relatively simple consumer goods, an effective market for them must be ensured. This calls for a policy of diverting purchasing power to the relatively poorer segments of the population. Success of the SAARC in this direction is clearly linked to an egalitarian development policy in the region.

In addition to the horizontal integration of the regional consumer goods industry, intra-regional trade can also be increased through vertical integration. Typically, raw materials such as jute, cotton, leather, food, minerals, pass through several stages of fabrication. The essence of vertical integration is to allow one country to specialize in one stage of production of the final commodity thereby realizing the economies of scale associated with the particular stage of production.

We have found that the formation of the SAARC free trade areas will likely to have significant impacts on Southeast Asia's trade that cannot be attributed to the participating countries' observable

economic characteristics or even to unobservable factors, such as histories of intimate trade relations or beneficial trade structures, whose effects remained constant over time. At the same time, some limitations of the analysis should be recognized. The analytic framework takes no account of the potential impact of preferential trading arrangements on the growth of output in member countries or of the global trend to more openness to trade caused, in part, by a general postwar liberalization of trade. Within the methodology, several potential extensions of the underlying approach could also be considered. One is to differentiate trade in different types of products, such as food or manufactures. Another extension would be to expand the geographical coverage to include developing countries, possibly while allowing these countries to have different behavioral coefficients.

In this light, the case in favor of regional trading arrangements is a "second-best" argument that takes as given the impossibility of further MFN liberalization. The uninitiated might assume that free trade economists would under these circumstances necessarily support free trade areas (FTAs). But from the standpoint of static economic welfare, trade economists are ambivalent about the desirability of FTAs. So long as tariffs and other barriers against third countries remain in place, the elimination of barriers between two FTA members can as easily intensify distortions as eliminate them. The classical distinction is between the harmful trade-diverting effects of FTAs and their beneficial trade-creating effects. Although modern theories of trade have gone far beyond the diversion/creation distinction, it remains a useful guide to likely welfare effects.

We can expand the analysis of this paper in two ways by estimating the magnitude of trade creation and trade diversion effects of the SAPTA. There are basically two ways one can measure trade creation and trade diversion. Trade creation denotes a shift in production from higher-cost domestic producers to cheaper producers in the partner country. Trade diversion, on the country, represents a shift from lower-cost producers in the non-member countries to higher-cost producers within the group due to discriminatory trade policies against non-member countries. Thus, trade creation is equivalent to an increase in intra-regional trade and trade diversion decrease in inter-regional trade.

First, the *revealed comparative advantage* (RCA) concept is used to measure the comparative advantage of each industry in each country. The idea is that the more dispersedly distributed are the comparative advantages among the member countries, the greater will be the possibility of these countries complementing each other's industrial production. Therefore, *ceteris paribus*, if the *variance* of the RCA's of the member countries in one industry is large, the TC effects in that industry should also be large. Conversely, a smaller variance of the RCA's would suggest a smaller TC effect. Furthermore, *ceteris paribus*, a large difference in the RCA's of the member and non-member countries would imply a larger TD effects since more imports originally coming from non-member countries would be replaced by imports from the member countries. The RCA *variance* among the member countries is therefore used to evaluate the TC effects among them and the RCA difference between this group and the outside world is used to evaluate the TD effects. The feasibility or potential of this grouping depends, of course, on the net *difference* between TC and TD.

The second approach is to estimate TC between SAARC partners and TD as a result of SAPTA is partial equilibrium in nature, and follows that proposed by Robert Baldwin and Tracy Murray in their study of the TD effects of the Generalized Series of Preferences (GSPs) of GATT (Baldwin and Murray 1977).

References

- Anderson, James E. "A Theoretical Foundation for the Gravity Equation," American Economic Review, Vol. 69 (1979), pp. 106-16.
- Anam, M. and S.S. Rahman. "Economic Integration in South Asia: An Exploratory Analysis in Trade, Investment and Finance," Journal of Developing Societies, Vol. VII (1991): 139-158.
- Antoine-Mehanna, Rock and M. Kabir Hassan. 2001. "Is the Gulf Cooperation Council (GCC) a Successful Trading Bloc?: A Middle Eastern Framework," Middle East Business and Economic Review. (Forthcoming)
- Balassa, Bala (1965). "Trade Liberalization and 'Revealed' Comparative Advantage," The Manchashter School of Economic and Social Studies, 33: 99-124.
- Baldwin, Richard E. (1988). "Hysteresis in Import Prices: The Beachhead Effect," American Economic Review 74, pp. 773-85.
- Baldwin, Richard E., and Paul Krugman (1989). "Persistent Trade Effects of Exchange Rate Shocks," Quarterly Journal of Economics 104, pp. 635-654.
- Baldwin, R.E., and T. Murray (1977). "MFN Tariff Reductions and Developing Country Trade Under the GSP," Economic Journal, 87: 30-46.
- Bangladesh Bureau of Statistics, 1994. Foreign Trade Statistics of Bangladesh 1990-91 and 1991-92, Dhaka.
- , 1995. Statistical Year Book of Bangladesh, 1994, Dhaka.
- Bangladesh Economic Review, 1995. Ministry of Finance, Government of Bangladesh, Dhaka.
- Bangladesh Export Statistics, 1993. Annual Report, Export Promotion Bureau, Dhaka.
- , 1994. Annual Report, Export Promotion Bureau, Dhaka.
- , 1995. Quarterly Reports, Export Promotion Bureau, Dhaka.
- Batliwalla, C.J. "Financial Cooperation in South Asia," in Towards Regional Cooperation in South Asia: ADB/EWC Symposium on Regional Cooperation in South Asia, Manila, March 1987, Asian Development Bank, February 1982.
- Bergstrand, J.H. "The Gravity Model in International Trade: Some Microeconomic Foundations and Empirical Evidence," Review of Economics and Statistics, Vol. 67 (1985), pp. 474-81.

Bhagwati, Jagdish. 1993. "Regionalism Versus Multilateralism: An Overview," In New Dimensions in Regional Integration, edited by J. de Melo and A. Panagariya. New York: Cambridge University Press.

Bhuyan, A.R. and Rashid, M.A., 1993. Trade Regimes and Industrial Growth: A Case Study of Bangladesh; Bureau of Economic Research, D.U. and International Center for Economic Growth, San Francisco, U.S.A.

Centre for Policy Dialogue, 1995. An Independent Review of Bangladesh's Development; University Press Limited, Dhaka.

-----, 1996. An Independent Review of Bangladesh's Development; University Press Limited, Dhaka.

Chaudhari, S.K. 1995 Cross-Border Trade Between India and Bangladesh; Working Paper No. 58, NCAER, India.

Chowdhury, N. 1994. Impact of GATT Uruguay Round on Bangladesh's External Economy: Preliminary Results for Selected Sectors; Report. Prepared for the Metropolitan Chambers of Commerce and Industries, Dhaka, Bangladesh.

Dixit, Avinash (1989). "Hysteresis, Import Penetration, and Exchange Rate Pass Through," Quarterly Journal of Economics, 104, pp. 205-228.

Eichengreen, Barry and Douglas A. Irwin (1996). "The Role of History in Bilateral Trade Flows," NBER Working Paper Series (#5565), May 1996.

Frenkel, Jeffrey and Wei, Shang-Jin (1995). "Continental Trade Blocks: Are They Natural or Super Natural," NBER Working Paper

Government of Bangladesh. 1996 Memorandum for the Bangladesh Aid Group 1996-97.

Hassan, M. Kabir. Banking and Finance in Bangladesh: A Collection of Essays, Academic Press, 1995.

Hassan, M. Kabir. 2000. "International Trade With SAARC and Trade Policies of Bangladesh." Journal of Economic Cooperation. 21(3): 99-152

Hassan, M. Kabir. 2001. "Is SAARC A Viable Economic Block? Evidence from Gravity Model." Journal of Asian Economics. 12: 263-290.

Hassan, M. Kabir and M. Faridul Islam. 2001. "Prospect and Problems of a Common Market: An Empirical Examination of the OIC Countries," American Journal of Islamic Social Sciences. Forthcoming.

Kreinin, Mordechai, and Michael Plummer, 1992. "Effects of Economic Integration in Industrial Countries on ASEAN and the Asian NIEs," World Development 20(9): 1345-1366.

Mukherjee, I.N. 1996. South Asian Preferential Trading Arrangement: Assessing Trade Flows in the First Round of Trade Negotiations; Report Prepared for SAARC Chamber of Commerce and Industries, FES, New Delhi, India.

Rahman, S.S. and D. Balcome. Canadian Business Linkages with the Developing Countries, Volume 1: The Asian Experience, Report No. 23-87. Ottawa: The Conference Board of Canada, November, 1987.

Rashid, A. 1994. Study on the Likely Impact of the Recent GATT Agreement on Trade, Growth and Employment in the Textile Sector; Report of the Study Prepared for Metropolitan Chamber of Commerce and Industries, Dhaka.

Srinivasan, T.N. and Gustavo Canonero (1993a). "Liberalization of Trade Among Neighbors: Two Illustrative Models and Simulations," South Asia Region Discussion Paper Series, Supplement II to IDP #142.

Srinivasan T.N. and Canonero, G. (1993B). "Preferential Trade Arrangements: Estimating Effects on South Asian Countries" South Asia Region Discussion Paper Series, Supplement III to IDP #142.

Srinivasan T.N. 1994. Regional Trading Arrangements and Beyond: Exploring Some Options for South Asia: Theory, Empirics and Policy, Report No. IDP-142, South Asia Region, World Bank.

UNCTAD. 1994. Statistical Pocket Book. United Nations, Geneva.

----- . 1994. Hand Book of International Trade and Development Statistics. United Nations, Geneva.

----- . 1995. International Monetary and Financial Issues for the 1990s. Vol. VI. United Nations, Geneva.

World Bank. 1995. Bangladesh: Recent Economic Developments and Priority Reform Agenda for Rapid Growth, C.E.M. Dhaka.

----- . 1996. Bangladesh: Annual Economic Update: Recent Economic Development and Medium Term Reform Agenda; C.E.M., Dhaka.

----- . 1996. Bangladesh: An Agenda for Action, South Asia Department 1, Washington, D.C.

----- . 1996. Global Economic Prospects and the Developing Countries 1996; Washington, D.C.

Wong, J. (1985). "ASEAN's Experience in Regional Economic Cooperation," Asian Development Review, Vol.3, No.1: pp. 79-98.

Yilmaz, K and Varma, S. 1995. Trade Policy Reform in Bangladesh; Bangladesh: Industrial Surveys and Studies Program (Working Paper), World Bank, Dhaka.

Table 1: Direction of Exports (F.O.B.) by Selected Countries (in million Taka)

Countries	1994-95	1995-96	1996-97	1997-98
Australia	606.6	813.3	1183.8	1501.6
Belgium	5029.2	6832.1	8524.4	8880.8
Burma	161.8	69.2	13.0	2.3
Canada	2602.8	2634.0	2803.0	6942.9
China	1911.7	993.4	2326.4	2242.8
Czechoslovakia	27.0	13.2	10.5	13.2
Egypt	718.7	705.0	285.8	220.2
France	8041.5	11449.8	14716.4	20292.8
Germany F.R.	10390.0	11828.6	14679.7	20369.8
Hong Kong	4720.3	3257.9	3140.2	2553.0
India	1084.7	1312.0	1020.2	470.5
Indonesia	202.5	125.5	465.9	221.1
Iran	1196.7	1681.5	2200.2	1526.6
Iraq	3.6	8.9	0.9	103.6
Italy	7759.5	7883.2	8176.4	12405.7
Japan	4466.9	9091.8	5446.9	5602.1
Malaysia	282.8	226.4	432.4	821.2
Maldives	2.5	2.8	1.3	-
Nepal	45.2	355.6	214.5	1.8
Netherlands	4628.7	6685.4	8795.0	10304.4
New Zealand	102.4	126.0	124.2	130.5
Pakistan	1417.7	1521.3	1479.5	1512.2
Saudi Arabia	139.5	159.3	114.2	596.8
Singapore	2427.2	938.1	2486.8	2141.6
Srilanka	564.8	158.6	208.8	58.1
Sudan	1209.7	358.6	803.1	906.3
Sweden	1598.3	1730.4	1938.6	2397.7
Thailand	509.4	692.0	339.8	787.0
Turkey	621.9	1059.9	698.7	964.5
U.K.	11252.2	13919.5	14300.8	16836.0
USA	48432.0	47598.8	59411.1	90398.4
Russia Federation	1176.7	311.4	692.5	969.6
Yugoslavia	9.8	-	-	11.2
Other countries	13625.3	12177.0	289134.0	17222.0
Total Export	136969.6	144520.6	171554.2	229408.3

Source: Foreign Trade Section, BBS.

Table 2: Direction of Import (C.I.F.) by Selected Countries (in million Taka)

Countries	1994-95	1995-96	1996-97	1997-98
Australia	3326.3	5517.6	8964.2	8819.7
Belgium	861.5	869.9	1465.0	1570.0
Burma	1034.2	192.3	257.3	5230.0
Canada	1940.2	3445.0	3295.4	5311.9
China	18964.6	7623.6	22298.7	33008.7
Czechoslovakia	-	40.6	238.4	225.3
Egypt	75.4	164.5	973.8	437.1
France	2767.4	2988.3	7565.0	4385.9
Germany F.R.	5344.4	5539.6	8753.1	8267.3
Hong Kong	24880.6	17048.0	3883.5	18101.9
India	24717.0	44243.5	57079.2	47276.5
Indonesia	3685.9	2919.9	4922.6	9997.8
Iran	222.2	-	858.7	722.0
Iraq	-	-	3.7	0.8
Italy	3118.3	4518.1	3300.6	3431.9
Japan	13504.1	17727.5	21044.5	21743.6
Malaysia	1760.5	4972.8	9060.1	8348.5
Maldives	5.0	0.9	12.5	12.4
Nepal	25.6	282.1	445.5	496.5
Netherlands	1153.4	2550.5	2920.7	3317.8
New Zealand	642.4	585.1	662.7	606.4
Pakistan	8651.7	4637.6	2792.4	3586.3
Saudi Arabia	1451.3	3562.2	5800.6	4963.0
Singapore	17012.6	18387.1	19811.8	2069.3
Srilanka	249.5	383.5	575.7	374.3
Sudan	5.5	158.9	330.8	941.1
Sweden	584.4	2948.9	2304.6	2209.8
Thailand	3567.8	3080.6	5804.5	6064.2
Turkey	0.3	94.6	661.7	398.1
U.K.	3316.1	4754.1	9150.4	11626.5
USA	11705.4	10140.2	13764.6	13750.3
Russia Federation	1907.3	1968.5	4240.1	3850.1
Yugoslavia	-	54.5	148.2	0.1
Other countries	62083.2	83245.7	66796.0	87771.3
Total Import	218564.5	254646.2	290186.6	318916.4

Source: Foreign Trade Section, BBS.

Table 3: Exports of Principal Commodities (in million Taka)

Commodities	1994-95	1995-96	1996-97	1997-98
Total Exports	136970	144521	171554	229408
1. Prawns and shrimps	11233	11803	10781	11745
2. Tea	1314	1254	1380	2150
3. Spices	4	2	6	1
4. Raw hides and skins	371	2	3	1
5. Raw Jute	3181	2968	4344	3776
6. Jute yarn	1890	2405	2854	2684
7. Jute mfg. total	11362	10360	10531	9528
(a) Hessian	2285	1956	2108	1812
(b) Sacking	40	35	45	14
(c) Carpet backing cloth	1370	1459	1156	1304
(d) Others	7667	6910	7222	6398
8. Leather and leather manufacture	7739	6108	5366	4809
9. Ready made garments	79140	90595	114793	171660
10. Handicraft	168	135	66	150
11. Others	20568	18889	21430	22904

Source: Foreign Trade Section, BBS.

Table 4: Imports (C.I.F.) of Selected Commodities (in million Taka)

Commodity	1994-95	1995-96	1996-97	1997-98
1.Live Animals, Animal Products	2307	2576	3609	3534
2.Vegetable Products	23714	24032	19226	28652
3.Animal or Vegetable Fats and Oils and their Cleavage Products; Prepared Edible Fats; Animal or Vegetable Waxes	8633	14778	20702	10777
4.Prepared Foodstuffs; beverages, Spirits and Vinegar; Tobacco and Manufactured Tobacco Substitutes	3401	2231	5677	5928
5.Mineral Products	23379	28495	37161	36613
6.Products of the Chemical or Allied Industries	17905	14596	24094	22506
7.Plastics and Articles thereof Rubber and Articles thereof	7820	8896	12054	11522
8.Raw Hides and Skins, Leather, Furskins and Articles thereof; Saddlery and Harness, Travel Goods, Handbagsand Similar Containers; Articles of Animal Gut(other than Silk Worm)	185	165	268	125
9.Pulp of Wood or of other fibrous Cellulosic Materials; Waste and Scrap of Paper or Paper-Board; Paper and Paper-Board and Articles-thereof	4400	5227	9002	7747
10.Textiles and Textile Articles	69478	71711	57587	87260
11.Footwear Headgear Umbrellas, Sun, Umbrellas Walking Stick, Seat Sticks, Whips, Riding Crops and Parts thereof; Prepared Feathers and Articles Made there with; Artificial Flowers; Articles of Human Hair	381	469	222	304
12.Articles of Stone, Plaster, Cement, Asbestos, Mica or Similar Materials;Ceramic Products; Glass and Glassware	1318	1186	1631	2020
13.Natural or Cultured Pearls, Precious or Semi-Precious Stones, Precious Metals, Metals Clad with Precious Metal and Articles thereof; Imitation Jewellery; Coin	80	256	446	156
14.Base Metals and Articles of Base Metal	16647	23658	29763	32108
15.Machinery and Mechanical Appliances; Appliances; Electrical Equipment; Parts thereof; Sound Recorders and Reproducers, Television Image and Sound Recorders and Reproducers, and Parts and Accessories of Such Articles	19983	32083	37485	43556
16.Vehicles, Aircraft, Vessels and				
TOTAL:	218564	254646	290187	318916

Source: Foreign Trade Section, BBS.

Table 5: Bangladesh Export to SARC Countries (in million US\$)

<i>Countries</i>	<i>1998-99</i>			<i>1997-98</i>		
	<i>Value</i>	<i>% of Share of export to SAARC countries</i>	<i>% Share of export to all countries</i>	<i>Value</i>	<i>% of Share of export to SAARC countries</i>	<i>% Share of export to all countries</i>
Bhutan	0.46	0.45	0.01	0.02	0.02	Negligible
India	59.72	58.17	1.12	65.64	57.83	1.27
Maldives	-	-	-	-	-	-
Nepal	0.83	0.81	0.02	1.93	1.70	0.04
Pakistan	38.10	37.11	0.72	44.67	39.36	0.87
Sri Lanka	3.55	3.46	0.07	1.24	1.09	0.02
Total of SAARC	102.66	100.00	1.93	113.50	100.00	2.20
Total of all countries	5312.86			5161.20		

Source: Bangladesh Bureau of Statistics