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Chapter 6

A New Way to Locate the Comparative Advantages of India and Bangladesh on the Basis of Fundamentals Only

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1. Introduction

Regional trade groupings have emerged as a hard reality on today's global economic scenario. They range from preferential trading arrangements to economic union. The basic objective of such trade groupings is to promote intra-regional trade among the member countries making way for economic cooperation among them and thereby helping them to raise their pace of development. The formation of South Asian Association for Regional Cooperation (SAARC) is an effort in this direction.

SAARC was established in 1985. Even though the ideas for a regional grouping of the South Asian nations have been mooted since 1980, the Charter formally establishing SAARC was adopted at the first Summit in Dhaka in 1985. Being formed by the seven member countries namely, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and SriLanka, the purpose of the establishment of SAARC was to accelerate economic and social development in the member countries through joint action in certain agreed areas of cooperation.

The SAARC countries contain about 21% of the total world population, but only 3.5% of the land area. About half of the worlds poor live in this region. Barring Maldives, all the SAARC countries have low income. GNP per capita ranges

TABLE 6.1

BASIC FEATURES OF SAARC COUNTRIES

Regional Performance Figure	Bangladesh	Bhutan	India	Maldives	Nepal	Pakistan	Sri Lanka
Area (000 km sq.)	144	47	3287	0.3	147	796	66
Population (2002, million)	136	8.51	1048	2.87	24	145	19
Annual population growth (%) (1990-2001)	1.9	2.9[1]	2	2.6[1]	2.6	2.7	1.4
Life Expectancy (2000, years)	61	63[1]	62	69[1]	59	63	73
Literacy Rate (2000,%)	41	42.2	57	97[1]	42	43	92
Per capita GNP (2002, US dollars)	360	590	480	2090	230	410	840
GDP(2001,US dollars million)	46652	300	477555	240	5525	59605	16346
GDPGrowth Rate(2001-02)	4.4	7.7	4.4	2.3	-0.6	4.4	3.0
Rate of inflation (2000,%)	5.8	7	5.4	3	2.1	4[1]	14.2[1]
Per Capita Export (2001, US dollars)	54.02	77[2]	62.9	282.9	53.3	72.8	299.8
Per Capita Import (2001,US dollars)	78.8	98[2]	76.4	1196.14	74.3	88.6	351.1
Per capita foreign debt (2000, US dollars)	120.8	128.95[3]	97.7	787.4	117.6	234.7	472.1
Currency	Taka	Nugultrum	Rupee	Rufiyaa	Rupee	Rupee	Rupee
Exchange Rate (April 2000, per US dollars)	54	44.9	46.8	11.8	71.1	58	82.6

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1.2001; 2. 2000; 3. 1998
Source: World Development Report 2004; World Development Indicators 2001 & 2003. Nationmaster.com
CIA World Fact book 2002.

from 230 US dollars (Nepal) to 2090 US dollars (Maldives) in 2002.

Table 6.1 presents some basic features of the SAARC countries.

As seen from the table, among all SAARC countries India has the largest land area, population and also GDP, while Maldives have the least of all of these. Clearly, India constitutes three-fourth of SAARC on these three accounts. Sri Lanka recorded the highest per capita export figure of 299.8 US dollars in 2001 while Nepal accounted for the lowest of 53.3 US dollars in the same year. On the other hand, Maldives had the highest per capita imports of 1196.1 US dollars in 2001 while Nepal with a figure of 74.3 US dollars again had the lowest in that year. The per capita foreign debt in the SAARC region ranged from 787.4 US dollars (Maldives) to 97.7 US dollars (Bhutan) in the year 2000.

The most obvious measure of cooperation between the member states of any regional grouping is the level of trade taking place. But unfortunately the performance of the SAARC members on the trade front can hardly be termed as moderate when benchmarked with many other countries in Asia. In particular, the SAARC states are plagued with trade imbalances among themselves. This urged the member states to undertake a concrete step when a study on SAARC Trade, Manufactures and Services was commissioned at the Islamabad Summit in 1998. An Inter-Governmental Group set up by the Colombo Summit in 1991 to formulate and seek agreement on an institutional framework for trade liberalization among the members finalized a draft agreement on SAARC Preferential Trading Agreement (SAPTA). Finally, the agreement on SAPTA was signed at the Dhaka Summit in 1993. Thereafter, in December 1995, being ratified by the member states it came into force with an attempt to integrate and strengthen the regional trade links in South Asia. The agreement on SAPTA

aims at track expansion among the members through exchanging concessions relating to tariffs, para-tariffs, non-tariffs measures and direct trade measures. The agreement on SAPTA allows for various approaches to trade liberalization such as product-by-product, across the board tariff reductions, sectoral approach and direct trade measures.

The present status of the SAPTA initiative reveals that the trade of items, to which concessions have been extended, is quite low. In fact, for many of the products trade flows are zero. Moreover, the preferential imports account for a very low share of total Intra-SAARC trade. However, a more important issue is to identify products with high trade potential by examining the trade complementarities on one-hand and production complementarities on the other. Even in sectors where the countries are competitors, possibilities of intra-industry trade can be explored.

However, the ultimate aim of this region is not to stop at preferential trading arrangements rather to take SAPTA towards a new vision of free flowing trade in the region under the arrangement of South Asian Free Trade Area (SAFTA). Accordingly, at the end of the 12th SAARC Summit at Islamabad, Pakistan on January 6, 2004 the foreign ministers of the seven member states signed a framework pact on the Free Trade area in the region paving the way for the regional integration of the economies. As per the terms of this pact the developing countries of the region —India and Pakistan— will have to bring down their custom tariffs to between zero and five percent within seven years of the start of the agreement. Sri Lanka has been given eight years for the same whereas the rest of the Least Developed Countries (LDCs)— Nepal, Bhutan, Bangladesh and Maldives—will have ten years to do that. As such the South Asian Free Trade Area (SAFTA) treaty will come into force on January 1, 2006 and will be fully implemented by December 31, 2015.

Against this backdrop we now try to develop a theoretical model and analyze it empirically, which will help to identify the products in which the two member countries of SAARC, namely India and Bangladesh, have trade potentials. Thereafter, we shall turn to assess the potential gains to bilateral trade between the two countries.

Our choice of the two member countries of India and Bangladesh is urged by the fact that in recent years issues concerning bilateral trade between Bangladesh and India have received heightened interest and come under close scrutiny. Bangladesh's trade deficit with India has been increasing at an accelerated rate in recent years. The deficit grew most visibly in the 1990's when Bangladesh started to liberalize at a rapid pace with the deficit rising from 200 million to about a billion within the scope of the last five years. Such a state of affairs has given rise to concern, both at the policy level and at the level of public perception.

The paper is organized as follows. In the next section we review the literature. Then, in Section 3, we develop the model, which helps us to locate the comparative advantages of the two economies. In Section 4, the comparative advantages of the economies are located on the basis of the results obtained and possible explanations are given for the findings. In Section 5, the magnitude of the gains to free bilateral trade is computed. The paper concludes with a summary on the possible explanations of the findings in Section 6. The Appendix outlines the data used, their sources, and their adjustments.

2. Survey of Literature

There is a good volume of literature that has developed in recent years with an attempt to analyze prospects of free trade and its impact on the regional groupings.

Nitsch (2000) has studied the impact of national borders on international trade within the European Union and found that even there the national borders have a decisive

impact on the trade partners. Anoruo and Ahmed (1999) made an assessment of the role of international trade in economic growth of developing countries.

Anderson (1998) in his paper provided benchmarks of trade restrictiveness using the Trade Restrictiveness Index. He found that trade weighted average tariffs substantially underestimate restrictiveness measured by the uniform tariff equivalent, with the degree of underestimation positively correlated with the dispersion of the tariff structure. Fernandez (1998), on the other hand, examines several possible benefits that regional trade agreements may confer to their partners, including credibility, signaling, bargaining power, insurance, and coordination. He assesses the necessary conditions for each of these candidates to work, gives stylized examples of specific types of policy where it might be applicable, examines real cases where the explanation might be relevant, and discusses their overall plausibility. A related work by Casella (1996) tries to find out if there are systematic forces such that countries of different sizes participating in a free trade bloc gain differently from the entry of new members. If economies of scale imply that firms located in large countries enjoy lower costs, then the gains from enlarging the bloc will fall disproportionately on small countries, because the entry of new members diminishes the importance of the domestic market and improves the small countries' relative competitiveness.

A related issue, which has led to much concern among the contemporary economists, is that of bilateral trade between countries. Bagwell and Staiger (1999) have noted the important issue that the value of concessions that a government wins in a current negotiation may be eroded in a future bilateral negotiation to which it is not a party. They have shown that in the absence of rules that govern the bilateral negotiation the potential for opportunistic bilateral agreements is indeed severe. They have also tried