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ADVANCING REGIONAL INTEGRATION IN SOUTH ASIA

Opening up Markets to Neighbors: Gains for Smaller Countries in South Asia

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A large body of literature shows that all countries benefit from trade openness, irrespective of size; other work shows that smaller countries benefit *even more* from mutual trade liberalization, due to their greater dependence on trade.ⁱ Trade liberalization, however, can be a difficult political sell because economic gains are often dispersed over time and space, while losses can be immediate. Vested interest groups lobby governments for protection from more competitive imports. Moreover, when one of the countries involved in the process is disproportionately large, lobbies in smaller countries find it easier to bargain for domestic protection, on the often misplaced grounds that the larger economy might swamp the smaller one. The gains from closer association between a large and small country are often missed. Larger countries have strong protectionist lobbies as well, but since trade is usually a smaller share of their economies, they may be somewhat less influential than their counterpart lobbies in smaller countries. In all countries, whether large or small, strong leadership appears to be critical in envisioning and implementing trade reforms.

In South Asia, the South Asia Free Trade Area (SAFTA) came into effect in 2006. But free and unfettered trade is still a work in progress. For example, all countries maintain long “sensitive lists”, where the SAFTA tariff concessions do not apply. Even India, which offers virtual free trade to the least developed countries (LDCs), still has extensive protection on imports from other countries in the region. Drawing from theory and evidence, this note looks

at how all countries, especially the smaller ones, could gain from mutual trade liberalization (one critical aspect of regional integration). Consumers and exporters in smaller countries benefit significantly from trade liberalization, as goods become cheaper for consumers while exporters gain access to a much larger market and more competitive inputs. Import-competing firms (producers) in the smaller country present a mixed picture, with the more productive ones gaining (especially ones that use imported inputs) and the less efficient losing.

Consumers and Exporters: Undisputable Gains

Consider the three key players in this debate: consumers, exporters and producers. Consumers, the silent majority in any country and often ignored in trade policy decision-making, gain in several ways from increased regional cooperation: through lower prices (leading to an increase in real income), more product variety, and better quality goods.ⁱⁱ Think of cheaper consumer goods from Bangladesh flowing to poor families in India’s less accessible North East, thereby reducing their monthly food expenditure. Analysis by a consumer advocacy and research group shows that intra-regional tariff reduction would lead to an approximate gain of \$2 billion a year in welfare for South Asian consumers.ⁱⁱⁱ Similarly, the cost of basic household goods in

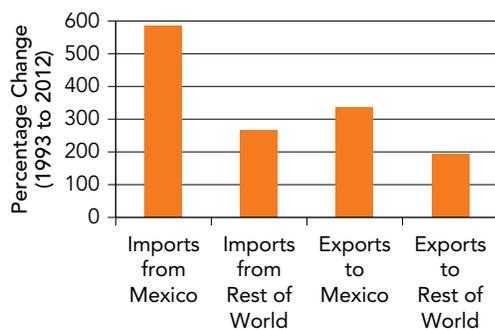
Consumers, the silent majority in any country, and often ignored in trade policy decision making, will always gain from increased regional cooperation through lower prices, more product variety and better quality of goods.

Mexico has fallen significantly (by half according to one estimate) since the North American Free Trade Agreement's (NAFTA) implementation.^{iv}

Exporters are also big winners. With access to much larger markets and sourcing opportunities for key inputs, the quality and quantity of exports would go up and new export products would emerge. A recent study shows that if Bangladesh were to sign a bilateral Free Trade Agreement (FTA) with the larger country India, its exports to India would grow substantially more than if it receives one-sided concessions from India. This is due to Bangladeshi exporters gaining access to more competitive imported inputs.^v

Mexico's experience after joining NAFTA is a good example of sustained gains in trade arising from an agreement between a smaller country, Mexico, and a much larger trading partner, USA. Figure 1 shows that from 1993, the year before NAFTA's inception, to 2012, US imports from Mexico rose by about 500 percent, more than twice as fast as imports from the rest of the world. US exports to Mexico also rose faster than exports to the rest of the world,

FIGURE 1: US-Mexico trade far outstripped trade with the rest of the world



Source: Authors' calculations based on WITS (World Bank) data

many of these being product inputs needed by Mexico's manufacturing industries, including the exporting sector that has a large foreign-value added component. A 2006 study finds that Mexico has become an export platform for US investors since 1994: a platform that has acted as a catalyst for Mexican export growth to its NAFTA partners and the rest of the world.^{vi} Without NAFTA, Mexican exports to USA would have been lower.^{vii} Similarly, in Mercosur (Southern Common Market) – the free trade agreement between Argentina, Brazil, Paraguay, Uruguay and Venezuela – exports from a small country such as Paraguay to Mercosur

countries (including the larger country, Brazil), grew faster than its exports to the rest of the world.

Producers: A Mixed Story, but Opportunities Aplenty

There are several major ways through which trade liberalization can affect small country firms, all representing sources of dynamic gains from trade associated with higher productivity.

First, lowering import tariffs, quotas and other non-tariff barriers (NTBs) leaves domestic firms open to foreign competition and cheaper products. This creates pressure on domestic firms to become more efficient and increase productivity. Those unable to cope would, in time, be pushed out of the market; however the net effect would be a higher level of firm productivity. The negative impact on employment arising from firms unable to compete will be counterbalanced by expansion of the more productive and export-oriented firms. Second, firms in the small country gain by increasing their size and scale via access to a bigger market, which in turn could enable cost reduction, and the ability to spread the costs of technology absorption. Third, firms in the small country will be able to compete more effectively, both at home and overseas, through availability of cheaper and higher quality inputs. Fourth, there would be dynamic gains for the economy and its firms through the continued impact of competition on productivity, access to newer technologies and inputs, and the ability of firms to grow beyond their own relatively small markets. Gains would be compounded over time – more firms would become increasingly efficient, absorbing new technology, learning lessons from foreign competition, and gradually branching into non-traditional export areas.

Finally, trade liberalization could also encourage more foreign direct investment (FDI): trade and FDI liberalization tend to complement each other, i.e., opening up FDI leads to more trade, and vice versa. In turn, FDI can bring skills, technology and foreign capital, as well as access to new markets. Thus, it is an additional source of dynamic gains from increased international engagement.^{viii} FDI can also lead to increased exports from the host country – for example, FDI by an Indian apparel producer in Bangladesh can lead to increased apparel exports from Bangladesh to South Asia as well as the rest of the world. Investment-friendly measures as part of the regional cooperation agenda can also help encourage more FDI.

In the Mexican case, the sectors of its economy oriented towards NAFTA (mostly large firms employing 500 people or more) enjoyed productivity growth of 5.8 percent annually between 1999 and 2009, substantially higher than the national average.^{ix} Since NAFTA, Mexico has also seen a surge in FDI from the US, a major expansion of its auto industry, improvement in labor skills, and an increase in manufacturing output.^x Also, since NAFTA, Mexican states bordering the US have received a higher share of US-based FDI compared to other Mexican regions.^{xi}

The US-Mexican Asymmetry: An Example for Smaller South Asian Nations

Mexico is much smaller than the US, but turns out to be the biggest winner from NAFTA despite initial domestic skepticism. Prior to joining NAFTA in 1994, the arguments made by some in Mexico echo current ones in South Asia: nascent and important industries would suffer, firms would lose to US competitors, unemployment would increase, etc. Twenty years after NAFTA, data paint a more positive picture. Mexican exports are now \$1 billion a day, more than 10 times their 1994 baseline; per capita income has risen at an average of 1.2 percent annually; and Mexico is now the world's 13th largest economy (as large as another NAFTA partner, Canada). Critics of NAFTA often point to the low Mexican growth rate since it joined NAFTA, compared to ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand) or even Chile, but a recent study shows that this did not arise from NAFTA.^{xii}

Importance of Leadership and Vision

The above evidence suggests that smaller countries in the region could reap significant benefits from a more integrated South Asia. Given that the region is in the process of making SAFTA effective, nations that hold out from the process could suffer by being “innocent bystanders”, which is a welfare loss faced by a country that does not fully participate in a regional agreement being created around it.^{xiii}

How can countries overcome their fears and the pressure of strong domestic lobbies?

Strong leadership is a critical ingredient in opening up markets. In the NAFTA case, Mexican policy makers were prepared to take a strategic and long-term view of the impact of trade reforms, including the realization that there would be short-term losses even as the economy as a whole would benefit. Also, to ensure that the benefits of free trade were realized, the leadership made strong commitments to deregulate the economy. To mitigate the negative impact, and improve reform acceptability, they instituted policies such as the PROCAMPO program, established in 1993–1994 to compensate crop producers who were expected to face declining prices after the initiation of NAFTA. In the case of India, Prime Minister Manmohan Singh decided in 2011 to provide a duty-free-quota-free market to all LDCs in the region, overriding objections by domestic textile and other lobbies.

Another aspect of trade reform is some element of gradualism.^{xiv} For sectors where there are concerns about large job displacements, trade liberalization can be phased in over a reasonable but credibly finite period, to allow time for adjustment - with sunset clauses that would end protection within a defined period. The phasing in period also provides an opportunity to address horizontal competitiveness issues, such as flexibility of land, labor, and capital markets. Finally, it would be important for policymakers to note that not all gains from opening up borders would be apparent right away. Many of the dynamic gains in new products and technologies, lower prices, bigger markets etc., would manifest themselves over time.

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Endnotes

- i. Studies (Falvey et al. 2004, 2006; Melitz and Ottaviano 2005; Baldwin and Forslid 2010) demonstrate that countries benefit with greater trade openness irrespective of the differences in country size. Other studies (Cabralés and Motta 1996; Kowalczyk 2006; Sara 2008) show that small countries benefit more from free trade agreements with larger countries. Wonnacott and Wonnacott (1981) demonstrated that a small country is better off signing a free trade agreement with mutual reductions in trade barriers with a large country than from only getting one-sided trade concessions from the large country. Helpman (2004) also makes the case that smaller countries are more dependent on trade, both for exports and imports, and the effect of trade on the growth of small economies is significantly larger. Hence, the efficiency of trade patterns (and therefore trade reforms) becomes even more important for smaller countries.

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- ii. See, for example: Tovar, J. (2012). "Consumers' Welfare and Trade Liberalization: Evidence from the Car Industry in Colombia," *World Development*, Elsevier, vol. 40(4), pages 808-820.
- iii. Chatterjee, B & George, J. (2012). "Consumers and economic cooperation: cost of economic non-cooperation to consumers in South Asia," CUTS International.
- iv. Aly Sergie, M. (2014). NAFTA's Economic Impact. Council on Foreign Relations Background. <http://www.cfr.org/trade/naftas-economic-impact/p15790>
- v. De, P., Raihan, S., and Kathuria, S. (2012). "Unlocking Bangladesh-India trade: emerging potential and the way forward," *World Bank Policy Research Working Paper* 6155.
- vi. Tunea, C. (2006). "Patterns of FDI in Mexico after NAFTA – the role of export markets and geographical determinants." *Proceedings, Canadian Economic Association Conference* 2006.
- vii. Gould, D. (1998). "Has NAFTA changed North American trade?" *Economic and Financial Policy Review*, Federal Reserve Bank of Dallas, issue Q1, pages 12-23.
- viii. Wang, Y. (2012). "Openness and Productivity: the role of imports, FDI and international telecommunications," *Latin American Journal of Economics*, Vol. 49 No. 1 (May, 2012), 125-145.
- ix. McKinsey Global Institute (2014). "A tale of two Mexicos: growth and prosperity in a two-speed economy," Mexico City: McKinsey & Company. The study shows that firms less connected with NAFTA (those employing 10 or fewer persons) saw a decline in their productivity, since they were more influenced by domestic economic changes. See footnote xi for some of the domestic handicaps in Mexico.
- x. Scotiabank (2014). "NAFTA: What's Next," *Special Report*, March 31, 2014.
- xi. Clement, N., Rey, S., Fuentes, N., and Brugges, A. (2002). "The US-Mexican Border Economy in the NAFTA Era: Implications for the Environment" in *The US-Mexican Border Environment: US-Mexico Border Communities in the NAFTA Era*, ed. By Norris C. Clement, SCERP Monograph Series No.4.
- xii. Hufbauer, G., Cimino, C., and Moran, T. (2014). "NAFTA at 20: Misleading charges and positive achievements," *Peterson Institute for International Economics*. The study shows that Mexican exports between 1993 and 2013 expanded 640 percent, Chilean exports expanded 730 percent and ASEAN-4 exports expanded only 420 percent. Mexico suffered from three specific handicaps: first, drug wars, starting around the same time as NAFTA, brought down GDP by around 1 percent annually; second, the peso crisis, coincided with the onset of NAFTA; and third, persistent monopolization of key sectors, poor infrastructure and corruption (unlike Chile and ASEAN-4) dragged down the Mexican economy.
- xiii. Krugman, P. (1991). "The move toward free trade zones," in *Federal Reserve Bank of Kansas City, Policy Implications of Trade and Currency Zones*, 7-42. Kansas City: Federal Reserve Bank.
- xiv. Trebilcock, M.J. (2014). "Dealing with losers: The political economy of policy transitions" *Oxford University Press*.



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