Costs of Non-Cooperation in South Asia: An Illustration and Way Forward

Policy Brief

RIS

I. Introduction

The South Asian economic integration has remained afflicted with a narrative that is more often than not a negative one. As a part of this, the arguments put forth include the assertion that the region lacks in trade complementarities due to similarities in production structures. Therefore, the region can only compete in products and there is limited scope for intra-regional trade.

The effect of such an argument is enormous. It has apparently led to a tendency to neglect trade integration in South Asia let alone adopting a comprehensive approach towards it, whereby trade in goods, trade in services and investment are sought to be regionally integrated simultaneously. Pakistan's consistent postponement of Most Favoured Nations (MFN) status to India and Sri Lanka's ever evasive approach towards Comprehensive Economic Partnership Agreement (CEPA) are but two glaring examples. The examples of Pakistan and Sri Lanka are deliberate as they both are the only two non-LDCs (Least Developed Countries) apart from India in the region. Both have tried to solve the problem by changing the nomenclature: from MFN to NDMA (Non-Discriminatory Market Access) in the case of Pakistan and from CEPA to ETCA (Economic and Technological Cooperation Agreement) in the case of Sri Lanka. It is yet to be seen if such moves are to yield any real progress. To top it all, these tendencies have manifested in stalling a regional economic integration process within the aegis of the South Asian Association for Regional Cooperation (SAARC) by scuttling the full implementation of South Asian Free Trade Area (SAFTA) and SAARC Agreement on Trade in Services (SATIS) as well as the SAARC Agreement on Promotion and Protection of Investment. These processes do not progress because the LDCs also take their own time in understanding and are often not in a position to lead the process. In short, obviously enough, the onus of providing an impetus to the regional economic integration process in South Asia lies with India, Pakistan and Sri Lanka.

Not only that the negative narrative has had such deleterious effects on bilateral and regional integration processes, but also such a view-point is flawed on account of both conceptual and empirical considerations. This also results in 'Costs of Non-Cooperation'(CNC).

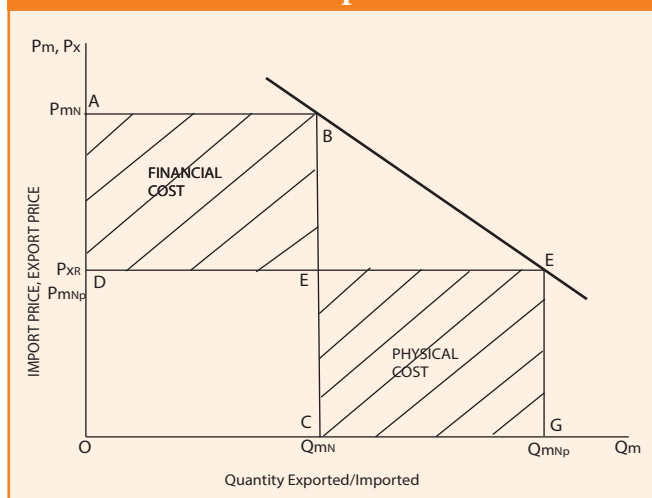## II. Costs of Non-Cooperation: An Exposition

The 'Costs of Non-Cooperation' are defined here as the following: A country imports from the global market but not from the regional market at prices higher than that price at which the same product is available from the regional market. The additional foreign exchange

Figure 1: Types of Costs of Non-Cooperation

downward sloping demand curve it can now import more quantity when import price is lower. Now if country N imports at a price PmNp from regional market i.e. a price lower than the global market price, it can import its potential quantity QmNp which is higher than the quantity QmN given its downward sloping demand curve. This would entail an import expenditure of OD*OG given by the area of rectangle OGFD which is equivalent to area OABC which was the expenditure in earlier case. With same expenditure it could import higher quantity to the tune of OG-OC i.e. CG by co-operating in the regional market. This physical loss of CG in quantity terms gives us the physical cost of non co-operation which is represented by the area of the rectangle CEFG.

III. Conceptual Considerations

Let us unravel the conceptual contours of addressing the 'Costs of Non-Cooperation'. It is true that production structures in South Asian region are similar. But this cannot deter trade within the region. First, it is now a common knowledge that similarities in production structures and in consumers' tastes and preferences is a good regional feature, whereby intra-regional trade of the intra-industry variety can take place. A country can export one type of textiles and import another type of textiles. Countries can simultaneously both export and import various types of medicines while the parent industry which is pharmaceuticals remains the same. Going by this logic of the New Trade Theory based on the determinants of product differentiation, imperfect markets and economies of scale, the South Asian region is amenable to intra-industry trade.

Secondly, this is further facilitated by horizontal specialisation and vertical integration in various stages of production within the same industry across different countries of the same region. This is also the rationale for creating regional values chains.

Thirdly, one needs to be mindful of the fact that the biggest economy in South Asia

expenditure incurred on such imports from the global market is one type of 'Costs of Non-Cooperation'. This is 'Financial Cost of Non-Cooperation. It may be highlighted that the lower price of regional products may not necessarily be due to lower quality as compared to products that are imported from the global market. Another type of Cost of Non-cooperation is the Physical Cost of Non-Cooperation arising due to the loss in terms of quantity because higher import price constraints additional import quality demanded.

The cost of non-cooperation and its two types viz. 'Financial Cost' and 'Physical Cost' can be explained with the help of Figure 1. The X axis is quantity imported/exported and the Y axis is import/export prices. Considering the downward sloping import demand curve of a country N in a region say South Asia importing quantity QmN at a price PmN, its total import expenditure would be OA*OC. Similarly, if a region exports products to the rest of the world at price PxR then the same quantity imported by country N that is OC at QmN would entail import expenditure of OD*OC in which case there will be a saving of import expenditure of precious foreign exchange to an extent of AD*DE. Therefore, the financial cost of non-cooperation is given by the area of the rectangle ABED.

Now consider this in terms of physical cost i.e. in quantity terms. Let us say country N keeps its expenditure the same. Given the

i.e. India has experienced tremendous product diversification in its exports basket – from labour-intensive industries towards higher value-added knowledge-intensive industries.

Considerations as above provide useful insights as to why 'Costs of Non-Cooperation' should not arise or could always be tackled. For the sake of brevity, we are not going into several other factors that might be giving rise to 'Costs of Non-Cooperation'. We rather turn our attention to the empirical estimation of 'Costs of Non-Cooperation' by focusing on Pakistan and Sri Lanka, the two non-LDCs of the South Asian region.

IV. Empirical Estimation

The empirical estimates of 'Costs of Non-Cooperation' were first estimated in 1995 (Das, 1995). Further, RIS (1999) carried out a detailed quantitative assessment of Costs of Non-Cooperation in the SAARC region. The empirical exercise revealed that in 1994 Sri Lanka and Pakistan imported many items at higher unit values than that would have prevailed if they imported from within the SAARC region. On this account, Sri Lanka lost US$ 266 million and Pakistan lost US$ 511 million. For Sri Lanka the unit values of imports from outside the region were on an average twice the unit values associated with regional import of the same items. Illustrative examples of the price comparison of Kawasaki-Bajaj two-wheelers imported from India by Sri Lanka with its original Japanese Kawaskai brand were highlighted (Kelegama, 1999 and RIS, 2004). These meant that it may not be always possible to argue that the items that are available from within the region at lower price are necessarily inferior to those sourced from the global market.

Another study of two-way trade complementarities between India and Pakistan also confirmed the existence of trade complementarities (State Bank of Pakistan, 2005). It predicted that Pakistan would benefit more, with imports mopping up net savings ranging from US$ 400 to 900 million. The study estimates that if Pakistan-India trade were to open up, bilateral trade volume could cross US$ 5.2 billion. The study also revealed that both countries had achieved only two per cent of their total bilateral trade potential

during the past 25 years. According to the study, 32 per cent of Pakistan's export includes products that were bought by India from other countries and constituted one third of India's total imports. The report noted that about 1,181 items worth US$ 3.9 billion, covering 45 per cent of the total items exported by Pakistan, were at par with India's imports during 2004. It indicated that about 70.3 per cent of the common items exported from Pakistan have unit values less than or equal to Indian imports' unit values, and there is a large scope for the export of those items simply by producing the quality required by India. The State Bank of Pakistan study (2005) also showed that India earns US$ 15 billion in export revenue from 2,646 items being imported by Pakistan from other countries and notes that in 2004 the unit value for Pakistan's imports was higher than the unit value of Indian exports for 48.7 per cent of these items. Forty five per cent of those common imports were not included in the Pakistan positive list and hence their import from India was not allowed. Pakistan was losing US$ 400 million to 900 million by importing those items from other sources. However, it may be mentioned that despite the fact that Pakistan has a 'negative list' regime vis-à-vis India in terms of imports the overall trade volume have not increased, these are due to various other reasons and also due to the import-pessimism that exists when it comes to importing from India. However, analysis of this aspect would take the focus away from the present focus on 'Costs of Non-Cooperation'.

IV.1 Values and Trend

A recent assessment of the welfare loss for Pakistan and Sri Lanka arising out of importing items at a higher unit values from outside the region than that would have prevailed if they imported from within the SAARC region shows that not only the costs of such non-cooperation have been very substantial over the years but they have been increasing as well, re-iterating that greater regional cooperation and integration offer immense opportunities and benefits for SAARC member countries.

As we can observe from Table 1 the empirical estimates of 'Costs of Non-Cooperation' carried out for Pakistan and Sri

Table 1: Costs of Non-Cooperation					
	Values in US$ Million			**Growth (%)**	
Year	*1994*	*2009*	*2014*	*1994-2009*	*2009-2014*
Pakistan	511	1319	6821	158	417
Sri Lanka	266	600	2848	126	375

Source: Author's calculations based on COMTRADE, various years

Lanka present an alarming picture. On account of this, in the year 2014 Pakistan suffered a loss to the tune of US$ 6821 million while Sri Lanka in the same year lost around US$ 2848 million. The estimates of Costs of Non-Cooperation in 1994 i.e. two decades back were US$ 511 million and US$ 266 million for Pakistan and Sri Lanka, respectively. Thus the current levels of overall non-cooperation costs for both Pakistan and Sri Lanka are very high. To add to the worsening scenario, these costs are not only increasing but increasing at a faster rate implying that a lot of potential opportunities are being unutilised or being wasted. If we compare the period 1994-2009 and 2009-2014 we can clearly see that rate of increase of these costs have also substantially increased from approx 160 per cent to 420 per cent for Pakistan and from 126 per cent to 375 per cent for Sri Lanka between the two periods.

To understand the trend more clearly the detailed year-wise estimates of the Costs of Non-Cooperation for the years 1994 and from 2009 to 2014 have been plotted for both the countries. As we can see from Chart I, for Pakistan these costs have been on rise with a very steep slope except for year 2013 in which there is an arrest of this rise. For Sri Lanka also the picture is more or less the same with only difference being in the level of these costs.

IV.2 Composition

For any useful analysis, apart from having a detailed look at the absolute levels and overall values and trends of these costs, it is imperative to look at the structure and composition of these costs in terms of product categories constituting these costs. Such an analysis was carried out for both the countries and the estimation result are presented in Table 2 along with values and share in total for the top ten products making up for almost 50 per cent and 40 per cent of the costs for Pakistan and Sri Lanka, respectively.

As we can see from Table 2 there are some products indicated as bold and italics which are in top ten product categories for both Pakistan and Sri Lanka highlighting the importance of these items, namely petroleum oils, gold (non-monetary) and aviation spirit in reaping the benefits of cooperation for the entire region. Also it is evident from the Table that, for Pakistan, petroleum oils product category makes up for around 30 per cent of the total Costs of Non-Cooperation while for Sri Lanka petroleum oils and gold together make up for around 23 per cent of the total Costs of Non-Cooperation. This leads to an interesting insight that even if Pakistan and Sri Lanka had focussed on just one product i.e. Petroleum oil (HS 270900) they could have reaped a benefit of approximately US$ 9400 million over the last five years by sourcing them from within the SAARC region. In addition to this, any reduction in Costs of Non-Cooperation on account of imports sourced from within the region would also imply that in such a scenario the export
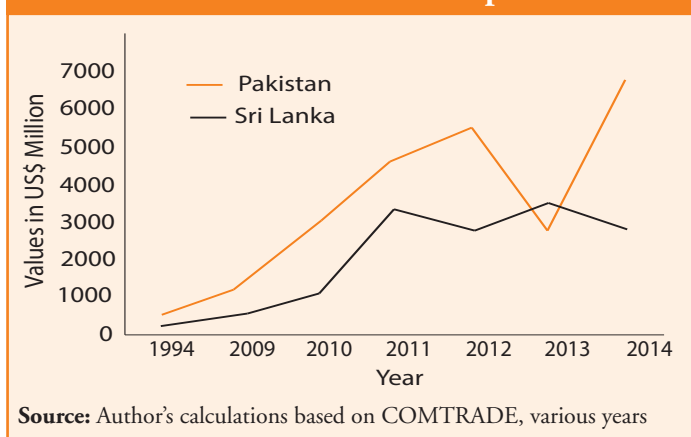
Chart I: Costs of Non-Cooperation

Source: Author's calculations based on COMTRADE, various years

Table 2: Overall Composition of Costs of Non-Cooperation for Pakistan for 2010-14 (Values and Shares of Top 10 Products)

Codes	Description	CNC 2010-14 Values in US$ Millions	Share in Total (%)
270900	*Petroleum oils and oils obtained from bituminous minerals, crude*	*7442.04*	*28.31*
270119	Coal nes, whether or not pulverised but not agglomerated	1040.86	3.96
151190	Palm oil and its fractions refined but not chemically modified	1033.17	3.93
120510	Rape/colza seeds, sowing, erucic acid >=2%	901.98	3.43
710812	*Gold in unwrought forms non-monetary*	*870.45*	*3.31*
520100	Cotton, not carded or combed	823.89	3.13
280920	Phosphoric acid and polyphosphoric acids	806.61	3.07
271011	*Aviation spirit*	*457.69*	*1.74*
382490	Chemical/allied industry preparations/prods nes	441.04	1.68
870899	Motor vehicle parts nes	253.39	0.96
Share of Top 10 Products in Total			53.52
Total of All Products		26290.37	100.00

Overall Composition of Costs of Non-Cooperation for Sri Lanka for 2010-14 (Values and Shares of Top 10 Products)

Code	Description	CNC 2010-14 Values in US$ Millions	Share in Total (%)
270900	*Petroleum oils and oils obtained from bituminous minerals, crude*	*1922.19*	*14.61*
710812	*Gold in unwrought forms non-monetary*	*1043.26*	*7.93*
600690	Wide knit/crochet fabric, nes	675.62	5.13
600410	Wide crochet/knit elasticised fabric	319.67	2.43
252310	Cement clinkers	248.40	1.89
580620	Narrow woven fab,cntg by wt>/=5% elastomeric yarn/rubber thread nes	230.26	1.75
170199	Refined sugar, in solid form, nes	220.79	1.68
271011	*Aviation spirit*	*214.60*	*1.63*
252329	Portland cement nes	206.35	1.57
240110	Tobacco, unmanufactured, not stemmed or stripped	204.66	1.56
Share of Top 10 Products in Total			40.17
Total of All Products		13158.09	100.00

Source: Author's calculations based on COMTRADE, various years

Table 3: Change in Top Product Composition over 2010-2014 for Pakistan

Products which went out of Top 10 ↑		Products which came in Top 10 ↓	
Codes	Description	Codes	Description
170199	Refined sugar, in solid form, nes	280920	Phosphoric acid and polyphosphoric acids
120510	Rape/colza seeds, sowing, erucic acid >=2%	382490	Chemical/allied industry preparations/prods nes
310530	Diammonium phosphate, in packages weighing more than 10 kg	690890	Tiles, cubes and sim nes, glazed ceramics
271011	Aviation spirit	901839	Needles, catheters, cannulae and the like, nes
720441	Ferrous waste & scrap,i or s,from the mechanical working of metal,nes	860791	Locomotive parts nes
390210	Polypropylene	481092	Multiply paper

Source: Author's calculations based on COMTRADE, various years

earnings of other countries in the region would increase and hence reduction in these costs is for the regional benefit and not the country in question alone. Hence, the potential for cooperation for the region are huge and benefits multifold.

Another analysis was carried out to figure out the change in composition of products leading to costs of non-cooperation for both the countries between the two periods 2010 and 2014 and a summary of it is presented in Tables 3 and 4. As we can see there has been considerable change in product composition leading to costs of non-cooperation both Pakistan and Sri Lanka showing the products which have lost importance and those which have now gained importance in which more focus for cooperation is required.

V. Costs of Non-Cooperation from the Perspective of External Debt

Not only does the empirical estimation presented above in terms of values, trends and composition provide a strong case for cooperation for both Pakistan and Sri Lanka

Table 4: Change in Top Product Composition over 2010-2014 for Sri Lanka

Products which went out of Top 10 ↑		Products which came in Top 10 ↓	
Codes	Description	Codes	Description
170199	Refined sugar, in solid form, nes	600410	Wide crochet/knit elasticised fabric
40221	Milk and cream powder unsweetened exceeding 1.5% fat	252329	Portland cement nes
271119	Petroleum gases and other gaseous hydrocarbons nes, liquefied	252310	Cement clinkers
520521	Cotton yarn,>/=85%, single, combed,>/=714.29, not put up	580429	Mechanically made lace of oth tex mat,in the piece,in strips/in motifs
710812	Gold in unwrought forms non-monetary	600632	Wide synth knit/crochet fabric, dyed
310210	Urea,wthr/nt in aqueous solution in packages weighg more than 10 kg	870322	Automobiles w reciprocatg piston engine displacg > 1000 cc to 1500 cc

Source: Author's calculations based on COMTRADE, various years

highlighting the opportunities being lost and being lost rapidly over time but also simultaneously presents an opportunity for the entire region to benefit that is to be brought out by reduction in these costs in terms of increased exports earnings.

One gets a very interesting insight if Costs of Non-Cooperation are analysed in relation to the external debt and servicing of external debt of these countries. The share of cost of non-cooperation in external debt stocks for Pakistan is around 42 per cent and that for Sri Lanka is about 40 per cent implying that both of these countries can simply reduce their external debt stock to the tune of the 40 per cent of existing just by taking care of these Costs of Non-Cooperation through cooperation in regional market (Table 5). Debt service is the cash that is required to cover the repayment of interest and principal on a debt for a particular time period. If we see in terms

of share of cost of non-cooperation in debt service then the reduction in these costs would entail for both countries that there is no need for debt servicing on external debt implying their credibility would get a quantum jump as they would now be seen as countries without any requirement for external debt.

VI. Way Forward: Policy Steps

The forgoing analyses amply demonstrate that there are enormous benefits of economic cooperation in the South Asian region especially from the point of view of greater trade in goods integration. It is against this backdrop, a way forward is outlined below in terms of certain policy steps:

(i) *Adopting an integrated approach*: Trade in goods needs to be viewed in conjunction with trade in services and investment. This is because the full

Table 5: Share of Cost of Non Cooperation of Pakistan in External Debt and Debt Servicing						
	2010	2011	2012	2013	2014	2010-14*
External debt stocks, total (in Million US$)	64003	65520	62144	60045	62184	62779
Debt service on external debt, total (in Million US$)	4273	2938	4721	8032	5948	5182
Cost of Non-Cooperation (in Million US$)	2938	4724	5463	2796	6821	26290
Share in External Debt Stock (%)	4.59	7.21	8.79	4.66	10.97	41.88
Share in Debt Service on External Debt (%)	68.76	160.79	115.72	34.80	114.68	507.30
Share of Cost of Non Cooperation of Sri Lanka in External Debt and Debt Servicing						
	2010	2011	2012	2013	2014	2010-14*
External debt stocks, total (in Million US$)	21762	25887	35792	40257	43609	33461
Debt service on external debt, total (in Million US$)	1396	1302	1999	2020	2490	1842
Cost of Non-Cooperation (in Million US$)	1098	3314	2821	3475	2848	13158
Share in External Debt Stock (%)	5.05	12.80	7.88	8.63	6.53	39.32
Share in Debt Service on External Debt (%)	78.65	254.45	141.09	172.06	114.36	714.49
*Note: This is based on Average Unit Price Calculation i.e Total Trade Value over 2010-14 / Total Quantity over same period						

potential of any one of these is cannot be harnessed unless the inter-linkages across these three dimensions are fully understood and expedited through adequate policy endeavour.

(ii) *Full implementation of SAFTA:* SAFTA therefore, needs to be fully implemented by reduction of sensitive list and utilization of tariff concessions in a non-discriminatory manner.

(iii) *Implementation of SATIS*: As highlighted above intra-regional trade in services in South Asia has to be posited in an integrated framework vis-a-vis trade in goods and investment. Therefore, SATIS which has been negotiated must be implemented at the earliest.

(iv) *Implementation of regional investment agreement:* To augment intra-regional investment it is imperative also to expeditiously sign and implement the SAARC Regional Investment Protection and Promotion Agreement.

(v) *Institutionalising trade facilitation architecture:* Further to tap the full potential of South Asia trade integration, the success stories of trade facilitation mechanisms available at low cost in South Asia must be adopted at the regional level so as to enhance trade and transactional efficiency.

(vi) *Alleviating infra-structural bottlenecks:* Needless to mention that to reduce Costs of Non-Cooperation physical and institutional infrastructural bottlenecks need to be addressed on a priority basis by drawing upon the new mechanisms of finance from the BRICS New Development Bank and that of Asian Infrastructure Investment Bank.

(vii) *Banking infrastructure:* No business in the region is possible including trade in goods, unless the banking infrastructure in the region is evolved as financial transactions are made on the basis of trust. And this is well served by opening banking branches on a mutual basis across countries of South Asia.

In short, the Costs of Non-Cooperation are high in South Asia and are also increasing, as the illustrations reveal. To address this some of the above mentioned policy measures in addition to changing the regional mindset towards a greater 'economic optimism' are warranted on an urgent basis.

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