Trade and Development Monitor

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CONTENTS

OPINION IN LEAD

Exports sophistication: Road to higher growth

Increasing exports to achieve higher economic growth has been one of the main features of the economic policy of South Asian countries. An increase in economic activities in export sectors, chiefly non-agricultural, means that there is some form of structural transformation happening in the economy. The level of structural transformation determines a developing country's income level as has been the case with all developed and emerging economies. It is the process of continually changing production structure, and products, and shifting output and employment structures from low-productivity and low-wage activities to high-productivity and high-wage activities. It involves upgrading and diversification of production and exports baskets.

What determines how fast structural transformation is happening? Hidalgo *et al*. (2007)[1], argue that it depends on the existing capabilities and the ability to move to the production of sophisticated goods. A product space analysis is used to see the level of and prospects for structural transformation in an economy. Felipe *et al.* (2010)[2] calculate an "Index of

Opportunities", which is based on a country's accumulated capabilities to undergo structural transformation, to capture the potential for further upgrading, growth and development. The index has four dimensions, all related to a country's export basket and its position in the product space: exports sophistication; exports diversification; exports standardness; and potential to export other products with comparative advantage.

Of the 96 non-high income countries, China and India are the top two, with index values of 0.9011 and 0.8590 respectively, in terms of the highest potential to undergo structural transformation. Their level of exports sophistication and future capabilities to further undergo structural transformation is very high. Nepal ranks 33rd with an index score of 0.4729, followed by Pakistan in 37th position with 0.4557 score, Sri Lanka 44th position with 0.4326 score, and Bangladesh 73rd position with 0.3576 score. However, if we look at the ranking among 130 countries (both developed and non-developed countries), India ranks 5th, Pakistan ranks 60th, followed by Nepal in 61st position, and Bangladesh in 99th position. Almost all the developing countries, except China and India, have low rank, meaning that their ability to undergo structural transformation via exports sophistication is not at the level of developed countries. Developing countries have accumulated very few and unsophisticated capabilities.

On this note, a relevant question is: how can developing counties, including South Asian countries, enhance exports sophistication and speed up the process of structural transformation? A viable route, as was tested in the case of developed counties, is through the support of export sectors by a well-designed and targeted industrial policy. It could lead to the accumulation of capabilities to facilitate economic transformation, leading to high diversification and sophistication of the exports basket. Felipe *et al.* (2010) argue that without industrial policies and targeting, and given their low per capita, China and India would have shied away from sophisticated industries. A well-targeted industrial policy helped China and India accumulate critical capabilities in core sectors.

Harrison and Rodriguez-Clare (2010)[3] recommend "soft" industrial policies for developing countries. Soft industrial policies promote collaboration among government, industry, and cluster-level private organizations with an aim to directly increase productivity. It seeks to directly address coordination failures that keep productivity low in existing or promising sectors rather than engage in direct interventions that might distort prices.

"Soft" industrial policy avoids measures such as tariff protection, export subsidies, and tax breaks for foreign corporations—all of these are price distorting measures. This "hard" industrial policy, as Harrison and Rodriquez-Clare (2010) put it, might be incompatible "with the multilateral and bilateral trade and investment agreements that many LDCs have implemented over the last decades." Moreover, there is less possibility of manipulation by vested interest groups in the case of "soft" industrial policies. Importantly, "soft" industrial policy reduces the scope for corruption and rent seeking associated with "hard" industrial policy such as protection or selective production subsidies.

Since India already has a pretty sophisticated set of exports basket, promising it a good prospect for further structural transformation, other South Asian countries could also promote the industries that may hold "latent comparative advantage". The industrial policy should be such that the promotion of industries is consistent with the endowment structure of the economies so that industries that have "latent comparative advantage" are exploited (Harrison and Rodriquez-Clare 2010). "Soft" industrial policy could be of varying nature such as helping particular clusters by increasing the supply of skilled workers (like India did with the services sector), encouraging technology adoption, promoting labor-intensive manufacturing sector (like China), and improving regulation and infrastructure.

[1] Hidalgo, C, B Klinger, AL Barabasi, and R Hausmann. 2007. The Product Space Conditions the Development of Nations. *Science* 317:482-487.
[2] Felipe, J, U Kumar, and A Abdon. 2010. As you Sow So Shall You Reap: From Capabilities to Opportunities. Working paper No. 613. The Levy Economics Institute of Bard College, August.

[3] Harrison, AE, and Andres Rodriguez-Clare. 2010. Trade, Foreign Investment, and Industrial Policy. In *Handbook of Development Economics*.

ANALYSIS

Constraints to intra-SAARC trade

In terms of the extent of intra-regional trade, South Asia is one of the least integrated regional blocs despite the establishment of a regional forum, South Asian Association for Regional Cooperation (SAARC), in 1985. As a share of total foreign trade, intra-SAARC trade is just around 5 percent. The intra-regional trade potential is estimated to be around US$40billion, but just US$11 billion was realized in 2008. Furthermore, the total value of intra-regional trade is less than 2 percent of regional GDP.

To boost regional trade, the SAARC Preferential Trading Arrangement (SAPTA) was signed in 1993. Based on a positive-list approach, SAPTA did little to boost intra-regional trade. SAARC leaders then agreed to launch the negative list-based Agreement on South Asian Free Trade Area (SAFTA) by 2000. Unfortunately, rising political tensions between India and Pakistan threw a spanner in the works. The SAFTA framework was only adopted in 2004 after political tension cooled off between the two countries, and came into force in 2006.

SAFTA too has failed to deliver. High export similarity, delay in incorporating services trade into SAFTA, large sensitive lists, and, perhaps most importantly, Indo-Pak hostility have acted as key obstacles to the expansion of intra-region trade in South Asia. Moreover, various self-imposed trade restrictions have also restricted the expansion of intra-SAARC trade. A large number of goods are being protected under sensitive lists. Around 53 percent of the value of imports from SAARC nations is subjected to the sensitive lists of member countries. Under SAFTA, non-least-developed country (LDC) members are required to reduce existing tariffs to 20 percent within two years of implementation of the agreement. Then, in the next five years, they are required to reduce tariffs to a range of 0-5 percent. For LDCs, in the first two years, tariffs should come down to 30 percent and to 0-5 percent in the next eight years. Despite this, tariffs reductions under SAFTA still fall short of the concessions under some of the bilateral trade agreements between SAARC nations, mainly with India as a partner.

Additionally, Pakistan has refused to grant most-favoured-nation status to India, which, on its part, continues to maintain high tariff and non-tariff barriers on goods of particular interest to Pakistan. Consequently, Pakistan accounts for less than one percent of India's formal trade, while India accounts for about zero percent of Pakistan's formal trade, although informal trade is substantial.

The sensitive lists should be pruned in a gradual, time-bound manner. Pruning these lists, while certainly a delicate political issue, may not be as difficult as made out to be. For, not all items on the lists make sense there on any grounds, be it domestic industry protection or revenue. In other words, quite a few of them have been included in the list without any scientific basis. Taking cognizance of the potential for intra-industry trade would also greatly assist in deciding on downsizing the sensitive lists. For the LDCs, revenue loss is a major concern about trimming their sensitive lists. Agreeing on a meaningful revenue compensation mechanism will increase both the economic and political feasibility of pruning the sensitive lists by these countries.

In a welcome development, the SAARC Framework Agreement on Trade in Services (SAFAS) was signed at the 16th SAARC Summit this year. SAARC needs to give momentum to this by expediting the agreement on the schedules of commitments of member countries.

In order to ensure that the gains from intra-regional trade liberalization are well-distributed among the members, and the LDCs in particular too stand to benefit, SAARC would do well to consider a proposal made by SAWTEE for creating an LDC Integration Fund, with an annual contribution of US$1.1 billion, calculated at 0.07 percent of the gross domestic product of

SAARC member states. The contributions will be made by SAARC member states, observers and other multilateral and bilateral donors. An indicative list of priority areas for spending the fund includes: development of transport corridors to improve regional connectivity and rural access; construction of a regional grid to facilitate trade in electricity and a regional pipeline to transport petroleum products; trade facilitation, particularly modernization of customs; construction of laboratories and testing facilities; and construction of warehouses and cold storages to facilitate trade in agricultural products.

OTHER NEWS

India says US visa issue may be solved outside WTO

India is confident of resolving a visa restrictions issue with the United States (US) outside the World Trade Organization (WTO) framework, a senior Indian government official said on 26 August.

India had objected to US legislation passed in August to strengthen security along the border with Mexico, funds for which will be raised through a hike in visa fees that may affect Indian companies like Infosys Technologies and Wipro.

India's trade secretary, Rahul Khullar, said the move was not compatible with WTO rules.

The Indian government is speaking to the US government on the issue.

Members of the apex Indian infotech association will also meet US senators on the visa issue in September as part of a delegation to the US led by Trade Minister Anand Sharma.

"That consultation is ongoing as we speak and as that consultation proceeds, I am confident this problem will get resolved," Khullar told reporters, indicating that India may not take the US to the WTO if the issue is resolved bilaterally.

The Indian software industry largely thrives on the model of cross-border movement of its professionals.

India has long advocated free movement of professionals at global trade bodies like the WTO.

Source: The Economic Times, 26.08.10, economictimes.indiatimes.com

FDI makes a comeback in Bangladesh

A positive trend has appeared in foreign direct investment (FDI) in Bangladesh, which observers see as a result of gradual easing of global recession and improved investor confidence.

Bangladesh Bank data show a 22.62 percent rise in FDI in the second half of the last fiscal year (2009/10). During January-June, the net FDI inflow reached US$439 million from US$358 million in the same time a year ago (2008/09).

However, the first half of the last fiscal year (2009/10) witnessed a 66 percent drop in FDI. Due to this negative growth, FDI fell around 34 percent during the entire fiscal year 2009/10.
On the better FDI flow, Executive Director of the Centre for Policy Dialogue Mustafizur Rahman said: "We still do not know how and where it increased, but if the trend continues in the current fiscal year it can be said that the increase is sustained."

A central bank high official pointed to the prevalence of FDI sluggishness in Bangladesh as elsewhere in the world because of recession.

World Bank senior economist Zahid Hussain said the improvement in FDI flow during January-June may be reflecting improved investor confidence in Bangladesh. Rising wages in China and India may also have induced some to shift investments to Bangladesh.

An official of the Board of Investment said FDI in Bangladesh is still low compared to neighbouring countries.

Source: The Daily Star, 25.08.10, thedailystar.net

Floods hit Pakistan economy

The flooding in Pakistan will inflict serious damage on its economy, posing another challenge for a cash-strapped government struggling to keep a recovery on track amid high inflation and a relentless insurgency.

Assistance from the International Monetary Fund and Western countries will likely help Pakistan avoid another brush with bankruptcy as it tries to cope with the damage, which by some estimates may reach US$43 billion. But the floods will weigh heavily on economic growth this year and leave a long-term mark on the economy.

"The hit on the growth rate is going to be very severe," said Philip Wyatt, a senior economist at UBS. "We can see a loss of one or two points of economic growth, depending on the damage." In the fiscal year ended June 30, Pakistan's economy grew 4.1 percent.

Moody's Investors Service, which had expected Pakistan's economic growth to expand to 4.5 percent this fiscal year, may lower its estimate to 3 percent to 3.5 percent, analyst Aninda Mitra said.

The flood began in July and at one point covered one-fifth of the South Asian nation. It has damaged crops sown over 1.93 million acres, or 776,996 hectares. Cotton output will shrink to 11.76 million bales from the 14 million bales estimated at the start of the season by Pakistan's food and agriculture ministry. Cotton is an important raw material for the key textile export sector, one of Pakistan's few sources of export income.

According to the United Nations, the disaster has affected close to 20 million people, killing 1,500 and leaving 1.2 million homes damaged or destroyed.

Coping with the social and economic costs of the catastrophe will strain the government's finances. The budget deficit was already on track to reach 4.5 percent of gross domestic product (GDP) before the crisis but now could widen to as much as 6 percent to 7 percent of GDP, said Mr. Mitra of Moody's. That is a grim prospect for a country that had external debt totaling US$55.63 billion as of June 30.

The natural disaster is the latest setback for the Pakistan economy, which after several years of strong growth almost ground to a halt in 2008, hurt by budget overruns, a loss in export competitiveness due to high inflation, and an insurgency that continues unabated.

Source: Wall Street Journal, 25.08.10, online.wsj.com

ADB to increase funds for regional cooperation

The Asian Development Bank (ADB) has set an aim of increasing allocations for all regional cooperation activities to 30 percent of its total operational spending by 2020.

In an announcement on its website, ADB said it has allocated more than US$1 billion, or 10 per cent of the resources of its concessional Asian Development Funds, to regional projects between 2009 and 2012.

It said it has also expanded its regional Trade Finance Facilitation Programme from US$150 million to US$1 billion, and is working on an Asian Infrastructure Financing Initiative to pool resources for regional infrastructure needs.

The bank said this at the start of the “Second High Level Forum on Emerging Vision for Shared Prosperity: South Asia and Beyond”, being held at its headquarters from August 12-13.

Leading government officials from South Asia and neighbouring countries had assembled in Manila to discuss regional cooperation which will take stock of progress on work done to boost trade and develop cross-border road corridors and energy infrastructure.

The first forum in 2009 identified key focus areas for increasing physical connectivity, improving trade facilitation and developing cross-border energy infrastructure and trade in power. This year’s event will focus on strengthening implementation in these key focus areas.

South Asia has taken many steps to boost regional cooperation over the past 20 years, including establishing a free trade area in 2006 and reducing tariff and non-tariff barriers. However, it is lagging behind East Asia in terms of regional integration.

Source: The Express Tribune, 13.08.10, accessed from /tribune.com.pk

Japan plans to bind large firms to CO2 caps

Japan's compulsory emissions trading scheme is set to start in April 2013 and cover large CO2-emitting companies, a draft of the government's proposals showed on 30 August, but several issues are still open to debate.

The draft, obtained by Reuters, will be presented to an expert committee at the Environment Ministry, which aims to finalize its proposal for Japan's cap-and-trade scheme by the end of this year.

Issues to be discussed later include how CO2 emission quotas should be allocated and how big they should be, who should be responsible for CO2 emissions from electric power generation, and whether to link the scheme with similar ones abroad, the draft showed.

It also showed compliance companies would be able to emit more by using carbon offsets at home and from abroad.

Similar grants can be given to companies facing international competition, those whose CO2 emissions per unit of product are relatively high, and those whose products help cut CO2 emissions globally, such as solar panels and hybrid cars, the draft said.

Earlier this year, Japan's parliament discussed a climate change bill that included a shortlist of policy measures to achieve an ambitious goal of cutting emissions by 25 percent by 2020 from 1990 levels.

But the government gave up enacting the bill, which would have launched a nationwide compulsory emissions trading scheme, as time ran out before an upper house election in July.

Source: Reuters, 30.08.10, reuters.com

ACTIVITIES

Third South Asian Training Programme on CGE Modelling

SAWTEE, together with the South Asian Network on Economic Modeling (SANEM), organized the Third South Asian Training Programme on CGE Modelling from 2-6 August 2010 in Kathmandu. About two dozen researchers, academics and policy makers participated in the training. SAWTEE and SANEM had organized two such training programmes in 2008 and 2009 in Kathmandu.

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