Impact of Preferential Trade Agreements (PTAs) on Firms' Internationalization and Export Diversification in Pakistan

ABSTRACT

The recent growth of preferential trade agreements has opened avenues for research to look into their possible outcomes. Internationalization of firms and the product and market diversification is becoming a central issue for developing countries with limited internationalization of home-based firms, concentrated export markets and export products. There is significant theoretical and empirical evidence on the arguments that these PTAs produce rents to the member nations' firms. But the literature on PTAs fail to link the preferential market access and information about domestic market provided to the member countries' firms under PTAs with the 'why', 'where' and 'how' decisions of firms' internationalization and their export diversification strategies. The literature on new trade theory and strategic trade policy depicts strong positive and normative relationship between the support provided by home govt. to the home-based firms and their international performance against foreign rivals. This paper postulates the impact of PTAs on internationalization and export diversification strategies of member countries' firms. The model is tested using evidence from the experience of Pakistan's preferential trade relationships with some of its trading partners and other empirical studies on PTAs. The paper extends the theory of internationalization and strategic trade policy by identifying role of PTAs as a policy tool to enhance the involvement of domestic firms in international markets and achieve objectives of export diversification at firm and country level.

Key Words: Internationalization Strategy, Preferential Trade Agreements, New Trade Theory, Export Diversification

Introduction:

The benefits from global markets depend upon a nation's ability to participate through international trade and investment activities. Since, a large proportion of international economic activities are carried out by MNEs, this participation depends, including other domestic macroeconomic factors, on the international presence, experience and expertise of national domestic firms and entrepreneurs (Markuesen and Venables 1998; Hayes and Abernathy 1980). Theories of firms' internationalization conceptualize and explain 'why', 'how' and 'where' the firms engage in overseas operations. Internationalization of firms has been the focus of research in international business and the researchers have explained the dynamics of the phenomenon from various dimensions. The premiere work on the topic is of Johanson and Vahlne (1977) from the Uppasala school in the context of export development to explain the process approach of internationalization. Whitelock (2002) has summarized the literature on internationalization in terms of four approaches namely Uppsala model; the eclectic paradigm; transaction cost analysis; and the interactive network approach. Dunning (2001) have also summarized the major intellectual strands and external influences in international business research.

Due to the centrality of MNEs in international economic activities, internationalization of firms has been the common ground of research for scholars in the field of international business and international economics. The two closely linked but largely gapped disciplines of international economics and international business have enormous theoretical connections and must benefit from each other.

The new wave of globalization has shifted the theoretical focus from country-focused, production-led and factor endowment-based trade theories to firm focused and demand-led new trade theories with normative prescriptions of strategic trade policy (Ethier 1982; Brander and Spencer 1983, 1985; Eaton and Grossman 1986; Grossman and Horn 1988; Grossman and Helpman 1991; Cebi 2003; Gawande and Krishna 2003). The international markets are heavily characterized by the presence of few large MNEs, information asymmetries, firm-level economies of scale, horizontal intra-industry trade flows on the basis of product differentiation among similar economies, and political economy influences in international markets. In the context of strategic interaction among firms in international markets, these theories analyze the impact of R&D subsidies and other support provided by the home govt. on the international market share and growth of domestic champions.

The recent growth of preferential or free trade agreements (PTAs/FTAs) between nations at bilateral (BTAs) and regional level (RTAs) has opened avenues for researchers to look into their possible outcomes for the member nations and rest of the economies. There is significant theoretical and empirical evidence on the argument that these PTAs produce rents to the member nations' firms. These arguments are in line with the literature on new trade theory and strategic trade policy, which explain and necessitate pro-competitive home-govt. intervention to support national champions in imperfect international markets with the objectives of shifting rents to home firms and enhancing domestic welfare. But the literature on PTAs fail to link the preferential market access and information about domestic market provided to the member countries' firms under PTAs with the important variables affecting home-based firms' internationalization i.e. decision to go abroad, foreign market selection and mode of entry.

This research study aims at:

- Synthesizing the literature on firms' internationalization along with the relationship between international trade theories and theories of internationalization.
- Developing theoretical rationale of PTAs/FTAs through the new trade theory arguments and strategic trade policy application.
- Postulating the linkage between PTAs and export diversification i.e. market and product diversification.
- Elaborating the precise relationship between PTAs and internationalization of member countries' firms.
- Testing the hypothesized relationships through a survey of exporting firms from Pakistan and longitudinal trade data from Pakistan's preferential trade relationships with some of its trading partners like Malaysia, Mauritius, Iran, Sri Lanka and China.

The study, on the basis of above models and postulations, elaborates the role of PTAs as a new strategic trade policy tool available for promoting and regulating the internationalization and international diversification strategies of home firms specially in context of developing countries.

LITERATURE REVIEW: PUTTING FORWARD THE CONTEXT

Objective of this section is to acquaint the researchers in international business literature with the evolution of theories of international trade and commercial policy, which would help them understand their implications for firms' internationalization. This section is the extension of the work done by Markusen (2001), which did not incorporate the evolution of theory of trade policy also did not explain the impact on firms' internationalization.

New Trade Theory

Explaining the history of theory and practice of trade policy in developed and developing economies, Krueger (1990) has shed insightful light on the theory and policy development path of international trade and commercial policy. The transformation of protectionist trade policies into free trade policies, influenced by Ricardian trade theories of comparative advantage, has worked well in supporting an export-led growth in trading countries. These production-led trade theories of comparative advantage assuming perfect markets and constant returns to scale explained well the efficiency based inter-industry and vertical intra-industry trade flows among trading partners up to 1970s. Initiated by the work of Brander and Spencer (1985), basis of the new trade theory are horizontal intra-industry trade flows based on product differentiation, imperfect markets, externalities and increasing returns to scale etc. The positive literature (new trade theory) has been developed to analyze and explain the greater trade and investment flows across countries with greater similarity and two-way trade in similar but differentiated products under MNE-based monopolistic competition or oligopoly models of international trade (Dixit and Stiglitz 1977; Helpman and Krugman 1985; Krugman 1990a, 1990b). The central idea of new trade theory, related to international business strategies of firms, is that the home govt. support to the domestic champions can alter strategic alternatives vis-à-vis their rivals in imperfect international markets in their favor.

Strategic Trade Policy

Based on these analyses, the normative literature (strategic trade policy) justifies the govt. role in the support of national champions competing with the champions of foreign countries (Dixit 1984, 1987a, 1987b; Dixit and Kyle 1985; Markusen and Venables 1998). Such demand-led export growth trade policy is strategic due to its responsiveness to the demand differences across borders and competitive structure of international markets as against the conventional production-led free trade policy. Such activist trade policy supports the national champions through pro-competitive support measures aimed at their competitiveness and facilitation in international business activities and also acknowledge the externalities arising out of such activities. The study by Reimer and Steigert (2006) has summarized the research literature on the new trade theory and strategic trade policy. Brander's (1995) study characterizes that strategic trade applies to settings in which firms have a mutually recognized interdependence. More specifically, the profits of one firm are directly affected by the strategic choices of other firms. Other researchers on the topic have discussed other characterizations of strategic trade such as when government promotes industries that generate dynamic externalities (Markusen and Venables 1998). At the firm level, strategic trade policy impacts the firms' strategic choices in light of its competitors' strategies and govt.'s support initiatives. The key ingredient is a credible pre-commitment in the light of which the domestic firms choose among their strategic alternatives. The pre-commitment in the form of govt. intervention is made through tariff or subsidy or any support measure in the favor of domestic firms competing internationally.

Though the outcomes of strategic interventions are moderated by a number of assumptions about the competitive responses of firms, the strategic trade theory nevertheless explains how such interventions can affect the MNEs' decisions of location of production, trade and mode of foreign operations, in international markets. Thus, the strategic trade theory and policy makes a good case to use it for supporting the internationalization strategies of home firms.

Theories of Firms' Internationalization

Galán, Galende and González-Benito (1999) explain that studying the internationalization process involves answering three basic questions: *why* does a firm decide to initiate this process? *how* (through which form) are the international activities realized? and *where* does the firm locate its foreign activities? (See Figure 1)

Figure 1: Internationalization Decisions of Firm

The evolution of domestic firms into multinational ones has attracted the theorist and policymakers for so long and a vast body of literature both theoretical and empirical exists in this area. The synthesis of the literature on the internationalization has been worked out by various scholars in international business. The most notable is the work of Buckely and Ghauri (1999) and Dunning (2001). The available research on internationalization can be categorized into major paradigms: industrial organization theory (Hymer 1960; Vernon 1966; Kindleberger 1969; Caves 1971; Agmon and Lessard 1977, Porter 1986; Markusen and Venables 1998, Helpman 2006); internalization theory (Coase 1937; Penrose 1959; Buckley and Casson 1976, 1985; Rugman 1981, 1986;, transaction cost theory (Williamson 1975; Hennart 1982) and eclectic theory (Dunning 1980, 1988, 1993, 1995; Young 2000). Within these broad paradigms, the adaptations and innovations in the internationalization models have been introduced by the process model of internationalization (Johanson and Vahlne 1977, 1990; Johanson and Weidersheim-Paul 1975), network theory (Johanson and Mattsson 1986a, 1988b), innovation-based models (Cavusgil, 1980) and born global models (Knight, Madsen and Servais 2004; Knight and Cavusgil 2005). Other than this, some studies at country level have also explored the applicability of various internationalization models in domestic context (Rahman 2003; Klonowski 2005; Herrmann and Datta 2005; Zafarullah, Ali and Young 1998). Mentioning the above theoretical strands and the work of the respective researchers is just to assure about the researchability of basic theme of the study and should, therefore, not undervalue the theoretical and empirical contributions of other researchers in the area.

With the growth of the theories explaining the internationalization, the critics have also evaluated their explanatory power to explain the dynamics of the internationalization process or strategy in emerging market conditions. Axinn and Matthyssens (2002) have identified the limits of the internationalization theories and have mentioned the major trends that require the new theoretical developments on the internationalization. Koch (2001) has shed light on the ‘where’ and ‘how’ decisions of firms as part of their internationalization strategy. This review of literature on firms' internationalization also points to the absence of any coherent model incorporating the public policy determinants of firms' internationalization.

Linkage between International Trade Theories and Firms' Internationalization: a Critical Synthesis

The internationalization strategy of firms has been an issue of interest to the researchers of both international business and international economics in recent years. While the positive literature in international economics explains the flow of trade and investment across national borders, the normative literature elaborates the impact of govt. intervention through trade policy on such flows and resultant gains/losses for domestic economy. In the traditional comparative-advantage models in the context of perfect markets, countries and industries, not firm, are unit of analysis. That literature of international economics has little or no relevance to the field of international business. In modern literature in international economics and international business, MNEs are central in explaining the pattern of trade and investment at country level and analyzing the international business strategies at firm level. Economists have used MNEs to explain the international flow of goods, services and investments in the world economy and thereby develop normative prescriptions at national and international level. Internationalization, being the first step of firms' international operations and participation, is the focus of international strategies of firms and thereby of scholars in international business. This has created an unavoidable and tacit interdependence between the theories of international economics and international business (Markusen 2001). Morgan and Katsikeas (1997) have developed a critical synthesis between the theories of international trade and investment and firm internationalization. While discussing the evolution of trade and investment theories, they have mentioned the new trade theory in the context of imperfect markets as the one whose implications for firms' internationalization are yet to be explored. Though the industrial organization models i.e. new trade theories of international trade and investment explain the firms' international strategies in imperfect markets, they seldom explain the evolution from domestic to multinational firm (Markusen and Venables 1998; Markusen 2002).

Preferential Trade Agreements

Basic Concept: Three terms are used frequently in the study: preferential trade area (PTA), free trade area (FTA) and customs union (CU). Throughout, a PTA refers to a union between two or more countries in which lower tariffs are imposed on goods produced in the member countries than on goods produced outside. A PTA can be at bilateral level (BTA) as well as regional level (RTA). An FTA is a PTA with tariffs eliminated entirely on goods produced in member countries. A customs union (CU) is an FTA with all members imposing a common external tariff on a given good. The term PTA being wider, is used to include the arrangements with limited tariff preferences, FTAs and CUs. In the current study, in the context of Pakistan, the PTAs are referred to FTAs of Pakistan with some of its trading partners as Pakistan has not signed any complete PTA with any of its trading partners. These FTAs of Pakistan are designed under the *Enabling Clause* and article XXIV of GATT.

PTAs with Economies of Scale and Imperfect Competition: Let us now turn to a discussion of the implications of economies of scale and imperfect competition for the theory of preferential trading. Panagariya (1999) has discussed the theory of PTAs in the context of economies of scale, imperfect competition and differentiated products. Corden (1972) first analyzed the implications of economies of scale for preferential trading in a homogeneous goods model. Panagariya (1999), by contrast, assumes external economies and average-cost pricing and does not allow for transport costs. Explaining the significant effect of external economies and product differentiation on the output and trade growth between the PTA member countries, he has shown that there is stronger tendency of more trade between the PTA members countries. His study confirms that even if the non-member country firm is more efficient in the production of a particular good after the PTA, the average cost will decline more sharply of the PTA firm making the third country firm less competitive.

This finding is important to our study as it is in line with the postulations of new trade theory and in accordance with the emerging pattern of growing trade in differentiated goods in imperfect international markets. This also makes PTAs a valid tool for the strategic trade policy aiming at supporting home firms in imperfect international markets.

PTAs in Pakistan: Pakistan like many other developed and developing countries has concluded few FTAs with some of its trading partners. The history of preferential trade agreements in South Asia including Pakistan is not so old. It was in 2000 that the first FTA was signed in South Asia between India and Sri Lanka i.e. ISLFTA. The ISLFTA then became the foundation stone of a regional trade agreement among South Asian economies i.e. South Asian Free Trade Agreement (SAFTA) to which Pakistan is also signatory. It is only recently that Pakistan has initiated progress in this policy area. But within a span of few years she has been able to sign five preferential trade agreements at bilateral level with Malaysia, Iran, Sri Lanka, Mauritius and China. Though the positive outcomes of PTA in rent shifting and trade facilitation are well established in the research literature in the area, yet there is much less theoretical and empirical work done in the context of Pakistan. In South Asian context, the studies by Baysan, Panagariya and Pitigala (2005) and Panagariya (2004) are quite important in evaluation of implications of South Asian Free Trade agreement-SAFTA for the member economies. The theoretical arguments developed here in the favor of bilateral FTAs Pakistan for firms' internationalization and export diversification have gathered strong empirical support from these studies.

THEORETICAL FRAMEWORK

Linking New Trade Theory and Strategic Trade Policy with Firms' Internationalization

It is now clear from the above discussion that the process or phenomenon of internationalization is more strategic given the strategic interdependence of the rival firms in imperfect international markets. This dimension of the internationalization is not existent in a coherent form in the available theories and models of internationalization in international business literature specifically in a strategic trade policy context.

Two conclusions arise related to firms' internationalization from this discussion. First, a strategic theory of internationalization can be postulated arising out of competitive interactions amongst firms in international market. The terms 'strategic' also imply that such theory would be more applicable on firms competing in the markets for differentiated products, under monopolistic competition or oligopoly. Few examples of such industries are electronic industry, pharmaceuticals, space sciences etc. Second conclusion is normative extension of the first set of conclusions. This states that the home govt.'s pro-competitive support to the domestic champions can affect the internationalization strategy of home firms in imperfect markets. The new trade theory has termed such support as the pre-commitment by the home govt. which is executed through strategic trade policy.

The explanation of strategic process of internationalization in the context of new trade theory opens avenues for strategic trade policy measures supportive of home firms' internationalization strategy in imperfect markets. The normative literature on new trade theory suggests the strategic trade policy measures, which can impact the internationalization strategy of home firms. Strategic trade policy is the execution mechanism of such pre-commitments and thus can be used to affect the strategic process of home firms' internationalization. The pre-commitment may take the form of subsidies, tariffs, quotas, voluntary export restraints, R&D subsidies, preferential trade and investment agreements, capacity building, assistance in obtaining quality certifications or any other policy instrument that alters the payoffs among rival firms in international markets (Reimer and Stiegert 2006).

There is enough empirical evidence found in literature on new trade theory, strategic trade policy and international political economy that indirectly implies the impact of home govt. support on home firms' internationalization strategy. Ceibi (2003) has elaborated the role of lobbying as a strategic trade policy measure in support of home firms competing in R&D intensive industries. He concludes that home firms operating in

R&D intensive industries with large R&D commitments are good candidates for state lobbying efforts to provide them better access to international markets. Mody; Dasgupta and Sinha (1999) have exemplified the active role of FDI policy in Japan in coordination of institutions like Kidernan, JETRO and MITI in support of Japanese multinational in Asian markets. A proposal by The Keidanren (Japan Federation of Economic Organization) in 2000 urges the govt. to actively engage in free trade agreements as a strategic trade policy measure to influence the competitive position of Japanese firms against their rivals in international markets. Yoshimatsu (1998) has described Keidanren as the most influential business association in Japan. Singh (2005) has identified and advocated the role of public policy in influencing the FDI strategies of MNEs in East Asian economies.

Preferential Trade Agreements and Firms' Internationalization: The Model

Given the implications of new trade theories and strategic trade policy measures on the positive and normative analysis of firms' internationalization, it is now clear that public policy intervention can have a decisive impact on firm's 'why', 'where' and 'how' decisions. The literature on international political economy in international business research elaborate the formation, composition and role of PTAs to alter the strategic pay offs to the home firms. Lobbying has been explained in the strategic trade policy literature as a policy tool to facilitate the home firms in their international activities against foreign rivals in imperfect markets. Lobbying as a policy tool becomes more operational through the formation of PTAs between actual or potential trading partners. The model here postulates the impact of PTAs on firms' internationalization strategy through the intervening affects associated with the PTAs (See Figure 2). The PTAs also imply horizontal support to firms in an industry without discriminating between them and thereby satisfy the arguments against the policy of ‘picking the domestic champions’. By converting the two markets into a single internal market for goods and services covered by the agreement, the PTAs enhance the export intensity and encourage the domestic firms to alter their organization of production i.e. single domestic plant to multinational production.

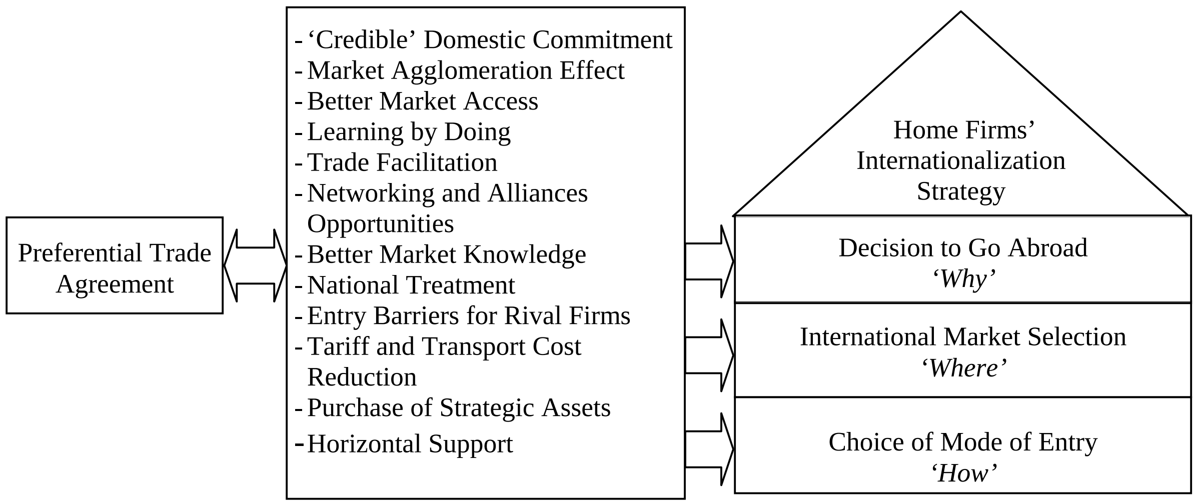

Figure 2: Impact of PTAs on Firm’s Internationalization Strategy

The home firms make their subsequent international commitments in the light of the policy commitment announced by home govt. PTAs announced by govt. provide a more secured and predictable environment to the home firms in the partner country and thereby influences their internationalization decisions. The formation of FTA expands the size of market available to firms in the member countries. This results into economies of scale i.e. reduced per unit cost, which creates entry barriers for the rival firms from third country. The economies of scale also make investments in R&D more feasible and, thus, further facilitating the entry and market commitment of home firms in the member country market. The formation of PTAs provides better market access, through reduction of tariff and non-tariff barriers, to the home firms in the partner country and thereby influences their entry decision. The PTAs enhances the degree of export involvement of home firms by providing them more practical learning opportunities. The irregular exporting firms become more regular and eventually the seeking export firms as they gather more explicit and tacit knowledge about the member country during the export activity. Formation of PTAs enhances the trade facilitation by reducing and simplifying the procedural details and also reducing the export marketing cost and thereby facilitating the foreign entry and also affecting the choice of mode of entry. Network theory of internationalization postulates the positive outcome of foreign network relationships and strategic alliances on the foreign entry and choice of mode of entry along with the international market selection. The formation of PTAs not only increases the export intensity but also provides firms to better develop the network and alliance relationships with the domestic firms to strengthen their position in the market. That further adds to the degree of export involvement. The national treatment reduces the liability of foreignness of home firms in the foreign markets and provides them a leveled playing field against their domestic and third country rivals. This also increases the home firms' participation in the public procurement in the foreign market. In all this affects the home firms internationalization decisions. The tariff and transport cost are the major barriers to foreign entry and determinants of the degree of foreign market commitment. The PTAs significantly reduce the tariff and thereby facilitate the home firms position against the third market firms. Moreover the creation of internal market also encourage the home firms to shift the production from single domestic plant to multi-plant production in the FTA market if transport cost are higher relative to cost of controlling foreign investment. Since the amount of preference given to home firms is equal to the amount of discrimination against the third country firms, the PTAs serve as entry barriers deter the entry of those firms. The home firms have to face less competition in the FTA market, as a result. Even if the non-member country firm is more efficient in the production of a particular good after the PTA, the average cost will decline more sharply of the PTA firms due to economies of scale making the third country firm less competitive in the long run. The rise in the bilateral trade share can be used as a proxy of entry barriers to the non-member firms. As the share of export of Pakistan to PTA country increases, assuming no change in the market size of the partner country, the non-member foreign firms' share decreases. PTAs encourage home firms to enhance their market commitment by committing more resources to the member country market. The firms also consider the PTA market as a gateway to serve other neighboring market of the country. This leads to purchase of strategic assets there, which not only facilitates their operations in the member country market but also enable it to enter the other markets. Moreover, the firms also get opportunity to purchase the country specific strategic assets in the PTA member country, which enable their strategic position against their rivals in the home as well as third country markets.

Impact of PTAs on Export Diversification

The formation of PTA between trading partners provide them opportunity of export diversification. The export diversification refers to product and market diversification and results when a country or exporting firm reduces the degree of concentration in few products or markets. Figure 3 below depicts the relationship between PTAs and export diversification. Pakistan like many other developing countries is facing the problem of export product and market concentration. This concentration has brought volatility in the export earnings of Pakistan that are used to pay for imports and service the foreign liabilities. The PTAs can help diversify the export product and market portfolio in Pakistan and other developing countries facing the same problem.

Product Diversification Effect: Baysan, Panagariya and Pitigala (2006) have explained the trade expansion effects associated with India-Sri Lanka Free Trade Agreement (ISLFTA) despite the apparent limited grant of preferences. According to them answer lies in the fact that the political economy pressures against preferences generally operate against the existing import from the partner country. Goods that the partner country does not supply at the time of the negotiations do not pose an obvious threat and therefore manage to receive significant impact on their trade growth (Baysan, Panagariya and Pitigala (2005). And it is in these products that the scope for trade expansion can be quite large. The trade expansion is another way of explaining the product diversification effect associated with the PTAs. The market diversification effect also impacts the product diversification indirectly. As the country enter in the PTA with an existing trading partner, the trading relations are deepened due to preferential market access and other benefits explained above. The exporting country firms exploit these benefits by seeking new opportunities and developing new products to effectively serve the export market demand. A PTA with a new or non-conventional trading partner accelerates the impact of market diversification on product diversification as the new potential sector for exports are identified and firms seek to exploit the new opportunities through new products. The identification of new sectors, which are not part of the major export portfolio of home country also lead to product diversification if the country has potential to serve them. The emphasis on the emerging or non-conventional export products in the product coverage of PTAs can help the country boost its exports in such value added industries and reduce the concentration in the traditional sectors.

Market Diversification Effect: The formation of PTAs with the minor and new trading partners helps reduce the degree of concentration of exports in few countries. This impact is magnified if the country is successful in becoming member of a large regional trade agreement. The PTA member country can also be used as a gateway to enter more markets, especially if the PTA member country is a hub economy in the international trading network. The knowledge spillovers and learning effects, which are central in expanding to other markets at firm level, are also associated with inter firm networks developed between the PTA members' firms. The firm-level learning and innovation are more imperative if the other PTA member is a knowledge based economy. The productivity and competitiveness outcomes of PTAs through learning and purchase of strategic assets there etc. can also help firm enter the non-PTA markets.

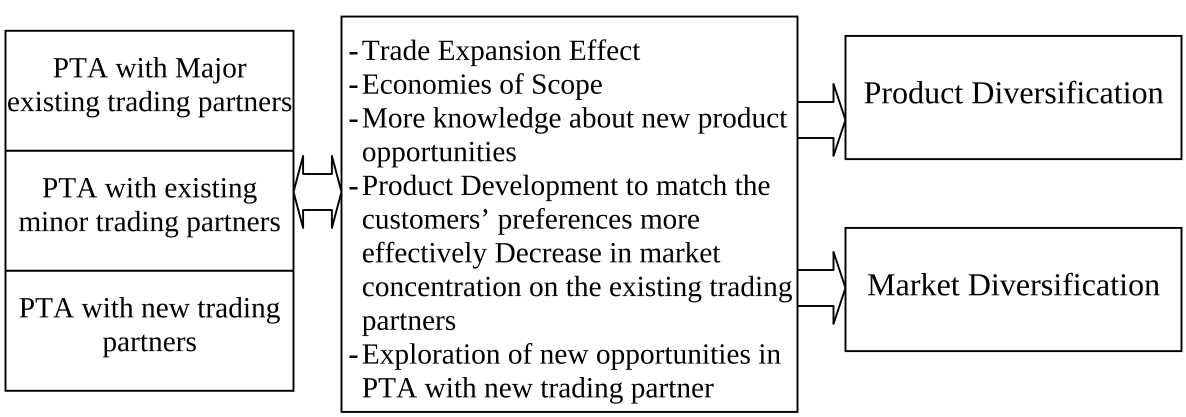

Figure 3: Impact of PTAs on Export Diversification

METHODOLOGY

The study has followed a mixed methods research design using both inductive and deductive approaches. Due to the evolving nature of the topic, the qualitative research design is adopted to develop the theoretical framework. Extensive review of secondary literature on the topic has made possible to identify the missing links in the theory of internationalization. This inductive approach has been quite useful in postulating the hypothesized relationships patterned from available theoretical and empirical literature. The model developed here is also enriched by the qualitative interviews with export marketing managers in Pakistani companies. The postulations of the model and hypothesized relationships are then tested using the quantitative research design. The longitudinal trade data of Pakistan with its FTA trading partners is analyzed to obtain empirical support on the hypothesized relationships. The survey method is used to collect quantitative information from the sample of export managers in Pakistani firms doing business in FTA member countries to analyze their perceptions regarding the influence of preferential trade regime on their internationalization and diversification strategies. The questionnaire was administered through mail, telephonic and personal interviews. The sample has been drawn using the simple random sampling technique from the list of the exporting firms who have been doing business with the Pakistan's FTA member countries. The list of such exporters has been obtained from the Customs Department of Central Board of Revenue, Pakistan. The survey data has been analyzed using descriptive statistical techniques.

Limitations of Study and Directions for further Research:

The concept of preferential trade agreements is an evolving phenomenon in the policy making framework of Pakistan. Most of the PTAs have only recently signed and their long term impact is yet to fully realized. The model proposed in this study should be further tested on the trade data of other developing countries and their international firms to generalize the findings. Similarly the impact on services trade has not been made part of this exercise.

DISCUSSION OF RESULTS

First, the longitudinal trade data of Pakistan with her FTA partner has been analyzed to demonstrate the internationalization and export diversification impact of FTAs at national level in Pakistan. Secondly, findings from a survey of exporting firms to these markets are discussed, which was conducted to obtain the firms' perceptions about impact of FTA on their internationalization and export diversification strategies at firm level in Pakistan. Both trade data and survey results confirm the strong and singular effect of PTAs on firms' internationalization and export diversification in Pakistan at national as well as at firm level. The strong impact of FTAs on internationalization and export diversification here do not include the learning and knowledge spillovers effect which are more long term. In a span of only one year, the trade statistics show a very strong impact of FTAs on the study variables, and thereby promise for much more impact once the learning and spillover effects at firm level are realized over the coming years.

Table 1: Impact of FTA on Value of Pakistan's Exports to FTA Partners: The Internationalization Effect

Amount in Thousand US$

Country	2003-04	2004-05	2005-06	2006-07	2007-08 (FTA Period)	2008-09P (FTA Period)
China	255,595	281,982	412,213	547,561	674,127	1,264,533
Iran	55,218	116,188	174,322	178,101	103,086	267,924
Malaysia	75,563	66,925	63,079	73,249	85,091	193,725
Mauritius	40,700	40,059	31,854	39,524	45,048	80,696
Sri Lanka	86,823	142,753	132,895	192,236	205,626	413,951

P: Provisional

Source: State Bank of Pakistan, Statistics and DWH Department

The table 1 above clearly demonstrates the strong impact of FTA on the value of exports from Pakistan to the FTA partners between 2007-08 and 2008-09. Almost all the FTAs between Pakistan and the above FTA partners were operational from 2007-08. A clear departure from the historical trend of trade growth between Pakistan and her trading partners can bee seen after 2007-08 compared to the export growth in the previous years. The exports to the FTA partners have witnessed around 200 percent increase over the one year period till now. Increase in the absolute value of exports to the FTA partners is an indication of enhanced firms' internationalization. This huge increase of exports is carried out by either more firms' entering the export market or by increase in the export intensity and export involvement of existing exporting firms to these FTA partner and, thus, represents the impact of PTAs on firms' internationalization in Pakistan.

The table 2 below demonstrates the trade expansion or market diversification effect of FTAs on Pakistan's exports. The increase in the relative share of exports to these countries has also indirectly reduced the degree of export market concentration of Pakistan on her traditional trading partners like US, UK and EU and thus supports the hypothesis of market diversification effect of PTAs. The above results also indicate that the signing of FTAs has significantly impacted the international markets selection decision of exporting firms from Pakistan in the favor of FTA member markets. Most of the new exporting firms entering these markets were previously exporting to other markets but altered their direction of export business after the agreement. It is worthy to note that the trade expansion effect results into market diversification if the FTA member is a non-traditional trading partner. Otherwise the trade expansion associated with FTA can result into increase in the degree of export concentration.

Table 2: Percentage Share of Exports to FTA Partner: The Market Diversification Effect

*Exports to FTA partner/total exports*100*

Country	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**	**2008-09[P]**
China	2.062	1.947	2.490	3.169	3.300	7.2611
Iran	0.445	0.802	1.053	1.031	0.505	1.5384
Malaysia	0.610	0.462	0.381	0.424	0.417	1.1124
Mauritius	0.328	0.277	0.192	0.229	0.221	0.4634
Sri Lanka	0.700	0.986	0.803	1.113	1.007	2.3769

P: Provisional

Source: State Bank of Pakistan, Statistics and DWH Department

Summary of Survey Results

1. 45% of the export managers strongly agreed with the view that the trading environment had become more predictable after the FTA. The 20% were somewhat agreed and 15% had no awareness about the FTA. The percent of the
2. The share of bilateral trade has increased significantly with most of the FTA partners except Iran. This also shows the product and market diversification effects of PTAs. The impact of such trade expansion on the concentration on the conventional products and markets has been negligible. The reason for such minor impact is the very small overall share of Pakistan's trade with its FTA partners in the base period.

3. The no. of registered exporting firms doing trade with FTA member countries rose significantly from 54 to 71 i.e. almost 31% increase. This result indicates the strong impact of PTAs on firms' internationalization.
4. The 62% of the firms indicated that they received significantly more orders after the FTA. This implies the strong positive impact of PTAs on learning by doing of firms and their international exposure.
5. 78% of the export managers agreed that the FTA resulted in simplification of trade procedures and better treatment at customs.
6. 54% of the export managers strongly agreed that after FTA, their network relationships grew, 10% were somewhat agreed, 5% did not know and 31% disagreed.

CONCLUSION

This study sheds light on the role of public policy which is the least understood area in firms' internationalization strategies. The study develops the theoretical rationale for linking the preferential market access and information about domestic market provided to the member countries' firms under PTAs with the home-based firms' internationalization strategy i.e. decision to go abroad, foreign market selection and mode of entry. This new role of PTAs has strong theoretical support from New Trade Theory, which signifies the strategic interaction between firms in imperfect international markets and explains the relationship between the support provided by home govt. to the home-based firms and their international performance against foreign rivals. Role of PTA as a horizontal support measure of strategic trade policy increases its importance as a pro-competitive tool. Findings of the study can be generalized to the other developing countries as well.

The findings suggest that Pakistan should sign more FTAs with non-traditional trading partners in order to benefit from the market diversification effect arising out of trade expansion associated with PTA. The study opens avenues for further theoretical and empirical research in the area of public policy determinants and their effectiveness in firms' internationalization. The findings call for an active role of strategic trade policy in Pakistan and other developing countries that can provided pro-competitive horizontal support to home based firms in imperfect international markets. Moreover, the design of industrial policy also needs to be adapted in line with the provision of the strategic trade policy, so that both can complement each other to boost innovation and a competitive enterprise development in Pakistan. However, the policy makers also need to be cautious about the intense information requirement and govt. failure while using strategic trade policy and designing PTAs in the favor of domestic champions. The study has implications for international diversification and firms' internationalization specifically in developing countries.

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