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Prospects and Challenges for Increasing India-Pakistan Trade

Ishrat Husain

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1101 15th Street NW, 11th Floor
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ISBN: 978-1-61977-002-7

November 2011

Atlantic Council

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Prospects and Challenges for Increasing India-Pakistan Trade

In the face of massive economic challenges, a burgeoning population, energy and water shortages, and huge and growing numbers of unemployed workers, especially youth, Pakistan needs to look for ways to move itself out of the economic hole into which it has fallen. Greater trade with India offers an immediate and rich possibility of economic growth for both Pakistan and India. Recent meetings between the commerce ministers of both countries in New Delhi appear to have yielded some good intentions to increase trade from its current level of $2 billion a year to $6 billion, still well below what many scholars estimate to be the potential. Yet, the obstacles remain, in the form of rules and regulations that inhibit trade, and in the lack of private-sector initiatives that would surmount governmental foot dragging. In the end, it is the private sector—not official trade—that will boost incomes on both sides of the border. And the question remains: Will India and Pakistan see the advantage of opening borders as being mutually beneficial?

Economic theory and empirical evidence have clearly established the links between trade, productivity, and economic growth. Countries that have large internal markets have also benefited by integrating themselves into the world economy, and thus opening up their economies. World trade in 2009 amounted to $12 trillion. The size of Pakistan's domestic market is only $180 billion (GDP). Currently, its share of global trade is only 0.14 percent. Even a 0.5 percent share in the global export market implies that its exports could rise from the current $25 billion to $60 billion, creating millions of jobs.[1]

On the other side, imports bring the transfer of technology into the country via imported goods and services, and, as a result, raise the potential of increased domestic production. For India, the potential market for its exports to a neighboring country would reduce the costs of trade and remove many of the underlying issues that have bedeviled its relationship with Pakistan since independence in 1947. Moreover, wider trade with Pakistan creates the possibility of transit trade beyond Pakistan, to Afghanistan and Central Asia.

It is also becoming quite obvious that the balance of global economic power is moving away from developed countries to developing countries. China has overtaken Germany to become the largest exporting country, and has surpassed Japan to become the second-largest economy in the world. China and India are projected to be the two fastest-growing economies of the world over the next several decades. Pakistan is a neighbor to both of these large and expanding economies. Its national economic interests dictate that it should expand its trade with both of these countries and penetrate their markets on the basis of its comparative advantage in a number of sectors. India, sharing a larger and more-accessible common border with Pakistan, offers the biggest immediate gains from trade.

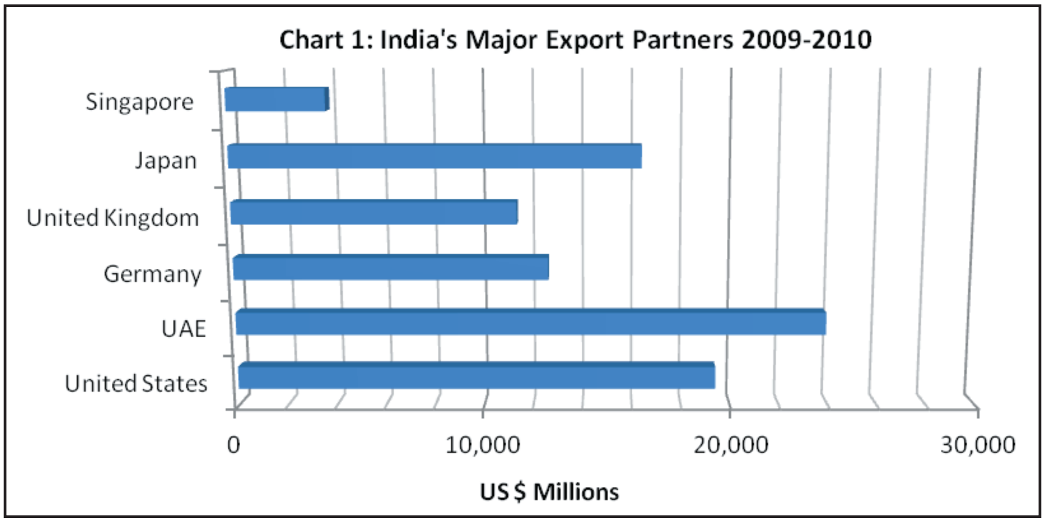
The question often raised inside Pakistan is: Will expansion of trade with India bring benefits to Pakistan, or would it be swamped by its large neighbor? A lot of myths and misperceptions on this point have taken root in public discourse. Empirical evidence, based on an examination of specific sectors, indicates that India-Pakistan trade is a win-win situation. When combining the top two deciles of income distribution, India has a middle class of approximately 300 million people, with rising purchasing power that matches that of southeastern Europe, while Pakistan's middle class is approximately 30 million. Even

1 According to a survey by the Textile Commissioner's Organization of Pakistan, 600,000 additional jobs were created between 1999 and 2007, when exports of textiles increased by $6 billion.

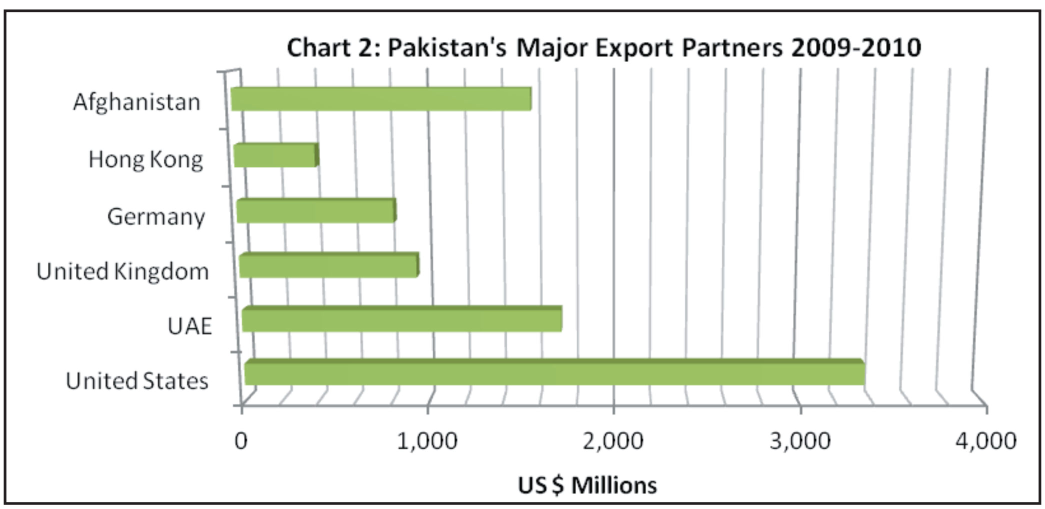
a 10 percent share of the Indian middle-class market would double the market size of Pakistani companies and businesses.

Numerous studies on India-Pakistan trade have so far demonstrated that the relaxation of constraints in the way of bilateral trade would benefit both countries. The theoretical argument is that countries in relative geographical proximity tend to trade more with each other than with more-distant countries because of lower transport and communication costs. Gravity models have been used to test this hypothesis empirically. (Under these models, the economic size and proximity of potential trading partners affects their trade flows.)

Researcher Amita Batra, using an augmented gravity model, showed that all three gravity effects of distance, size, and income were statistically significant for India-Pakistan trade.[2] An Indian Council for Research on International Economic Relations (ICRIER) study showed a much higher volume—about $10 to $11 billion (Pakistan, 55 percent textiles; India, 90 percent non-textiles) from the current official trade of about $2 billion a year.[3] Ijaz Nabi and Anjum Nasim estimated that trade between India and Pakistan could increase



Source: Department of Commerce, Government of India



Source: Director General, Foreign Trade Institute of Pakistan

2 Amita Batra, "India's Global Trade Potential," *Global Economic Review*, Vol. 35, No. 3 (2006).

3 Amita Batra, "India's Global Trade Potential: The Gravity Model Approach," Working Paper 151, Indian Council for Research on International Economic Relations (ICRIER), 2004.

threefold if Pakistan followed India's example and accorded India Most Favored Nation (MFN) status, and both countries imposed a maximum tariff rate of 50 percent.[4] A State Bank of Pakistan study came to the conclusion that bilateral trade could increase fivefold if MFN status were granted and non-tariff barriers were removed by both India and Pakistan.[5] Zareen Naqvi and Philip Schuler estimated that the trade between the two countries could jump from $2.5 billion in 2007–08 to $5 to 10 billion, or two to four times its current basis.[6] Mohsin Khan, a senior fellow at the Peterson Institute for International Economics, has suggested in a recent study that trade between the two countries could be five to ten times larger than the present value, thereby raising GDP and household incomes in both countries.[7] Net welfare gains are positive in every single scenario, ranging from the most conservative to the most optimistic.

Trade will lead to some limited specialization and trade in intermediate inputs for use in exports to high-income countries.[8] Granting MFN treatment to India would benefit Pakistan, and a free trade agreement (FTA) would further increase those benefits.

This paper draws extensively and freely from the findings of a major and comprehensive research study carried out by the State Bank of Pakistan (2006). Other more-recent studies (for example, Mohsin Khan's work) have supported the findings of this one, but are not as broad-based. The State Bank of Pakistan (SBP) study showed that the potential of trade (exports plus imports) between the two countries amounted to $5.2 billion in fiscal year 2004 (FY04), when the actual trade was about $1 billion. In FY04, Pakistan imported 2,646 common items worth over $7 billion from the rest of the world (which accounted for 53 percent of the total imported items, and 47 percent of the aggregate value). India also had exports of the same items worth over $15 billion (covering 24 percent of the total value of its imports).

Analysis revealed that for 48.7 percent of the items in FY04, the unit values for Pakistan's imports were more than the unit values of India's exports. Even after excluding the items which are currently permissible for imports from India, about 45 percent of the items still remain on the common list, which could be imported from India at a lesser cost than the current cost of imports from the rest of the world. Allowing imports of such items from India (i.e., expanding the current list of positive items that can be imported from India) will give Pakistan an estimated average savings of $400 to $900 million.[9]

A disaggregated analysis at the sectoral level carried out by the SBP study illustrates the picture more clearly. The broad conclusions drawn from the sectoral analysis contained in the SBP study are reproduced below and on the following page.

Table 1: India-Pakistan Trade

(US $ Millions)

Year	Pakistan's Exports to India	India's Exports to Pakistan	Total Trade Flows
2004–05	288	547	835
2005–06	293	802	1,095
2006–07	343	1,235	1,578
2007–08	255	1,701	1,956
2008–09	320	1,914	2,234

Source: Federal Bureau of Statistics, Pakistan; Reserve Bank of India

4 Ijaz Nabi and Anjum Nasim (eds.), "Trading with the Enemy in Regionalism and Globalization," Sajan Lahiri, London: Routledge, 2001.

5 State Bank of Pakistan, Research and Economic Policy Department Report, "Implications of Liberalizing Trade and Investment with India," 2006.

6 Zareen Naqvi and Philip Schuler (eds.), "The Challenges and Potential of Pakistan-India Trade," The World Bank, Washington, D.C., 2007.

7 Mohsin S. Khan, "India-Pakistan Trade: A Roadmap for Enhancing Economic Relations" policy brief, pp. 9–15 (Washington, D.C., Peterson Institute for International Economics), 2009.

8 Using an intra-industry flow matrix, it can be surmised that agricultural raw materials, iron and metals, automotive parts, chemical, elements and compounds, and cotton fabrics can benefit both countries. Both can specialize in products at different stages of production, or in differentiated products.

9 The negative list, for example, includes pharmaceuticals, cosmetics, and jewelry, while the positive list includes, among other items, chemical elements and compounds, concentrates of iron and steel, tires and tubes of rubber, machinery and its parts, etc.

Table 2: Direction of Trade Flows from India and Pakistan

Trade Flows From	Within Region		To Other Developing Countries		To High-Income Countries	
India	4.2	4.5	17.5	27.4	78.2	65.3
Pakistan	4.5	12.4	12.0	23.8	81.2	61.9

Source: SAARC Secretariat, Kathmandu

Table 3: India's Trade with Pakistan and the Rest of the World 2008–09

(US $ Millions)

Exports to Pakistan	1,914
India's Total Exports	189,000
Percentage Share of Pakistan	1.01%
Imports from Pakistan	320
India's Total Imports	257,600
Percentage Share of Pakistan	0.12%
Trade from Pakistan	2,234
India's Total Trade	446,600
Percentage Share of Pakistan	0.50%

Source: Economic Survey of India

Table 4: Pakistan's Trade with India and the Rest of the World 2008–09

(US $ Millions)

Exports to India	320
Pakistan's Total Exports	19,121
Percentage Share of India	1.7%
Imports from India	1,914
Pakistan's Total Imports	31,747
Percentage Share of India	6.0%
Trade from India	2,234
Pakistan's Total Trade	50,868
Percentage Share of India	4.39%

Source: Federal Bureau of Statistics, Government of Pakistan

Textiles and Clothing

The textile and apparel sector continues to be the driving force for economic growth in both India and Pakistan. This sector contributed 18.8 percent in India and 65.6 percent in Pakistan, of the total value of exports in FY04. In both countries, the textile and apparel sectors exhibit different degrees of specialization. India is regarded as a major alternative source to China for apparel and high-value-added textile products. Pakistan, although a supplier of a limited range of products, is considered a competitive supplier of cotton goods, particularly men's apparel, home textiles, and fabrics.

Currently, trade in textiles and clothing between India and Pakistan is almost nonexistent. The comparison of exports of both countries identifies 176 common items which have comparable unit values. Out of these 176 items, India has a price advantage (i.e., lower realized export unit value) in 48 textile products, while Pakistan has a price advantage in 128 textile products.[10] Since other factors—such as quality, production, and design of products, etc.—are also important, it is hard to conclude on the basis of just export unit value that the granting of MFN status would result in a unidirectional flow of textile products, meaning Indian textile products would flood the Pakistani market.

Although Pakistan ranks above India in both the textiles and clothing sectors in terms of the revealed comparative advantage (RCA), this should be interpreted cautiously.[11] The higher magnitude of RCA index in the case of Pakistan shows the vulnerability of the export earnings of Pakistan to sector-specific events. Pakistan's economy is far less diversified as compared to the Indian economy, and depends heavily on the textile industry. Garry Pursell's study shows that there would be some gains for both countries, but that the scope for penetrating each other's domestic-use markets (in contrast to supplying inputs to the export industry) would be limited.[12] High-quality products such as bed linens and cotton-lawn fabric from Pakistan are in demand in India.

10 Single yarn, cotton fabrics, denim, woven fabrics, ensembles, jackets and blazers, trousers, blouses, T-shirts, jerseys, men's swimwear, skirts, garments.

11 Revealed comparative advantage (RCA) is a measure of competitiveness, and is estimated as a ratio of the share of a given product in a country's exports to it share in world exports. If it takes a value greater than 1, the country has an RCA in that product. If it is less than 1, the country has a comparative disadvantage.

12 Garry Pursell, cited in Naqvi and Schuler, 2007.

Iron and Steel

In FY04, India was the major supplier of raw material (iron ore) to this vital industry, and accounted for 69.2 percent of the total imports of iron ore in the world, followed by Australia (19.9 percent) and Iran (10.9 percent).[13] Unlike Pakistan, India has a well-established steel industry, and is a net exporter of steel and steel products. The Indian steel industry produces a wide range of steel products. On the back of abundant raw materials, highly skilled technical manpower, and competitive labor, India is the eighth-largest crude-steel producer, and the largest producer of sponge iron in the world.

Pakistan's iron- and steel-product imports from India account for just a small fraction of its total imports. In FY04, Pakistan imported $662 million worth of iron and steel products (326 items), of which India supplied only 25 items, worth $7.1 million. About 46 items are identified as potential imports that are cheaper to import from India on the basis of lower unit value of Indian exports, compared to the import unit value of Pakistan's imports from the rest of the world.

Chemicals and Pharmaceuticals

Pakistan's chemical industry has by and large developed on a fragmented and ad hoc basis, motivated by a combination of the existence of a small local market and traditionally high tariffs. As a result, it suffers from the lack of economies of scale, national integration, and subsequent lack of competitiveness. As a result, the country is highly dependent on imported chemicals to cater to the needs of its agriculture and industrial sectors. During FY04, imports of chemicals stood at $2.8 billion, an increase of 29.5 percent over the previous year.[14]

Compared to Pakistan, the Indian chemical industry is well established and has shown impressive growth over the years, contributing about 6.7 percent to the Indian GDP. In terms of volume, it is the twelfth largest in the world, and third largest in Asia. With a current turnover of about $30.8 billion, it accounts for 14 percent of the total manufacturing output in India.[15]

The pharmaceutical industry in Pakistan plays an important role in the economic development of the country. Total local production/consumption of pharmaceuticals is currently estimated at $2 billion. There are about 316 pharmaceutical manufacturing companies, including 30 multinationals (47 percent share), which are meeting around 80 percent of the country's requirement. Almost 95 percent of the basic raw materials used for the manufacturing of medicines are imported from China, India, Japan, the United Kingdom, Germany, the Netherlands, and others. Other production inputs, such as technology, labor, packaging materials, power, and raw materials, are easily available, and the government provides good incentives for importing raw materials and technology.

Compared to the pharmaceutical industry of India, the size of Pakistani companies is relatively small, and hence uncompetitive. The Indian pharmaceutical industry has become a net exporter and is now putting up US Food and Drug Administration–approved plants, and is exporting to advanced economies. Indian companies are the only suppliers worldwide for some pharmaceutical raw materials. The country ranks fourth worldwide, accounting for 8 percent of the world's production by volume and 1.5 percent by value. India is also among the top twenty pharmaceutical exporters, and among the top five manufacturers of bulk drugs in the world.

During FY03 and FY04, Pakistan imported 4.3 percent and 6.8 percent of its total imports of chemicals and pharmaceutical products, respectively, from India. Out of its total imports of $2.9 billion (1,105 items) in FY04, India supplied 353 items worth only $196.8 million. Out of the total imported chemicals and pharmaceutical products from India, 166 items had a lower unit value compared to the unit value of the same items imported from elsewhere. These items have the potential for enhancing imports from India. Pakistan already imports raw materials for its pharmaceutical products from India, and the scope for finished-product imports from India is substantiated by these unit-value comparisons.

Automobiles

The automobile industry in Pakistan operates under franchise and technical-cooperation agreements with leading world manufacturers, and can be broadly categorized into various segments, i.e., cars and light commercial vehicles (LCVs), two- and three-wheelers,

13 State Bank of Pakistan report, 2006

14 State Bank of Pakistan report, 2006.

15 State Bank of Pakistan report, 2006.

tractors, trucks, buses, and vendor industry vehicles. The automotive industry contributed over 30 billion rupees (US $659.96 million) to the government exchequer in the form of duties and taxes in FY03, with a contribution of 17 billion rupees (US $373.98 million) from the top four manufacturers alone.

From the late 1980s to the early ’90s, the demand for automobiles in Pakistan was on the rise, setting the stage for a decade of robust growth. The industry had achieved a phenomenal growth of 50.2 percent in FY04, and increased competition led to the introduction of innovative automobile products, such as larger-capacity sedan cars and pickup trucks, as well as a decline in financing costs.[16]

Compared with Pakistan, India has a strong engineering base, and has successfully created a sizable capacity for production of vehicles. It enjoys a clear edge over Pakistan in the automobile sector. Indian auto companies are highly cost-competitive due to appropriate levels of mechanization and low-cost automation, and have achieved a high level of productivity by embracing Japanese concepts and best practices. India is already the second-largest two-wheeler manufacturer, second-largest tractor manufacturer, and fifth-largest commercial vehicle manufacturer in the world, and has the fourth-largest car market in Asia.

The automobile industry in India is now gradually evolving to replicate those of developed countries. Pakistan can import automotive components and spare parts from India at a lower price than Thailand. On the other hand, India is expected to benefit from free trade due to its relatively low raw-material, electricity, and labor costs. This would make imports of automobiles from India much cheaper for Pakistan than those from other countries, such as Japan or Korea. Joint ventures between the firms from two countries located near the industrial clusters would lower the unit costs of production and distribution.

Information Technology

In India, the IT industry has made tremendous progress and has emerged as one of the fastest-growing sectors. In 1998, the IT sector accounted for only 1.2 percent of GDP. By 2009, its contribution had jumped to 5.8 percent of a much larger GDP. The annual growth rate of the industry has been simply phenomenal. The revenues earned in 2000 were only $4 billion. Ten years later they had surged to $62 billion. Infosys, for example, employed 10,000 people in 2001, which multiplied twelvefold, to 125,000 by 2010. A majority of the multinational IT companies operating have either software development centers or research development centers in India. India’s expertise in emerging technologies has actually helped the country to attract new customers, and IT and services companies in Europe and Japan are outsourcing to India.

Although the IT industry in Pakistan is in its infancy, it is growing at a fast pace, even as it struggles to catch up with the regional and global industry. Officially recorded IT exports increased from US $46 million in 2004–05 to US $250 million in 2009–10, showing a 40 percent annual growth rate. As per the World Trade Organization (WTO)–prescribed formula, the size of the IT industry in Pakistan is currently in the range of $2.8 to $3 billion, and IT-related exports are around $1.6 billion.[17] However, most of the companies are small- to medium-sized, with few entities concentrating on the export of software- and IT-enabled services. Pakistan has lagged behind other regional countries in using IT as a catalyst for economic revival. This is one of the potential areas which could be exploited. India, with its wider software industry, can extend help to Pakistan to promote IT through the establishment of joint ventures. The wages of IT professionals in India are rising fast, and it is losing the labor-cost advantage. Hence, a joint venture between a Pakistani IT company, supplying skilled professionals of comparable quality at lower wages, and an Indian company, procuring international contracts in its name, would be a win-win situation for both the countries and the industry.

The above SBP study is corroborated by another study on Pakistan-India trade, carried out by the World Bank, which concluded that Pakistan stood to gain from liberalization of trade.[18]

Trade Liberalization under SAFTA

The South Asian Association for Regional Cooperation (SAARC) member countries, including Pakistan and India, reached the landmark Agreement on South Asian Free Trade Area (SAFTA) on January 6, 2004, with a pledge to allow free trade among member countries by eliminating trade

16 State Bank of Pakistan report, 2006.

17 Government of Pakistan, The Tenth Five-Year Plan, 2010–15 (Draft) Planning Commission, Islamabad, May 31, 2010.

18 Zareen Naqvi, Philip Schuler, and Kaspar Richter, “Overview” chapter in Naqvi and Schuler, 2007.

barriers and scaling down their tariffs in two phases, to 0 to 5 percent from January 1, 2006, onward. The treaty allows free cross-border movement of goods within the region, with the provision for a list of sensitive items for member countries to safeguard national interests.

SAFTA is likely to contribute significantly to intraregional trade, along with a scope for enhanced trade between India and Pakistan—particularly in transportation equipment and engineering goods, including IT products. Complete elimination of tariffs under SAFTA may increase intraregional trade by 1.6 times over the existing level.[19] The intra-SAARC trade in South Asia is about $25 billion, or 4.8 percent of South Asia's trade with the world. The above projections need to be viewed against the cost of noncooperation, which was estimated by an earlier RIS[20] study to be about $511 million for Pakistan. In other words, the opportunity cost or foregone benefit of free trade within SAFTA is high.

Table 5: Trade within Regional Blocks

(Percentage % of Total Exports)

	1990	1995	2000	2005	2009
SAARC	3.5	4.5	4.6	6.6	5.4
ASEAN	18.9	24.4	23.0	25.3	24.5
EAC	17.7	19.5	22.6	18.0	18.9
CACM	15.3	21.8	19.6	23.2	22.3
CIS	—	28.4	19.8	17.7	14.8

Source: SAARC Secretariat, Kathmandu

SAARC: South Asian Association for Regional Cooperation
ASEAN: Association of Southeast Asian Nations
EAC: East African Community
CACM: Central American and Caribbean Market
CIS: Commonwealth of Independent States

Advantages of Trade Liberalization for Pakistan

The liberalization of bilateral trade between Pakistan and India would not only lend impetus to the integration of both economies, but it would also be seen as a good model by other nations in the region. The potential advantages of trade liberalization for Pakistan appear to be great.

Going well beyond the immediate creation of trade flows, dismantling tariff and non-tariff barriers would also boost productivity and economic growth, and promote broader regional cooperation in South Asia in all areas.

Trade liberalization will unambiguously benefit Pakistani consumers, since product prices fall and consumer choice increases when trade barriers are reduced or removed. Increased trade flow that stems from the lifting of import prohibitions for items coming from India would lead to additional customs revenue for Pakistan (if corruption can be avoided in the collection of customs duties). Within the protective walls of regional economies, both countries can achieve specialization in various subsectors of the economy. Moreover, the strengthening of bilateral/regional trade would also cushion the economies of both countries from global financial or stock-market shocks.

Bilateral trade balance with any particular country does not have to be positive. There would be no trade in that case. Pakistan would run a trade deficit with India just as it does with China, and surpluses with other countries. India is a larger, more-diversified economy, and also produces goods that Pakistan exports. The determining factor is whether the cost of imports from India is less than comparable-quality imports from other sources. In that case, Pakistan's local industry and its consumers would both stand to benefit.

If the empirical evidence is so strong, why is trade between the two countries so low—less than 1 percent of Indian exports, and less than 5 percent of Pakistani imports? The volume of bilateral trade has not exceeded $2 billion, out of a total volume of Indian and Pakistani exports of about $200 billion.

Three main reasons lie behind the slow growth of trading relations between India and Pakistan:

1) Political relations between the two countries have remained discordant and contentious over a long period of time. A trust deficit does not allow for stability, which is a prerequisite in order for any exchange of goods and services to take place.
2) Both countries have, until recently, pursued import-substitution policies that sheltered local industry behind protective barriers.

19 Table IV.

20 Research and Information System for the nonaligned and other developing countries.

3) The commitment to regional economic integration in South Asia has remained quite weak.[21] Even in the face of bilateral political disputes, it is possible to promote trade within a regional preferential trading area framework. This has not happened in South Asia.

These constraints can be relaxed. Countries with adverse political relationships, without giving up their principled stand on disputes and differences, have engaged in cross-border investment, trade, and movement of people.

Table 6: India's Major Trading Partners 2009–10

(Percentage % Share)

Country	Exports	Country	Imports
USA	10.9	China	15.0
UAE	13.4	UAE	11.4
Japan	9.2	Switzerland	8.6
Germany	7.1	S. Arabia	7.1
UK	6.4	USA	7.0
Singapore	2.2		
Total (US $ Billions)	**178**	Total (US $ Billions)	**287**

Source: Department of Commerce, India

Table 7: Pakistan's Major Trading Partners 2009–10

(Percentage % Share)

Country	Exports	Country	Imports
USA	17.4	UAE	14.5
UAE	8.9	Saudi Arabia	9.7
Afghanistan	8.1	Kuwait	6.9
UK	4.9	Malaysia	5.0
Germany	4.3	USA	4.6
Hong Kong	2.2	Japan	4.4
		Germany	3.4
		UK	1.7
Total (US $ Billions)	**19.3**	Total (US $ Billions)	**34.7**

Source: Federal Bureau of Statistics, Government of Pakistan

Over time these activities have helped to foster a better understanding of each other's viewpoints. Although Singapore and Malaysia broke up as partners in a political union, both countries have improved political relations because of close economic ties. Confidence-building measures and the creation of stakeholders in the countries can eventually defuse the tension and soften the ground for peaceful resolution of disputes and disagreements.

It is therefore not right to wait to resume economic relations until the bilateral political disputes are resolved. If economic engagement is fierce and picks up steam, the hawks in each country may be confronted by the new stakeholders, who are benefiting from such engagement. Investors, traders, transporters, bankers, and business groups who will be working for Indian firms in Pakistan, and vice versa, will act as strong lobby groups to nurture, preserve, and promote peaceful bilateral political relations between the two countries. Any souring of the relations will hurt their vested economic interests. Resumption of economic relations should be allowed without any preconditions, and without the countries giving up their respective negotiating positions on political disputes. Composite dialogue between India and Pakistan should carry on at the same time to resolve those disputes and disagreements.

Prospects for Economic Integration

On the second constraint, it is heartening that both India and Pakistan have opened up their economies, abandoning the old import-substitution policies that favored autarky instead of importing lower-cost products from overseas, and embarked upon a process of integration with the world economy. The reforms they have carried out—such as cutting tariff rates, elimination of Quantitative Restrictions, regulating duties, and para-tariffs—leave them in a much better position to pursue preferential liberalization.

Pakistan and India signed SAFTA in January 2004, which came into force in January 2006. SAFTA is aimed at reducing and eventually eliminating tariff barriers, facilitating cross-border movement of goods, promoting fair competition in the region, and creating an effective framework for regional cooperation. But the agreement is still hindered by fairly restrictive "sensitive lists," strict rules of origin, and a slower time frame and scope.

21 Zareen Naqvi, "Pakistan-India Trade Potential and Issues" (unpublished paper), 2008.

A recent study by Nisha Taneja and colleagues has attempted to prune India's sensitive list under SAFTA.[22] Of the five member countries of SAFTA studied, Sri Lanka, Nepal, and Bhutan already have bilateral free trade agreements with India. Bangladesh enjoys the LDC status, and the operational sensitive list applicable to it contains only 331 items. This leaves Pakistan the only country having a non-LDC status. The sensitive list applicable to Pakistan has the largest number of items, 868 (910 under the six-digit level restructured list).

Regional trade agreements like SAFTA, if fully implemented, can have a positive effect on growth, trade, technological diffusion, and foreign investment. Trade within the region will unleash new technology, lower domestic prices, provide new technology, and usher in economies of scale in production and distribution as the effective market size expands. Joint ventures in pharmaceuticals, chemicals, petrochemicals, automobiles, agro processing, technology-transfer arrangements among IT firms, and joint gas-pipeline projects are some of the possibilities that can take place within SAFTA if harmonization takes place.

Empirical studies on South Asian regional trade have shown mixed results primarily because of the smaller countries of the region—Afghanistan, Bhutan, Nepal, Maldives—which are landlocked, or small islands in the presence of a giant continental economy, such as India. Other research has concluded on the basis of computable general equilibrium model simulations that the policy of unilateral liberalization would benefit South Asian countries much more than SAFTA, as small countries would gain little, or even lose.[23]

A European Trade Study Group (ETSG) report on regional trade in South Asia comes to an opposite conclusion using the gravity model.[24] Its analysis shows that there is a significant trade-creation effect with the rest of the world under the South Asian Preferential Trade Agreement (SAPTA). This report finds no evidence of the trade diversion effect with the rest of the world, and argues that further regional integration may bring about substantial benefits to the SAARC region, while SAFTA is most likely to promote interregional trade through further dismantling of tariff and other non-tariff barriers among members.

The Ease of Doing Business

Both India and Pakistan continue to use tariff and non-tariff barriers (NTBs) to protect their domestic producers, even after reforms have led to overall economic liberalization.[25] India is ranked 115th out of 125 countries on the World Bank's latest (2006–08) Trade (MFN) Tariff Restrictiveness Index (TTRI), and Pakistan stands at 102nd place. India's trade regime is much more restrictive than other large emerging economies like Brazil, China, Mexico, and Russia, or in comparison with neighboring countries in South Asia. India's ranking on the "ease of doing business" indicators are also quite low, with the latest ranking at 122nd out of 178 countries, compared to Pakistan's rank at 77th place for 2006–08.[26]

Research by Zareen Naqvi shows that India's MFN applied average tariff rate, at 14.5 percent (in 2007), is much lower than tariff rates a decade ago; however, the applied tariff rates for agriculture exports, at 39 percent in 2007, is one of the highest in the world. This is a major barrier that Pakistani exporters of agricultural products face in terms of expanding trade with India.[27]

In a number of sectors, specific tariffs and regulatory duties outside statutory MFN tariff rates are levied. Potential textile exports from Pakistan are subject to specific duties, which can go as high as 50 to 100 percent in equivalent terms. The Pakistani exporters of textiles and garments say that these are important barriers in their ability to access the vast Indian markets. According to Taneja's survey of Indian exporters doing business with Pakistan, very few NTBs in Pakistan restrict trade.[28] The World Bank's frequency-coverage ratio of non-tariff barriers measures India's at 51 percent, one of the highest in the world. In comparison,

22 Nisha Taneja and Saon Ray, Neetika Kaushal, Devjit Roy Chowdhury, "Enhancing Intra-SAARC Trade: Pruning India's Sensitive List under SAFTA," ICRIER Working Paper 255, New Delhi, (April 2011).

23 J. S. Bhandara, "How Desirable Is the SAFTA? A Quantitative Economic Assessment," *The World Economy*, 2003.

24 S. W. Hirantha, "From SAPTA to SAFTA: Gravity Analysis of South Asian Free Trade," European Trade Study Group, 2004.

25 Naqvi, 2008.

26 International Finance Corporation, "Doing Business,"2007 .

27 Naqvi, 2008.

28 Nisha Taneja, "Pakistan-India Trade: The View from the Indian Exporters," in Naqvi and Schuler, 2007.

Pakistan's ratio was much lower, at 29 percent. It also uses stringent domestic standards, whereas Pakistan applies normal international standards.

India—a much bigger economy, accounting for more than 80 percent of Gross Regional Product, and imbued with self-confidence and aspirations to become an economic power—could demonstrate a greater degree of generosity by removing these tariff and non-tariff barriers unilaterally without risking much in return. A wider offer to its neighboring countries in terms of opening up the markets and trade and removing barriers to mobility would ultimately benefit India, reducing hostility and favoring its exporting and importing industries, as well as benefiting Indian consumers with lower prices for goods imported from Pakistan. It would be advisable for India to establish asymmetric relationships with its neighbors and provide more concessions to them, initially expecting less from them in return in order to generate wider economic benefits for itself and its trading partners in South Asia in the long run.

Given the large and growing size of its effective market, the economic losses to India would be minuscule, while political goodwill and returns would be substantial over time. Pakistan, Bangladesh, and Sri Lanka would be much better off economically if they were able to penetrate the buoyant Indian market. Friendly, peaceful, and irritant-free neighbors would aid rather than hinder India in moving toward its long-term goals, enunciated periodically by its leaders. South Asia, a region with the highest number of people living below the poverty line, would surge ahead.

Recommendations for Bilateral and Regional Economic Cooperation

While India and Pakistan continue their dialogue in an effort to resolve core political issues, they should start by focusing on the removal of nonpolitical constraints that will promote bilateral trade. Businessmen in both countries will then be able to take advantage of the opportunities that will present themselves.

Short-Term Goals:

- Pakistan should grant MFN status to India, while India should reduce its tariffs on agriculture commodities, textiles, and other goods that are of potential value to Pakistan.
- Both countries should reactivate SAFTA and agree on a phasing out of the sensitive list (of items that each country deems important for its economy) over the next few years. A restrictive list would nullify all the potential gains of preferential trade access.
- Rationalize and simplify the technical barriers to trade and sanitary and phyto-sanitary measures[29]—which are, in fact, acting as powerful deterrents to the exchange of goods.

These are, in effect, NTBs that hinder the flow of goods. In 2005, Governor Y. Venugopal Reddy and the author had signed an agreement to open branches of two Indian banks in Pakistan, and two Pakistani banks in India. This agreement has not yet been implemented, as procedural difficulties have been allowed to overwhelm the substance of the agreement. Without banking services, the opening of letters of credit, and cross-border fund transactions, trade cannot take place.

Medium- to Long-Term Goals:

- The following tasks should be carried out immediately: trade facilitation through expeditious border crossings; streamlining of documentation requirements; coordination of border agencies; opening of new border crossings; quick customs clearance; improvement of electronic data interchange, telecommunication, and transport links; creation of new shipping protocols; and the easing of visa restrictions for businessmen. In addition, increase railway, air, and road connections between the two countries.
- Replace domestic tax, tariff, and subsidy policies that distort incentives for production and trade in both countries with more-neutral policies.

29 Technical barriers to trade pertain to matters of regulations, standards, testing, and certifications prescribed by each country. Sanitary and phyto-sanitary measures are the standards used to maintain food that is safe, for human and animal health protection, and safety regulations.

- Strengthen the policies used to manage and facilitate trade integration—such as the setting of standards, quality control, technical regulations, and material testing—and make them more user-friendly.
- Harmonization of legal regulations for investor protection, contract and intellectual property rights enforcement, and labor relations would promote the relocation of industries within the region, as the expanded market size and mobility of goods and services would result in economies of scale. Choosing locations for inputs, components, and raw materials that have low transaction costs would confer comparative advantage to final finished goods.

The 2006 composite dialogue between India and Pakistan had on its agenda the resumption of rail service between Khokhrapar and Monabao; bus service between Srinagar and Muzaffarabad; religious visits to Lahore and Nankana Sahib; a new shipping protocol; the deregulation of air services; and joint registration of basmati rice. This agenda should be revived and agreements reached to implement these measures. If implemented sincerely, these measures will open up a new vista for the two countries in the twenty-first century. It is high time the political leadership of India and Pakistan demonstrate the courage and conviction necessary to facilitate trade between their countries, for the benefit of their populations and the region overall.

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