**Normalizing India – Pakistan Trade Relations[[1]](#footnote-1)**

**Ishrat Husain**

India and Pakistan, the two largest economies in South Asia, have enjoyed very little trading relations for past four decades. The intransigency between these two countries has had deleterious effect on intra-regional trade flows within the South Asia region. Consequently, the region remains marginalized in regional trade integration compared to other regions of the world. The foregone benefits to the people inhabiting these countries of South Asia are substantial.

The correlation between trade, economic growth and poverty reduction has become quite evident in the last few decades. Unlike the export pessimism literature, the ascendancy of China, a developing country despite having a large internal market of 1.2 million consumers relying upon exports ,has generated renewed belief in the validity of the proposition of trade as an engine of growth.

South Asia was a single large unified market for goods and services until a few decades ago with sound infrastructure in form of railways, roads and ports the newly independent countries of South Asia also inherited common legal, institutional and administrative systems. Although historical evolution led to some divergences but the elements that bound them for trade, that still dominated. On the other hand, East Asia with countries having such diverse background and very little in common historically has become the most integrated region second after the European Union. There was almost a consensus among academic economists in both India and Pakistan normalization of trade relations would bring substantial economic benefits evenly. But the trade still didn’t take off. Political tension and rivalry between the two countries stood out as the main explanatory variable.[[2]](#footnote-2)

In last one year, there have been some healthy developments in resuming better trading relations. Academic consensus has now spilled over to the business community and a majority of the businessmen on two sides of the border appear convinced that liberalization of bilateral trade would be in their mutual interest. Finally, the policy makers, for a variety of internal and exogenous circumstances, seem to have overcome their reservations and a momentum has been built up in the last several months to move the process forward. [[3]](#footnote-3)

The breakthrough came in form of Pakistan’s decision to grant Most Favored Nation (MFN) status to India and moving away from a highly restrictive positive list of items that could be imported from India to a negative list. The negative list was to be phased out by December 2012 but there has been some unexpected delay due to the concerns expressed by Agricultural lobby in Pakistan. Out of 8,000 items only 15 percent or 1209 items are placed in the negative list. The remaining 6,800 can now be imported from India, while the previous positive list had only 2,000 items. This is a significant change whereby 85 percent of tradable goods can now be procured from India compared to 25 percent a year ago. It is too early to gauge the actual impact of the measures taken by both sides to liberalize and facilitate trade between the two countries but preliminary data shows some encouraging signs. Pakistan’s exports to India during April- December 2012 have jumped by 66 percent to $460 million while Indian exports to Pakistan rose by 16 percent. The South Asia Preferential Trade Agreement (SAPTA) which both India and Pakistan has signed will gradually phase out all tariffs on traded goods with zero tariffs by 2016.

India and Pakistan have also recently signed agreements addressing three key issues that have long plagued business in the region: standards and testing, custom clearance and dispute resolution. A few months ago India removed the restrictions on Indians investing in Pakistan and vice versa. In April, an integrated Border Post check between Attari and Wagah was inaugurated with modern facilities that will allow many more trucks to cross the border daily. India has reduced the number of items that are prohibited for import from Pakistan by 30 percent. The President of Pakistan ratified a liberalised visa agreement that will allow for ease in travel of businessmen between both nations. The recent unfortunate incidents across the Line of Control and the Subsequent media out bursts have given a setback to these relations showing the fragility and vulnerability of the process but hopefully the relations would rebound soon.

Other than the political constraints, the economic environment to promote trade has in fact improved considerably. Over the last decade, India and Pakistan, have succeeded in more than doubling their per capita income giving rise to a large middle class with sufficient purchasing power and changing tastes and preferences . The two countries have also made significant progress in lowering their tariff structure, dismantling quantitative restrictions, reducing rates of effective protection. The inward looking Import-Substitution Strategy that formed the main plank of economic policies in the two countries until early 1990s has been abandoned. A more outward-oriented Export-led strategy has been put in place. India is benefitting by pursuing this strategy as its share in the World trade has multiplied almost five times from 0.4% in 1995 to 1.8% in 2011. Pakistan hasn’t done so well for a variety of reasons, one of them being non-expansion of trade with two largest neighboring countries – China and India.

In the face of massive economic challenges, a burgeoning population, energy and water shortages, and huge and growing numbers of unemployed workers, especially youth and a sense that the country is being left behind others economically that Pakistan needs to look for ways to move itself out of the economic hole there is a widespread realization into which it has fallen. Greater trade with India offers an immediate and rich possibility of economic growth for both Pakistan and India.

Major political parties and other influential stakeholders have become aware that Pakistan has not taken advantage of its strategic location between two most populous and high performance economies. With the signing of the Free Trade agreement with China, Pakistani markets and producers have already adjusted to relatively cheaper imports from China. They do no longer consider that there is any substantial threat from Indian products flooding Pakistani markets and displacing domestic industries. Their working hypothesis is that Pakistan would be able to do much better and penetrate a much larger market. 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 a 10 percent share of the Indian middle-class market would double the market size of Pakistani companies and businesses.

The overwhelming support from Pakistani Businessmen for MFN status to India is partly a reflection of this sense of confidence. Traders and importers in Pakistan are anticipating much larger business volumes and thus profits for themselves from this opening up. Trade liberalization will unambiguously benefit Pakistani consumers since product prices should fall and consumer choice expand when trade barriers are reduced or removed. Increased trade flow that stems from the lifting of import prohibition for items coming from India would lead to additional customs revenue for Pakistan.

It may be useful to recall that in spite of many hurdles and obstacles; India- Pakistan trade has recorded almost a tenfold increase between 2001 and 2011 reaching a level of $2 billion. Unofficial trade, including that through third countries, is also estimated at almost the same amount.

Most Empirical studies calculate that because of low transport costs, dismantling of tariff and non-tariff barriers, grant of MFN status to India by Pakistan, and improvement of logistics arrangements, the total volume of bilateral trade should be able to rise to approximately $8-10 billion annually. Pakistan and India together shipped more than $300 billion worth of goods to all parts of the world in 2011. This increased volume would still account for about 3 percent of the two counties’ trade volume and will not cause any major dislocation to the existing channels of trade followed by the two countries. The full scale realization of the potential of trade will take some time, but like a newly planted sapling, it will require tender care in nurturing and protecting it from strong winds and other extraneous influences that will otherwise uproot this weak plant.

Pakistan realizes that the normalization of bilateral trade would not only lend impetus to both economies. But will go well beyond the immediate creation of trade flows to capital investment and joint economic ventures, cooperation in the fields of IT, Science and Technology, Research and Development would, in all likelihood, boost productivity of domestic industries and stimulate economic growth.

India can augment its exports to Pakistan in three categories – machinery, mechanical appliances and electrical equipment, and chemicals and textiles. These three categories account for 54 percent of India’s export potential.

Pakistan, according to the authors has the largest export potential in textiles, jewelry and precious metals and base metals, accounting for 45 percent.

One of the reasons for the gap between the potential and actual is that Pakistan's sensitive list applicable to India under SAFTA includes 58 percent of the items that have high potential for India. Similarly, India’s sensitive list for Pakistan has 32 percent of the items with high export potential for Pakistan.

Trade will lead to some limited specialization and trade in intermediate inputs for use in exports to high-income countries.[[4]](#footnote-4) The State Bank of Pakistan (SBP) study used a more disaggregated approach and based its estimates on the basis of the difference in the unit values of tradable goods. On the basis of these estimates it was calculated that the trade volume would multiply by a factor of four and the incremental benefits will be equally shared resulting in a Win-Win situation for both the countries.

Our projections show that even if Pakistan is able to triple its exports to India, it will remain an insignificant player with no threat of any consequence to the vast and expanding Indian market. It is unlikely that in near future the share of Pakistan in India’s total trade will ever exceed 1 percent.

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.

Despite the evidence of these positive advantages of normalizing trade there are still significant detractors who would be losers in the bargain. Some of them are vocal, articulate and powerful. They cannot simply be ignored as their nuisance value in retarding or reversing this new bonhomie is not trivial. There are others who firmly believe that we are giving up our principled stand on political disputes for the sake of a paltry sum of money. We must learn from other examples where 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.

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.

Normalizing trade relations are a precursor for other avenues of economic cooperation as it will unleash impulses for diffusion of new technology, lower domestic prices, 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.

There are major risks to normalizing trade relations which I have outlined in some detail elsewhere. We have to remain mindful of them , preempt and take corrective actions immediately . There is a huge Trust Deficit between the two countries which convolutes and complicates actions. Any unforeseen or unplanned contingency can trigger strong adverse knee--jerk reaction on either side and the axe may fall on Trade and the Trade flows. This lingering fear and uncertainty may become a major obstacle in the establishment of strong enduring relations between the businessmen of the two countries which are the sine qua non for increased trade volumes. The media in the two countries have not played a particularly helpful role in cementing the bonds and sensationalization of the stories, with few exceptions, has been the norm further contributing to tensions and misapprehensions. The alliance of the losers from the opening up of the trade with the opposition political parties and the media will remain a formidable challenge in a polarized and divisive polity. The composite dialogue on outstanding political issues has to continue with the same vigour, seriousness and commitment as the trade dialogue. If this does not happen the opponents of trade liberalization may be able to gain ground. Anticipating future potential sources of friction such as Water and taking action to find amicable solution to those problems should also form part of the risk mitigation strategy.

To overcome the concerns and anxieties of Pakistani businesses 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 in India’s long term interest to establish asymmetric relationships with its neighbors and provide more concessions to them, initially expecting less from them in return. This posture will be helpful in generating wider economic benefits for India 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.

**AN AGENDA FOR ACTION**

How can these risks be mitigated? This is by no means, going to be an easy task, perseverance and persistence will be required on both sides. It is important to listen to each other’s point of view rather than always assert your own viewpoint. India has to assuage the concerns of the Pakistani businesses and Pakistan has to do the same for the Indian businesses. So unilateral actions have to be taken by each other of the two countries along with bilateral actions. These are spelled out in some details in the following paragraphs.

**Pakistan’s expectations about India’s trade regime liberalization**

1. India’s average applied MFN tariff is 12 percent with 33.2 percent for agricultural products and 8.9 percent for manufactured products. About more than half of agricultural products bear tariffs at 30 percent. In general, these rates along with para tariffs increase two fold for textiles and clothing and threefold for chemicals and cements from the average applied rate. Both these groups are of interest to Pakistani exporters as these goods enjoy high revealed comparative advantage. India has also kept these items under the sensitive list for non-LDC member of SAFTA. 30 percent of all items included on India’s sensitive list against Pakistan are agricultural goods while 34 percent are textile products. According to Taneja et al, the removal of Pakistani textile items from India’s sensitive list will only affect competition with large Indian firms. Though they will oppose liberalization, the authors believe that there was no rationale for protecting large firms. In essence, this high level protection will apply only to Pakistan as Bangladesh as LDC and Sri Lanka under Free Trade Agreement will receive preferential treatment. The detractors in Pakistan use this point as an argument that India is not providing level playing field to Pakistani exporters under SAFTA. The export potential can, therefore, hardly be translated into actual realization. Any action that allows the entry into India of goods in which Pakistan has comparative advantage would a long way in ruffling the feathers. After all, the overall quantum of Pakistani exports even if they achieve the full potential value will hardly exceed 1 percent of total Indian imports. The goodwill generated by this gesture will, however, be enormous in rebuilding trust between the two countries.
2. India’s para tariff measures increase the effective applied tariff rates from average 12 percent of custom duty to 25.6% on average. In addition, as composite taxes are levied on certain textiles and clothing the average protection increases from 9.6 to 16.2 percent for clothing. India’s tariff regime also promotes tariff escalation as semi-manufactures attract lower rates compared to finished goods. A review of para tariff measures and tariff escalations will be helpful in removing some of the impediments facing the exporters.
3. The three agreements signed between Pakistan and India recently on (a) harmonization and mutual recognition of standards (b) custom clearance and (c) Dispute resolution are the steps in the right direction to ease the concerns of Pakistani exporters against the non-tariff barriers facing them. But the actual implementation of these agreements depends very much on the discretionary powers of the lower government officials. The apprehension that the goods can be delayed on the border arbitrarily can only be addressed if senior officials make themselves available to take prompt on-the-spot corrective actions. For example, Indian importers of Pakistani electric fans were faced with arbitrary valuation by the custom authorities on their repeat orders that escalated their landed cost almost four fold making the Pakistani fans noncompetitive in the Indian market frustrating all the efforts of the Pakistani exporter and the Indian importer. Indian total imports of textiles were over $3 billion while those from Pakistan were only $30 million mostly in non-value-added textiles. Total imports from SAARC countries were $300 million. Thus the Pakistani textile exporters’ grievance that they cannot access Indian markets despite their price and quality advantage is buttressed by the above statistical evidence. The estimates of potential exports suggest that Pakistan can increase its textiles particularly woven cotton fabrics including denim and lawn to $365 million – almost ten times the current level if a level playing field is provided .
4. As agriculture production is cyclic in nature and the cycles in the two countries may not always coincide it will be advisable, in the interest of price stabilization and food security, to allow imports from each other’s countries when the crop falls short of the normal demand. Perishable commodities such as vegetables, fruits etc. can cross the borders quite expeditiously if prior arrangements are made for SPS and other inspection formalities. Consumers in the country facing the shortfall in domestic production will thus benefit from this exchange of agricultural commodities. Cold storage facilities should be set up on both sides of the border to encourage the trade of perishable food products and fresh fruits such as mangoes and kinnows.

**Where Pakistan needs to liberalize its trade regime and facilitation mechanisms**

1. Pakistan has made a public commitment to phase out the negative list and allow a fall MFN status to India. This commitment should be honored despite the vocal opposition of a few powerful stakeholders in the agriculture sector. It is quite rare in the history of Pakistan that all the political parties are agreed upon the normalization of trade with India. So are all the large business and trade organizations of the country. This opportunity should not be missed and translated into action. Resistance on opening the land routes for additional commodities does not make sense as the road infrastructure in Pakistan is much superior while the railways system is almost in a shamble. As the volume of trade at Wagah-Attari border increases there would be a need to open up other border crossings with the passage of time. Pakistan had also agreed to increase the number of items through the road route and they should make the formal announcement to this effect.
2. India has built an Integrated Check-post at the Wagah-Attari border which came into operation in April 2012. The inauguration this check post has facilitated the movement of trucks across the border. It is now incumbent upon Pakistan to build similar infrastructure on the Wagah side. The railways infrastructures which carry almost the same volume as the trucks is in very pathetic condition. This needs to be upgraded and improved. Pakistan scores poorly on Logistic Performance Index and Custom Procedures, according to the World Bank estimates. There is need to simplify the custom clearance procedures and the recent web-based one custom software package should be introduced at this check post expeditiously. All the relevant agencies should have physical presence at the border.
3. Pakistani exporters have to interface with Rangers, NLC, Customs departments and Anti-Narcotics Force with overlapping responsibilities. A single joint interface is recommended and the present practice of multiple checks by an agency should be discontinued.
4. Pakistan’s import regime has become relatively more restrictive and complex and the reforms initiated in the early 2000s to simplify and liberalize it have not only been halted but put into a reverse gear. The myriad of Statutory Regulatory orders (SROs) issued arbitrarily by the Federal Board of Revenue has not only resulted in huge revenue leakages but an unpredictable and distorted import regime. Pakistan has to phase out these SROs and put in place an institutional mechanism for the grant of any concessions or exemptions that is fair, transparent, open and time bound. The sectors that have been protected too long are unable to compete. High tariffs have led to a state of complacency and little incentive for improvement in productivity and innovations. A time-bound plan should be put in place to reduce the tariff rates and open up these sectors for more competition. Knee-jerk policy actions taken by the various governments have not allowed , for example, the automobile industry to plan for the future.

**India and Pakistan both need to continue their Reforms**

1.Despite the impressive strides made by the two countries in opening up their economies, reducing tariff barriers and quantitative restrictions, dismantling some of the non-tariff barriers, the roles the Governments of India and Pakistan play in trade and market exchange remain quite dominant. The bureaucracy does not let it go as they believe they know what is the best for the country and the vestiges of inherent mistrust of markets and private sector have not been fully removed. Economic reforms since 1990s in two countries have brought about substantial changes but the hiatus in introducing the second generation of economic reforms is pulling down the momentum of growth. India’s track record is relatively much better as its share in the world market has indeed gone up but it is still far below the potential. Export of services particularly ICT sector have put India on the World map because the Government interference or interventions were almost non-existent. This shows that the Government should adopt a “Do No Harm” attitude and develop an enabling competitive environment in which private sector can effectively function. In Pakistan, the discontinuity in political regimes and their pre-occupation with their own survival has left economic reforms without any sponsor or champion.

2.The recent move to improve the infrastructure at Wageh-Attari border is a highly welcome move to ease trade facilitation. Empirical studies have shown that trade facilitation contributes more in stimulating flows of goods across borders than tariffs and duties. Trade facilitation would have much larger impact than simple reduction in tariffs . For example, it has been estimated that the biggest benefits of the US-Europe agreement that is being negotiated would come from removing the regulatory barriers. In countries such as India and Pakistan where petty bureaucracy has such powerful stranglehold the benefits of liberalizing regulatory barriers would be substantial. Harmonizing and synchronizing the regulations, simplifying the multilayered procedures would dilute the discretionary and arbitrary powers of the low paid officials but reduce the cost of doing business. Prohibition or specification of routes – sea, railways, and road – should be discouraged and the market players allowed choosing the most advantageous route without any let or hindrance by the Government The two countries have however, to work on further measures such as removal of the restriction on the type and capacity of trucks to be used and condition of transshipment of goods at the border the limited capacity of the warehouses, absence of cooking facilities etc. Containerized traffic should be allowed to flow in smoothly without the hassle and additional cost of offloading the cargo on the ground and reloading the truck of the other country into freight cars. Trade potential estimates would be triggered only when the transportation, logistical services and other transaction costs are lowered in comparison to other competitors. But it must be kept in mind that road routes carry only 17% of the total trade while sea route is the most dominant mode with 60 percent followed by Railways 15 percent. Port infrastructure development, links to railway, increased space at railway yards the type of freight cars require some attention if diversion of traffic to land routes is to be avoided – other land routes such as Monabao-khokharapar should also be opened up.

1. Visa liberalization agreements signed recently have to a great extent, overcome some of the difficulties faced by the businessmen on the two sides of the border but the actual practice of issuance of visa and the treatment after crossing the borders will determine the actual impact. Tense security situations such as the recent firings across the Line of Control would cause temporary disruptions but these should not be taken as the pretext for hardening of the attitudes on both sides.
2. The agreement on the opening of the bank branches of Indian banks in Pakistan and Pakistani banks in India has not yet been implemented. In absence of the opening of the letters of credit and confirmation the financial risks of doing business will remain high and deter new comers and SMEs from entering the trade. Immediate action should be taken to make these branches fully functional.
3. Telecommunication links between the two countries particularly the mobile phone connections are essential for businesses in this world of instantaneous communication. The two countries should relax the restrictions on this connectivity.

**Conclusion**

The main conclusion of this paper is that normalization of trade between India and Pakistan is in the mutual benefit of both the countries. The recent positive developments are highly welcome but there are a number of risks that have to be mitigated. For the future sustenance of these relations on a solid footing and avoid disruption or slow death, the process has to be carefully managed. The objective should be to strive an enduring uninterruptible long term relationship that is not prone to sudden disruptions, abrupt retaliations and knee jerk reactions. There is no guarantee that this would be an easy or smooth process but at least there is one change that can make some difference. The usual South Asian bureaucracy driven approach that is reactive, slow and ponderous can sooner or later act as the kiss of death. A more private sector led, problem solving and getting on with the job approach has better chance of avoiding some of the pitfalls and producing the expected results.

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1. Distinguished Lecture at the Indian Council for Research on International Economic Relations (ICRIER), New Delhi on February 5, 2013. [↑](#footnote-ref-1)
2. Shiro Armstrong, “East & South Asia in Global Trade & Economic Development”, A paper presented at EABER/SABER workshop held at ANU, Canberra on August 18, 2011. [↑](#footnote-ref-2)
3. The Agenda for normalizing trade as it was spelled out in April 2011 covers not only MFN issue, Non-Tariff barriers, border infrastructure, customs liaison and harmonization visa, but also trade in electricity and petroleum products, bilateral investments and opening of bank branches. While the progress on the first set of issues has been substantial the second set of issues have so far remained on the back burner. [↑](#footnote-ref-3)
4. 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. [↑](#footnote-ref-4)