**India – Pakistan Trade: Recent Developments, Future Prospects and Risks**

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 **Introduction**

Economic historians and analysts have been faced with a conundrum for quite some time. They found it hard to comprehend that South Asia, which was a single large market until a few decades ago with goods, services, capital investment and skilled labor flowing freely and the newly independent countries inheriting a common historical, legal, cultural and administrative background and a very well linked infrastructure was the least integrated region in the world while East Asia with countries having such diverse background and very little in common historically had become the most integrated region second after the European Union. Moreover, there was almost a consensus among academic economists in both the countries that the normalization of trade relations would bring substantial economic benefits evenly. Among many reasons responsible for this puzzle, the political tension and rivalry between the two major countries of the region – India and Pakistan - stands out as the main explanatory variable.[[1]](#footnote-1)

In last one year, there have been some healthy developments in relaxing this constraint and 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. [[2]](#footnote-2)

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. 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 be procured from India compared to 25 percent previously. 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.

Fifty percent of the goods on the negative list belong to Automobile, Iron and Steel, and Paper and Board Industries which were relatively more vociferous in their opposition to the movement from the positive to negative list.

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

Over the last decade, India and Pakistan, the two largest economies of South Asia, have succeeded in more than doubling their per capita income. Both economies have also managed to sustain a growth trajectory. The Confederation of Indian Industry noted in their 2011 report that both nations implemented significant economic reforms that have opened up their economies and brought about rapid growth, more than doubling the size of each economy in the last 10 years. Yet, according to a study conducted by Pradeep Mehta for the Pakistan Institute of Legislative Development And Transparency (PILDAT) earlier this year, intra-regional trade hovers at a paltry 5% of the total trade between all countries of South Asia. By choosing to take the lead in liberalizing their import regimes, India and Pakistan could set an example for other countries in South Asia to follow. Unofficial trade between India and Pakistan are estimated at approximately US$ 2.0 billion per year. This does not include trade via Dubai in which the products’ port of origin is often relabeled. Better trade relations between the two countries can directly improve the economic and political environment of the whole South Asian region.

In the face of massive economic challenges, a burgeoning population, energy and water shortages, and huge and growing numbers of unemployed workers, especially youth, it is realized that 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.

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 i.e. China and India. 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 the threat of Indian products flooding Pakistani markets and displacing domestic industries carries much substance. In some areas such as fashion wear, bed wear, home textiles, cement etc. Pakistan would be able to do much better and penetrate a much larger market. 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.

The overwhelming evidence of the advantages of bilateral trade liberalization has tilted the balance in favor of the proponents of increased trade with India. But 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.

Yet, despite these positive developments 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?

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 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 ship $300 billion worth of goods to all parts of the world. This increased volume would still account for about 3 percent of the two counties’ trade volume. Therefore, the expectations at least in the short run should, therefore, be tampered with a sense of realism on both sides. 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 liberalization of bilateral trade between Pakistan and India would not only lend impetus to both economies in a beneficial way but also remove the barriers to regional integration within South Asia. The potential advantage for Pakistan from broader regional economic integration appears to be large. Going well beyond the immediate creation of trade flows, 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.

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

 **Trade with India: A Factual Analysis**

Charts 1 and 2 show that India and Pakistan’s major export partners are countries outside the region ( except for landlocked Afghanistan which relies heavily upon Pakistan for exports as well as transit trade).

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.)



**Source:** Department of Commerce, Government of India

**Source:** Director General, Foreign Trade Institute of Pakistan



**Assessment of Potential trade**

 All studies on the potential trade between India and Pakistan have come to the same conclusion that the scope for expansion is huge. Although the numerical estimates do vary significantly depending on according to these assumptions methodology and baseline the value increases from three times to twenty times.

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.[[3]](#footnote-3)

Ijaz Nabi and Anjum Nasim estimated that trade between India and Pakistan could increase 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]](#footnote-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]](#footnote-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]](#footnote-6)

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 that year.[[7]](#footnote-7)

A more recent study by Taneja et al (2013 has updated the numbers and estimated that the bilateral trade potential between the two countries is about $20 billion – 10 times larger than the current level of trade of this, export potential accounts for $16 billion and import potential $4 billion.

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.

A study by Khan (2012) places the potential of formal trade between India and Pakistan roughly 20 times greater than recorded trade. This means that total trade between the two countries could expand from its current level of $2.5 billion to around $50 billion.

Mohsin Khan, 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.[[8]](#footnote-8) 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.[[9]](#footnote-9) The second order effects of investment, technology, transfer, cooperation in other areas such as Education and Health are not considered in calculating the benefits. 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. If India, for example, imported an item at a unit value that is higher than the unit value of the same item had it import it from Pakistan, then trade potential exists between the two countries. 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 exported of the same items worth over $15 billion (covering 24 percent of the total value of its imports) to the rest of the world. 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 were permissible for imports from India, about 45 percent of the items still remained, 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.[[10]](#footnote-10)

The present situation of India – Pakistan Trade, Direction of Trade Flows and their trading patterns can be seen in Table 1 – 4.

**Table 1: India Pakistan Trade (USD in millions)**

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **Pakistan’s****Exports to India** | **India’s Exports****to Pakistan** | **Total Trade****Flows** |
| 2004-05 | 288 | 547 | 835 |
| 2005-06 | 293 | 802 | 1095 |
| 2006-07 | 343 | 1235 | 1578 |
| 2007-08 | 255 | 1701 | 1956 |
| 2008-09 | 320 | 1914 | 2234 |
| 2011-12 | 313 | 1659 | 1972 |

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

**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 & the Rest of the World (USD in 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 & the Rest of the World (USD in 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.

 India’s exports to Pakistan multiplied almost three times between 2004-05 to 2008-09 from $835 million to $2,234 million while in the same period Pakistan’s exports remained almost stagnant making a very modest gain of only 11 percent. The volumes have actually gone down in 2011-12 but even at its peak Indian exports to Pakistan were 1 percent of its total exports but even much lower now. Similarly, imports from Pakistan accounted for only 0.12 percent of its total imports. 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.

 A parallel example on Pakistani side shows that India accounts for 1.7 percent of Pakistani export market. Indian imports, however, claim 6 percent share of Pakistan’s total imports and in all probability this share is expected to rise due to the phasing out of negative list, the MFN status and preferential duty structure under SAFT. To the extent that the imbalance in bilateral trade is gradual and not abrupt and disruptive and has visible positive impact on Pakistani economy – the consumers, producers and Government – there will not be much resistance.

**Industry Wise Impact Analysis**

**Textiles and Clothing**

This sector contributes less than one fifth to India’s exports but almost two-thirds in Pakistan. In both countries the textile and apparel sectors exhibit different degrees of specialization.

Textiles

 India’s textile and clothing sector has been protected through high import duties and specific duties. The sector is also included in India’s sensitive list under SAFTA and other FTAs. Recently, Sri Lanka and Bangladesh have been offered duty free access items on textile and clothing goods.

 Pakistan enjoys a strong comparative advantage in yarn, fabrics and other value-added textile. India, therefore, has included these items in its sensitive list to protect its industry. As the Pakistani industry has an unfavorable ratio of 75:25 in favor of cotton made rather than manmade fibre the import of cheaper polyester and other fibers from India should help the industry align itself with the global norm. Indian dyes and Chemicals are also relatively less costly than comparable products from elsewhere the cost of advantage to Pakistani textile industry from procuring these raw materials and input and diversifying its product range would farm its competitive position. Import of textile machinery from India would also effect cost saving in initial capital outlay on expansion, balancing and modernization.

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.[[11]](#footnote-11) Pakistani textiles face a major disadvantage as competing imports from Bangladesh and Sri Lanka enter the Indian market with zero tariff while high tariffs are levied on Pakistani imports. 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.

The higher magnitude of RCA index[[12]](#footnote-12) 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.13 High-quality products such as bed linens and cotton-lawn fabric from Pakistan are in demand in India.

 **Iron and Steel**

India has been a 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]](#footnote-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. 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. Pakistan’s steel industry can benefit by sourcing its iron ore and coke from nearby India rather than Brazil and Australia. This should effect some reduction in the cost of production of finished steel in Pakistan and help the downstream industries which use steel as an input.

 **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. The country therefore remains highly dependent on imported chemicals to cater to the needs of its agriculture and industrial sectors.

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.[[14]](#footnote-14)

The 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.

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, tractors, trucks, buses, and vendor industry vehicles. But the size of the industry and parts suppliers has remained much below its potential because of inconsistent policies and abrupt swings in allowing imports of fully built cars.

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. Exports account for 78 percent f the total industry revenue. India is the largest centre for business Process and IT offshore services. 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.[[15]](#footnote-15) 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.

Another study on Pakistan-India trade, carried out by the World Bank, also concluded that Pakistan stood to gain from liberalization of trade.[[16]](#footnote-16)

**Agriculture**

The main argument in opposing the import of Indian agriculture goods into Pakistan rests on the plea that the Indian producers get subsidies on fertilizers, electricity and diesel. Indian farmers are thus said to have an advantage in selling their products to Pakistan. Other groups, particularly those concerned with food security in Pakistan, have argued that lower prices of agricultural products imported from India will benefit our consumers, dampen food inflationary pressures and ease supply shortages. But even the broad brush with which the farm lobby paints the gloomy picture cannot withstand scrutiny.

India’s export potential in agricultural commodities is highly limited and accounts for only a negligible proportion of its total export potential vis-à-vis Pakistan.

More than 50 percent of agricultural incomes in Pakistan originate from the livestock sector, which is under no threat from Indian producers. In fact, it is the import of milk powder from the EU countries at subsidized rates that is creating problems for the processed milk industry in Pakistan. Another 37 percent of incomes in agriculture sector are derived from major crops: wheat, rice, cotton and sugarcane and the relative economics of these crops does not suggest that the producers of these crops will be affected adversely by opening to India. Pakistani procurement prices of wheat have been relatively higher than international and Indian prices in the recent years. Both countries run wheat surpluses and compete in international markets.

Pakistan is self-sufficient in sugarcane and, like India, is a major exporter of rice to the rest of the world. The cotton crop falls short of the domestic demand by 2-3 million bales annually and the mills are free to import from whatever source they feel appropriate. Prices are fixed internationally and cotton is traded worldwide at those prices. Except in an odd year when there is shortage due to crop failure and Indian produce would enter the market to augment overall supply, there does not seem to be any other significant risk for producers of any of these major crops. In the event of supply shortages, Pakistani producers won’t be hurt while Pakistani consumers will be insulated from price shock arising from domestic crop failure. The remaining sub-sectors – forestry and fisheries – account for 3 percent of agricultural income and minor crops about 10 percent. It is only in respect of some of these crops – mainly fruits and vegetables (onions and potatoes), lentils, maize, gram – that trade will take place, mainly between the two Punjabs.

Past experience shows that trade between the two countries in vegetables, lentils etc. acts as a price stabilizing force because it equilibrates supply and demand. Due to the proximity between the Pakistan Punjab and the Indian Punjab (the Haryana-Delhi belt), low transportation costs and the time advantage make trade in perishable and fresh agricultural good quite attractive. When India falls short of onions or potatoes and Pakistan has a bumper crop or vice versa, countries, their farmers and consumers gain from these transactions. Imports will also force Pakistani farmers, if they are uncompetitive, to strive to become more efficient by adopting better production, storage and preservation techniques and reduce post-harvest losses.

So if evaluated in terms of the overall net gain, the limited agricultural imports covering only a small proportion of the total agricultural value added will act as a price-stabilizing influence, enhance consumer welfare and promote efficiency in the long run. The fears raised against agricultural imports appear highly misplaced. In the short term, it is possible that there may be some losers but they will switch over to other crops for better remuneration. Pakistan’s annual food import bill is about $5 billion. If some of the items currently imported from third countries are instead purchased from India at lower end-use prices, consumers will be better off without hurting agriculture.

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.

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.

**AN AGENDA FOR ACTION**

**Major Risks to Trade Relations**

What are the major risks that can derail this process? There are many but at least eight of them need to be highlighted and steps taken to mitigate them.

First, there exists a huge Trust Deficit between the two countries for the reasons that are well known. This Deficit dominates the populist thinking on both sides. The bridging of this Deficit is not easy, will take some time and will depend upon a series of positively reinforcing measures taken unilaterally by both sides in a consistent manner. There is a palpable fear of collective punishment and sanctions on Trade against Pakistan if something goes wrong on the security and political front. Any unforeseen or unplanned contingency can trigger strong adverse reaction on either side. So far the two countries have behaved responsibly in military terms in post 1998 era but there is no guarantee that the axe of such a triggering episode may not fall on Trade and the Trade flows may be disrupted. Both the dialogue process and trade relations should continue ―”uninterrupted and uninterruptible” as Mani Shankar Aiyar has argued. At times of crises the policy of engagement rather than abrupt withdrawal would prove to be effective in defusing the situation and finding an amicable resolution to the problem.

The possibilities of the knee jerk reaction of suspending the trade or putting some tough retaliatory measures in the future cannot be ruled out. This stop and go policy would act as a powerful deterrent to the establishment of long term relationships across the borders as it creates uncertainty, fear and unpredictability about the trade regime. This tendency has to be curbed if the businessmen have to take advantage of the liberal trade regime.

Second, the South Asian political parties when in opposition behave quite differently and diametrically opposed to their policies when in power. Scoring points and discrediting the ruling party are their main hobby horses. They may easily join the ranks of the extremist elements who are the biggest detractors of normalizing relations between the two countries. The trigger point for such a coalition may be the persistence or expansion of trade imbalance in favor of India. Such bilateral imbalances are to be expected as India is a much larger and diversified economy. The political backlash caused by this imbalance may put undue pressure on anyone of Government in Pakistan which may choose to sacrifice Trade in order to survive. This myopic action which may win some relief for the ruling party will do enormous damage to the promotion of trade in the long run. Fickle minded populist actions are counterproductive for durable relationships to take shape.

The third risk arises mainly from the possible ascendency of the losers lobby. It must be realized that in the short run there will be some losers and some winners from opening up of the trade. While Traders and Importers in both countries would be happy to see their business expanding the inefficient manufacturing firms will be losers from this liberalization. They may lobby the Government and political parties by making noises that the onslaught of cheaper imports from the other country is destroying domestic industry and jobs. Depending on the power and influence of the lobby it is quite conceivable that some retaliatory measures may be taken that will kick off a spate of countervailing measures. The consequential dilatory tactics would once again widen the Trust Deficit and hamper the growing trade relations.

Fourth, the media and the civil society in both India and Pakistan have become quite powerful. In case the Small and Medium Enterprises suffer disproportionately from the trade liberalization the media could take up their cause and create such venom that the Trade flows can be set back .Another possibility is that integration through trade and capital flows may amplify the contagion effect. A negative shock to the Indian economy may be transmitted to the Pakistani economy which may slow down as a result depending upon the trade intensity. The media in Pakistan may use such occasions to put pressure on the Government to take some protectionist measures. If as a consequence tariffs, quantitative restrictions or non-tariff barriers or capital controls are introduced the credibility of the liberalization process will be damaged setting back the evolution of relationship. It is in the interest of everyone that the media should have enough positive stories to tell which generates goodwill. Frequent exchanges between the representatives of the media and holdings of seminars, meetings, roundtables of civil society organizations can help clear the mental fog and obdurate obfuscation. The businesses in the two countries will be well advised to advertise through the other country media.

Fifth, there would be constant need for the validation of the new popular narrative that the proponents of India-Pakistan Trade are espousing. Consumers should feel that the procurement of certain goods from the other side has really benefitted them while the producers should be able to testify that the sourcing of raw materials, machinery or components has in fact lowered their costs. Such human interest stories should be disseminated widely through the popular as well as social media. The validation of the new narrative can become one of the contributory factors in bridging the Trust Deficit.

Sixth, the Composite Dialogue on outstanding political issues should continue with seriousness, commitment and constructive attitude. If such a dialogue does not proceed forward those who are opposed to normalizing economic relations would be able to gain grounds by asserting that the principled stand and the core issues have been abandoned for the sake of paltry material gains. This can set the ball rolling for a larger movement that would blame Trade as the major impediment in the way of resolution of political issues. The political leaderships of the two countries are very much committed to peaceful resolution of the issues confronting them and the momentum on the dialogue should not be lost.

Seventh, other areas of economic cooperation such as subcontracting by Indian IT Firms to Pakistani Companies, Tourist Packages, and collaboration in Higher Education, Agriculture, Health, Research and Development between the two countries would be highly beneficial. India has developed many first rate hospital facilities at much lower costs than the Western countries. There is no reason as to why branches or subsidiary hospitals cannot be set up in Pakistan as they have been done in Bangladesh. Indian IT firms are market leaders in Business Process Outsourcing but are faced with increasing labor costs. They can sub-contract some of the work to Pakistani firms at rates that are relatively cheaper than what they pay in India and thus maintain their market share.

Eighth, there should not be any iota of doubt that disputes will arise in the course of business and grievances of all kinds will emerge. It is imperative that a Dispute Resolution/ Grievance Redressal mechanism is put in place right from the beginning. This mechanism should be expeditious, inexpensive and equitable. In place of the Governments, the Confederation of Indian Industries CII/ Federation of Indian chambers of Commerce and Industry FICCI and Pakistan Business Council PBC/ Federation of Pakistan chambers of Commerce and Industry FPCCI should be involved in setting up and operating this mechanism.

To overcome these 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.

**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 no-tariff barriers facing them. But the actual implementation of these agreements depends very much on the discretionary powers of the lower government officials. The apprehensions 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. These confidence building will boost the actual exchange of goods and services. Empirical studies have shown that trade facilitation contributes more in stimulating flows of goods across borders than tariffs and duties. 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. Indians 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 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.
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 fall short of the normal demand. Perishable commodities such as vegetables, fruits etc. can cross the borders quite expeditiously if prior arrangements are made from 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.

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

Despite the impression 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 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. Pakistani trade regime needs to be further liberalized and the maximum tariff rates and the number of slabs brought down significantly.

The recent move to improve the infrastructure at Wageh-Attari border is a highly welcome move to east trade facilitation. The two countries have however, to work in 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 tot the truck of the other country or into freight cards. 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.

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.

**Where Pakistan needs to be liberalized its trade regime and facilitation**

 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 perceptible 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.

 Studies have shown that Pakistan has high potential of exports in 126 products with an indicative value of $2.13 billion. Surgical goods, textiles, value-added agriculture, plastics, chemicals and allied products, leather articles, sports goods, fans, marble, cutlery and cement. The current exports constitute only a fraction of this indicative potential – just less than one seventh. Assuming that all these products do not translate into actual trade it may be realistic to conclude that the Pakistani exports to India could reach $1 billion a year in short term with further expansion contingent upon the experience gained through the quality, price, distribution, efficiency, and transaction costs incurred. The trade complementarity index of Pakistan’s exports to India has been gradually moving up signifying that India’s import basket has become more favorable to Pakistan’s export basket.

 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.

1. 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.
2. 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. Pakistan’s automobile sector has been protected too long and has therefore been 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 the sector for more competition. The industry is also justified that knee-jack policy actions taken by the various governments has not allowed then to plan for the future as they remain pre-occupied with survival in the short term.

**Conclusion**

To conclude, the future growth, disruption or slow death of India-Pakistan Trade will depend whether a proactive, sensible system is put in place to manage the relations. It is in the mutual interest of the two countries to strive for 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.

1. *Which sectors will the exports increase come from:
i. Textiles $360million*

*ii. Leather 356*

*iii. Cement 250*

1. *Direct shipping routes from Karachi to Chennai, Calcutta and Cochin will reduce the delivery time from 15 to 4 days and give a big boost to trade volumes.*
2. *India’s top three exports categories to Pakistan were chemicals, textiles and vegetable products accounting for almost two-thirds of the total exports. Pakistan’s top three export categories to India were Vegetable products, mineral products and textiles that formed almost one half of the total exports in India.*

**Annex – I**

**SECTORAL COMPOSITION OF NEGATIVE LIST**

|  |  |
| --- | --- |
| Automobile | 385 |
| Iron and Steel | 137 |
| Paper and Board | 92 |
| Plastic | 83 |
| Textile | 74 |
| Electric Appliances and Machinery | 57 |
| Pharmaceuticals | 49 |
| Machinery | 37 |
| Chemicals | 33 |
| Sports Goods | 32 |
| Ceramics | 28 |
| Cutlery | 22 |
| Glass | 22 |
| Miscellaneous Manufacturing | 22 |
| Leather goods | 19 |
| Rubber goods | 19 |
| Agriculture | 16 |
| Furniture | 16 |
| Aluminum products | 12 |
| Surgical goods | 10 |
| Footwear | 7 |
| Soap and Toiletry | 7 |
| Meters | 6 |
| Metal Products | 5 |
| Prefab Building | 5 |
| Stone and Marble | 5 |
| Wood | 4 |
| Gems and Jewelry | 3 |
| Optical Fiber | 2 |
|  | 1209 |

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1. 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-1)
2. 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-2)
3. Amita Batra, “India’s Global Trade Potential,” *Global Economic Review*, Vol. 35, No. 3 (2006). [↑](#footnote-ref-3)
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8. 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. [↑](#footnote-ref-8)
9. 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-9)
10. 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. [↑](#footnote-ref-10)
11. Single yarn, cotton fabrics, denim, woven fabrics, ensembles, jackets and blazers, trousers, blouses, T-shirts, jerseys, men’s swimwear, skirts, garments. [↑](#footnote-ref-11)
12. 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 its 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. [↑](#footnote-ref-12)
13. State Bank of Pakistan report, 2006 [↑](#footnote-ref-13)
14. Indian Brand Equity Foundation website [↑](#footnote-ref-14)
15. Government of Pakistan, The Tenth Five-Year Plan, 2010–15 (Draft) Planning Commission, Islamabad, May 31, 2010. [↑](#footnote-ref-15)
16. Zareen Naqvi, Philip Schuler, and Kaspar Richter, “Overview” chapter in Naqvi and Schuler, 2007. [↑](#footnote-ref-16)