**Prospects and Challenges for increasing India-Pakistan trade**

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Economic theory and empirical evidence have clearly established the links between trade, productivity and economic growth. Countries that have large internal markets have also benefitted from integrating into the world economy and opening up their economies. World trade in 2009 amounted to $12 trillion. The size of Pakistan’s domestic market is only $180 billion. Even a 0.5 percent share in the global export market implies that our exports could rise to $60 billion. Imagine the jobs that will be created directly or indirectly as a result of expansion in the production of exportable items. On the other side, imports bring into the country the transfer of technology embedded in imported goods and services and raise the country’s production possibility frontier. Thus, it follows that increased trade is in the larger economic interest of the country.

It is also becoming quite obvious that the balance of economic power is moving away from developed countries to developing countries. China has overtaken Germany to become the largest exporting country and surpassed Japan to become the second largest economy in the world. China and India are projected to be the two fastest growing economies of the world over the next several decades. Pakistan is blessed by its location being neighbour to both these large economies. Our national economic interests dictate that we should expand our trading relations with both these countries and penetrate their markets.

The question then arises: Will expansion of trade with India bring benefits to Pakistan or would we be swamped by our big neighbour? A lot of myths and misperceptions on this point need to be explored. India-Pakistan trade is a win-win situation. India has a middle class of about 300 million people with rising purchasing power that matches that of South Eastern Europe while Pakistan’s middle class is approximately 30 million. A 10 percent penetration into the Indian middle class market would double the market size for Pakistani companies and businesses.

All studies on India-Pakistan trade have so far demonstrated that the relaxation of constraints in the way of bilateral trade would benefit both the countries. The theoretical argument is that countries in relative geographical proximity tend  to trade with each other than with more distant countries owing to lower transport and communication costs.  Gravity models have been used to test this hypothesis empirically. Batra (2006) using an augmented gravity model showed that all three gravity effects were statistically   significant for India- Pakistan trade. An ICRIER study (2004) showed a much higher volume - about $10-11 billion (Pakistan 55 percent textiles; India 90 percent non-textiles). Ijaz Nabi and Anjum Nasim (2001)  estimated that trade between India and Pakistan could increase by a factor of three if trade relations were characterized  by MFN status and maximum tariff rate of 50 percent.  State Bank of Pakistan (2006)  study came to the conclusion that bilateral  trade could multiply by five times if the MFN status is granted and non tariff barriers are removed. Naqvi and  Schuler   (2007)  estimated that the trade between the two countries could jump from $2.5 billion in 2007-08 to $ 5-10 billion or 2 to 4 times itss current basis, Net welfare gains are positive in every single scenario - conservative to optimistic.

Trade will lead to some limited specialisation and trade in intermediate inputs for use in exports to high income countries. Granting MFN treatment to India would bring gains to Pakistan and an FTA would generate even larger benefits.[[a]](file:///F%3A%5C%5Ctemp_new%5C%5Cih%5C%5CIndia_Pakistan_Trade.html%22%20%5Cl%20%22cmnt1)

This paper draws upon extensively and freely from the findings of a major and comprehensive research  study carried out by the SBP (2006). This study  showed that the potential of trade (exports plus imports) between the two countries amounted to $5.2 billion  in Fy 04 when the actual trade was about $ 1 billion.  In FY04, there were 2,646 common items  of Pakistan’s imports worth over $7 billion (which accounted for 53 percent of the total items and 47 percent of the aggregate value). Under these items India also had  exports worth over $15 billion (covering 24 percent of the total value of imports). Analysis revealed that for 48.7 percent of the items in FY04, the unit values for Pakistan’s imports  were more than the unit values of India’s exports. Even after excluding the items which are currently permissible for imports from India, about 45 percent of the items still remain in the common list which could be imported from India at a lesser cost than the current cost of import from the rest of the world. Allowing import of such items from India (i.e. expanding the current list of positive items) will give Pakistan an average saving estimated between $400 million to $900 million.

A disaggregated  analysis at the sectoral level carried out by the SBP study illustrates the picture more clearly. The broad   conclusions drawn from the sectoral analysis contained in the SBP study are reproduced  in the paragraphs  given below as they have not yet been disseminated widely so far and would be of great public interest .

Textiles and Clothing

The textile and apparel sector continues to be the driving force for economic growth in

both India and Pakistan. This sector contributed 18.8 percent  in  India  and 65.6 percent

in Pakistan, of the total value of exports in FY04. In both countries, the textile and apparel sectors exhibit different degrees of specialization. India is regarded as a major alternative source to China for apparel and made-up textile products . Pakistan , although a supplier of limited range of products is  considered a competitive supplier of cotton

goods, particularly men’s apparel, home  textiles, and fabrics.  Presently trade in textile 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 price advantage in 128 textile products. Since  other factors like quality, production and design of products, etc. are also important , it is hard to conclude on the basis of just export unit value that granting of MFN status will result in a uni-directional flow of textile products, i.e. Indian products flooding the domestic market of textile products.

 Although Pakistan ranks above India in both the textiles and clothing sectors  in terms of the “revealed” comparative advantage (RCA) this should be interpreted cautiously . The higher magnitude of RCA index in case of Pakistan shows the country’s vulnerability of export earnings to sector specific events. Pakistan’s economy is far less diversified as compared to the Indian economy and depends heavily on the textile industry.

Iron and Steel

India was the major source of raw material (iron ore) to this vital industry and

accounted for 69.2 percent of the total imports of iron ore in FY04 followed by

Australia (19.9 percent) and Iran (10.9 percent). Unlike Pakistan, India has a well established steel industry and is a net exporter of steel and steel products. Indian steel

industry produces a whole 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 largest producer of sponge iron in the world.

 Pakistan’s iron & steel product imports from India were just a small fraction of its

total imports. In FY04, Pakistan imported $662 million worth of iron & steel products

(326 items) of which India supplied only 25 items worth $7.1 million. About 46 items

are identified as potential imports that are cheaper to import from India on the basis of

lower unit value of Indian exports compared to the import unit value of Pakistan’s

imports from the rest of the world.

Chemicals and Pharmaceuticals

Pakistan’s chemical industry has by and large developed on a fragmented and ad hoc

basis, motivated by a combination of the existence of a small local market and

traditionally high tariffs. As a result, it suffers from the lack of economies of scale,

national integration and consequent uncompetitiveness. Resultantly, the country is

highly dependent on imported chemicals to cater to the needs of its agriculture as well

as industrial sectors. During FY04, imports of chemicals stood at $2.8 billion, an

increase of 29.5 percent over the last year.

 Compared to Pakistan, the Indian chemical industry is well established and has

shown impressive growth over the years contributing about 6.7 percent in 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.

 The pharmaceutical industry in Pakistan  plays an important role in the economic

development of the country. Total local production/consumption of pharmaceuticals is

presently estimated at $2.0 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 manufacturing of medicines are imported from China, India, Japan, United

Kingdom, Germany, Netherlands and others. Other production inputs, i.e. 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 FDA  approved plants and is exporting to advanced economies. In some

pharmaceutical raw materials, the Indian companies are the only suppliers worldwide.

The country ranks fourth worldwide accounting for 8 percent of world’s production by

volume and 1.5 percent by value. India is also among the top twenty pharmaceutical

exporters and among the top five manufacturers of bulk drugs in the world.

 During FY03 and FY04, Pakistan imported 4.3 percent and 6.8 percent of its total

imports of chemicals and pharmaceutical products respectively from India. Out of total

imports of $2.9 billion (1105 items) in FY04, India supplied 353 items worth $196.8

million. Out of the total imported chemicals and pharmaceutical products from India,

166 items had a lower unit value of imports  compared to the unit value of the same

items imported from elsewhere. These items  have the potential for enhancing imports

from India.

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 and buses and  vendor industry. The automotive industry

contributed over Rs 30 billion to the government exchequer in the form of duties and

taxes in FY03, with a contribution of Rs 17 billion from the top four manufacturers

alone. From the late 80s to the early 90s, the demand for automobiles in Pakistan was

on the rise, setting the stage for a decade of robust growth. The industry has achieved a

phenomenal growth of 50.2 percent in FY04 and increased competition has led to the

introduction of innovative products as well as a decline in financing costs.

 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 automation 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 as presently these items are being imported from the Far East at higher prices. On the other hand, India is expected to benefit from free trade due to its low raw material,electric and labor costs.

Information Technology

In India, the IT industry has made tremendous progress and has emerged as one of the

fastest growing sectors. A majority of the multinational companies operating in the area

of information technology in India have  either software development centers or

research development centers. India’s expertise in emerging technologies has actually

helped the country to get new customers and the companies in Europe and Japan are

directing their outsourcing to India.

 In Pakistan, the IT industry is in its infancy but is growing at an enormous pace

while struggling to catch up with the regional and global industry. However, most of the

companies are small to medium-sized with a little representation of entities having full

concentration in the export of software and IT enabled services. Pakistan has lagged

dangerously behind other regional countries in exploiting 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.

Trade Liberalization under SAFTA

The SAARC member countries including Pakistan and India concluded a landmark

treaty SAFTA on January 6, 2004 with a pledge to allow free trade among member

countries by eliminating trade barriers and scale down their tariffs in two phases to 0-5

percent from January 1, 2006. The treaty allows free cross-border movement of goods

within the region, with the provision for a list of sensitive items for member countries to

safeguard national interests.

SAFTA is likely to contribute significantly to intra-regional trade along with a

scope for enhanced trade between India and Pakistan—particularly in transportation

equipment and engineering goods, including  IT products. Complete elimination of

tariffs under SAFTA may increase the intra-regional trade by 1.6 times the existing

level. In the dynamic framework the gains from liberalization are substantially (at least

25 percent) higher than the static gains.  The above projections need to be viewed

against the cost of non-cooperation, which was estimated by an earlier RIS study to be

about $511 million for Pakistan.

Advantages of Trade Liberalization for Pakistan

The liberalization of bilateral trade between the two countries would not only lend

impetus to the integration of both the economies but would also be seen as a good omen

by other nations. The potential advantages of trade liberalization for Pakistan appear to

be large. Going well beyond the immediate creation of trade flows, the advantages of

dismantling tariff and non-tariff barriers include the potential for boosting productivity

and economic growth, and can also extend  to promoting regional cooperation in all

areas.

 Trade liberalization will unambiguously benefit Pakistani consumers, since product

prices fall and consumer choice increases with reduced trade barriers. Increased trade

flow that stem from the lifting of import prohibitions from India would lead to

additional customs revenue for Pakistan. Within the protective walls of regional

economies, both countries can achieve specialization in various sub-sectors of the

economy. Moreover, the strengthening of  bilateral/regional trade would provide a

cushion to the economies of both countries from the financial or stock markets’ shocks

It should also be kept in mind that 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 others. 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 both our local industry and consumers would gain.

If the empirical evidence is so strong why is trade between the two countries so low - less than one percent of Indian exports and less than five percent of Pakistani imports. The volume of bilateral trade has not exceeded two billion dollars (the total volume of Indian and Pakistani exports is around $200 billion).

Zareen Naqvi (2008) has argued that  there are three main reasons that have impeded the growth of trading relations: (1) political relations between the two countries have remained discordant and contentious over a long period of time. A trust deficit does not allow stability which is a pre-requisite for any exchange of goods and services to take place, (2) both countries have, until recently, pursued import substitution policies that protected local industry behind protective barriers, (3) the commitment to regional economic integration in South Asia has remained quite weak. Even in face of bilateral political disputes it is possible to promote trade within a regional preferential trading area framework. This has not happened in South Asia.

These constraints can be relaxed. Countries with adverse political relationships, without giving up their principled stand on disputes and differences, have engaged in cross border investment, trade and movement of people. Over time these activities have helped in fostering better understanding of each other’s view points. Confidence building measures and 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 for resumption of economic relations until the bilateral political disputes are resolved. If economic engagement is fierce, it is most likely that the hawks in each country will be confronted by the new stakeholders who are benefitting from such engagement and without giving up their respective positions while carrying out the composite dialogue. Resumption of economic relations should be allowed without any pre-conditions and without the countries giving up their respective positions. Composite dialogue should carry on at the same time to resolve the disputes and disagreements.

On the second constraint, it is heartening that both India and Pakistan have opened up their economies, abandoned the old Import Substitution policies and embarked upon a process of integration with the world economy. The reforms they have carried out, such as cutting tariff rates, elimination of QRs, regulating duties, para-tariffs which leave them in a much better position to pursue preferential liberalisation.

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

Regional Trade Agreements like SAFTA will have positive effect on growth, trade, technological diffusion and foreign investment. Trade within the region will unleash new technology, lower domestic prices, provide new technology and usher in economics 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 harmonisation takes place.  Empirical studies on South Asia Regional Trade have shown mixed results primarily because of the smaller countries of the region---  Afghanistan ,Bhutan, Nepal, Maldives-- which are landlocked or small island in presence of a giant continental economy such as India. Bhandara (2003)  concluded on the basis of a computable general equilibrium model simulations that the policy of unilateral liberalization would benefit South Asian countries much more than SAFTA as small countries would gain little or even lose. Hirantha( 2004) comes to an opposite conclusion using the gravity model. His analysis shows that there is a significant trade creation effect with the rest of the world under South Asia Preferential Trade agreement (SAPTA). He finds no evidence of trade diversion effect with the rest of the world and argues that further regional integration may bring about substantial benefits to SAARC region and SAFTA is most likely to promote inter-regional trade through further dismantling of tariff and other non tariff barriers among members.

According to Zareen Naqvi ( 2008) both India and Pakistan still use tariff and nontariff barriers to protect their domestic producers even after reforms have led to overall economic liberalization. India is ranked 115th out of 125 countries on the World Bank’s latest (2006-08) Trade (MFN) Tariff Restrictiveness Index (TTRI) and Pakistan stands at 102 place. India’s trade regime is much more restrictive than other large emerging economies like Brazil, China, Mexico,and Russia or compared to neighboring countries in South Asia. India’s ranking on the Ease of Doing Business indicators are also quite low with the latest ranking  at 122th out of 178 countries compared to Pakistan’s rank at 77th place for 2006-08.

Research by Naqvi (2008) shows that India’s MFN applied average tariff rate at 14.5

percent (in 2007) is much lower than

tariff rates a decade ago, however, the applied tariff rates for agriculture exports at 39

percent in 2007 is one of the highest in the world .This is a major barrier

that Pakistani exporters of agricultural products face in terms of expanding trade with India.

In a number of sectors, specific tariffs and regulatory duties outside stautory MFN tariff

rates are levied. Potential textile exports from Pakistan are subject to specific duties

which can go as high as 50-100% in equivalent terms. The pakistani exporters of textile

and garments say that these are important barriers in their ability to access the vast indian

markets. According to Taneja ‘s survey (2007) of Indian exporters doing business with Pakistan, very few NTBs  in Pakistan restrict trade. The World Bank’s frequency coverage ratio of non tariff barriers of 51 percent was one of the highest in the world. In comparison, Pakistan’s ratio was much lower at 29 percent. It also uses its stringent domestic standards whereas Pakistan applies normal international standards.

India – a much bigger economy accounting for more than 80 percent of Gross Regional Product, imbued with self-confidence and aspirations to become an economic power – should demonstrate a greater degree of generosity  by removing these tariff and non tariff barriers unilaterally . A wider offer to its neighbouring countries in terms of opening up the markets and trade and removing barriers to mobility would be of ultimate benefit to India. It is advisable for India to establish asymmetric relationships with its neighbors and provide more concessions to them and expect less from them in return.

Given the large and growing size of its effective market the economic losses to India would be miniscule while political good will and returns would be substantial over time. Pakistan, Bangladesh, Sri Lanka will be much better off economically if they are able to penetrate the buoyant Indian market. Friendly, peaceful and irritant-free neighbours would aid rather than hinder India in moving towards its long term goals. A region with the highest number of people living below the poverty line would surge ahead.

Recommendations:

What needs to be done in practical terms to open up bilateral and regional economic cooperation. While India and Pakistan should continue the dialogue to resolve the core political issues they should start by focusing on non-political constraints that will promote bilateral trade. Businessmen of the two countries will then take care of the opportunities that will present themselves.

• Pakistan should grant MFN treatment to India while India should reduce its tariffs on agriculture commodities, textiles and other goods that are of potential value to Pakistan.

• Both countries should reactivate SAFTA and agree on a phasing out of the sensitive list over next few years. A restrictive list would nullify all the potential gains of preferential trade access.

• Technical barriers to Trade (TBT), Sanitary and Phyto Sanitary Measures (SPS) that are in fact, acting as powerful deterrents to exchange of goods should be rationalized and simplified. These are, in fact, non-tariff barriers that hinder the flow of goods.

• Trade facilitation through expeditious border crossings,  streamlining documentation requirements, border agency coordination , opening of new border crossings, quick custom clearance, Electronic Data interchange,  telecommunication, improved transport links, shipping protocols, easing visa restrictions for businessmen should be carried out immediately. Railway, air and road connections between the two countries should be increased.

• Governor Reddy and I had signed an agreement for opening of branches by two Indian banks in Pakistan and two Pakistani banks in India in 2005. This agreement has not yet been implemented. Without banking services, opening of letters of credit, cross border transactions of funds, trade cannot take place.

• Domestic tax, tariff and subsidy policies that distort incentives for production and trade should be substituted in both the countries by more neutral policies.

• Institutions to manage and facilitate trade integration such as setting standards, quality control, technical regulations, material testing should be strengthened and made user friendly.

• Harmonisation in legal regulations for investor protection, contract and IP Rights enforcement, labour relations, would promote relocation of industries within the region as the expanded market size and mobility of goods and services would result in economies of scale. Locations for inputs, components, raw materials with low transaction costs would confer comparative advantage to final finished goods.

Let us recall that the 2006 composite dialogue had on its agenda resumption of Rail Service between Khokhrapar and Monabao, bus service between Srinagar and Muzaffarabad, religious visits to Lahore and Nankana Sahib, new shipping protocol, deregulation of air services and joint registration of Basmati rice.

The above outlined measures, if implemented sincerely, can open a new vista for the two countries in the 21st Century. It is high time political leaderships of India and Pakistan demonstrate courage and conviction.

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