**MANAGING INDIA-PAKISTAN TRADE RELATIONS[[1]](#footnote-1)**

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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.
In last one year there has 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.

The breakthrough came in form of Pakistan’s decision to grant Most Favorite 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 will also be phased out by December 2012 and there will be no restriction on tradable items. Out of 8000 items only 15 percent or 1209 items are placed in the negative list. The remaining 6800 can now be imported from India, while the previous positive list had only 2000 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.

The sector – wise details of negative list are given in Annex – I. 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 he movement from the positive to negative list.

It may be useful to recall that inspite 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. Pakistan. Estimates based on different assumptions and models indicate a jump ranging between five to ten fold from the current levels if all the barriers—tariff and non tariff barriers------are dismantled .

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.

This paper (a) presents the reactions of Pakistani business groups to the grant of MFN status to India (b) identifies major risks to the growth of India-Pakistan trade and concludes by (c) arguing for careful management of this relationship by the two sides as it remains fragile.

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 stimulateeconomic growth.

Major political parties and other influential stakeholders have realized that Pakistani economy is lagging behind other countries and 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.

**VOICES OF PAKISTANI BUSINESSMEN**

The focus group consultation with the businessmen engaged in Automobile, Chemicals, Pharmaceuticals and Textiles sectors etc. held at Karachi and Lahore during early 2012 revealed strong reservation about the non-tariff barriers imposed by India. According to them, Technical Barriers to Trade (TBT), Sanitary and Phyto-Sanitary Measures (SPS) are in fact acting as powerful determents to exchange of goods. Unless these are rationalized and simplified the smooth flow and desired level of Pakistani exports from Pakistan will be hindered Table below shows the Indian non-tariff barriers Pakistani exporters have identified.

***Indian Non tariff barriers***

* Sanitary and Phyto-sanitary measures
* Technical barriers to trade
* Quotas and Import licenses on 600 items
* Aggressive Use of safeguard and anti-dumping measures
* Frequent invocation of Countervailing duties
* Stringent License requirements from the Bureau of Indian Standards
* Multiple custom clearance requirements
* Non-standard custom valuation methodology
* Stringent and lengthy certification requirements
* Restrictions on rail movement of goods
* Complicated and restrictive visa requirements
* Long dwell times at ports and border points
* Transit restrictions
* Absence of testing labs at the border crossing points
* State Governments’ restrictions on use, sale , and consumption of certain goods
* Uncertainty about inter-state movement of goods
* Non-acceptance of letters of Credit issued by Pakistani banks

In addition to the general reservations expressed about the above NTBs there were sector specific grievances that are briefly summarized in the following paragraphs. Some sectors such as Textiles were ,on the contrary, quite upbeat about the prospects of their industry.

The Pharma industry’s main concern was that India has the advantage of having a reservoir of essential raw materials and large economies of scale that will ease out their products due to lower costs of production and distribution of competing products from across the border. Laxity in enforcement of standards would also bring in drugs of dubious quality at low prices edging out some of the local substitutes from the market. Quality Control measures in Pakistan are not too stringent and was argued that arrangements have to be put in place to apply the same quality standards effectively to Indian products as India has against Pakistani products.

Agriculture sector was concerned about many kinds of hidden and implicit subsidies granted by several State Governments in India such as on electricity for tube wells. These subsidies would not provide a level playing field for Pakistani agriculture producers to compete. They also pointed out that the May 2006 notification of Super Basmati by the Indian Ministry of Commerce has been challenged by Pakistani exporters in 2008 and the case is still pending before the court despite a passage of four years. Barriers in the movement of trucks across the state boundaries and the consequential delays do damage perishable commodities.

In the Automotive sector, there is a clear difference of opinion. Some of the Japanese companies favor the opening of trade as they can import components and parts at much cheaper rates from India compared to Japan. The Manufacturers of auto parts are opposed to the idea because they believe that Indian auto parts will flood the Pakistani market and decimate the local industry. Efficient and low cost Pakistani exports would still be at a disadvantage as Indian assemblers have a tendency to prefer locally manufactured parts and have entered into long term agreements with these local firms. The question of switching from their partners to other suppliers, however competitive they may be, does not arise.

Chemicals and synthetic fibre sector argued that India was having a surplus of fibre which was equal to 80 percent of the local demand in Pakistan. They could simply dump them in the Pakistani market as the enforcement regime of Anti-dumping laws was quite weak. The domestic fibre industry which has recently invested hundreds of millions of dollars in expansion of the capacity would suffer financially.

Textile manufactures were by and large optimistic that on price and quality they can capture a significant share of Indian market provided the Indian textile industry does not use the Government machinery to thwart their inroads by different kinds of administrative and restrictive practices or non-tariff barriers. Some of the cotton lawn, home textiles and bed wear manufacturers were already exploring the opportunities for joint ventures with Indian partners to open retail outlets for selling those products which are in high demand. Imports of textile machinery from India will be cost efficient as compared to importing it from other parts of the world. Some of the garment and knit wear and other value added manufacturers expressed the concern that their Indian competitors were receiving various hidden subsidies and the level playing field was not even.

While it was explained that the non-tariff barriers were not Pakistan-specific and were applicable across the board the opponents of the trade liberalization narrated their actual experience with cross-border trade in the past which had not been too pleasant. Anecdotes of delay by the Customs Authorities, Testing laboratories and Bureau of Indian standards and Railways causing losses to Pakistani exporters were cited at these meetings. When it was pointed out that the bureaucratic indifference and inertia and hassle formed part of the administrative culture in the two countries that had inherited the common civil service it was asserted that the difference in the attitude towards Pakistani exporters was quite stark.

**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 countries’ 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, 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 precent 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 neighbouring countries in terms of opening up the markets and trade and removing barriers to mobility would ultimately benefit India, reducing hostility and favouring 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 neighbours 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 neighbours 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.

**POLICY RECOMMENDATIONS**

As the relationship is likely to remain fragile due to past historical experience a proactive management of the policies and processes and a vigilant eye on their implementation would be required for some time on both sides. It is therefore proposed that the following policy recommendations should be put in place, monitored regularly and remedial actions taken to move the process forward.

* Managing transition from the positive to negative list is quite critical to the future evolution of the relationship. If too abrupt large scale visible and one sided changes take place then the lobbying efforts of those adversely affected will intensify. India being the large economy has to pay particular attention that their export expansion is mainly substituting more expensive machinery, equipment, raw material, components and intermediate goods from third countries which will help Pakistani manufacturers in lowering their cost of production. Export of technology from India will be highly welcomed. The phasing, sequencing, timing, quantum and composition will have to be monitored carefully to avoid disruptive forces to surface. Although it is realized that the transaction will take place mostly between the private sector parties the Ministries of Commerce in the two countries will have to use some moral suasion in the transition phase. Voluntary Export Restraints by India for limited period may also be considered as a policy option if it is found that certain imports are exceeding their threshold value and are hurting the Pakistani industries particularly Small and Medium Enterprises.. After all, the volume of Indian exports to Pakistan will remain miniscule – 2 percent of the total at best. Any news stories that Indian goods have risen by 100 percent in one year would prove disastrous. Large bilateral trade imbalance should be kept to the minimum and promotional activities to allow Pakistani exporters access to Indian market would help a great deal.
* Rationalize and simplify the technical barriers to trade and sanitary and phyto-sanitary measures which are, in fact, acting as powerful deterrents to the exchange of goods. These are, in effect, NTBs that hinder the flow of goods.
* Visa restrictions on businessmen should be eased so that they can have long duration multiple entry visas that allow them visits to any number of cities without reporting to the Police. Businessmen have to travel frequently to different places at short notice. The present visa regime is cumbersome, time consuming and discourages exchange. India and Pakistan have been negotiating a more simple and streamlined process of visa application and approval for quite some time. No discrimination should be allowed in grant of visas between the large and small businessmen. This new visa regime should be put into effect immediately otherwise the other efforts to liberalize trade would prove ineffective.
* Both countries should reactivate SAFTA and agree on a phasing out of the sensitive list (of items that each country deems important for its economy) over the next few years. A restrictive list would nullify all the potential gains of preferential trade access
* Financial and banking services play a catalyst role in promoting international trade. In 2005, Governor Y. Venugopal Reddy of Reserve Bank of India and the author then the Governor State Bank of Pakistan had signed an agreement to open branches of two Indian banks in Pakistan, and two Pakistani banks in India. This agreement has not yet been implemented, as procedural difficulties have been allowed to overwhelm the substance of the agreement. Without banking services, the opening of letters of credit and cross border fund transactions, trade cannot flourish.
* One of the major problem impeding larger India-Pakistan trade flows is the poor state of logistics. The World Bank Logistics Performance Index that measures the efficiency of the Customs Clearance process, Quality of trade and transport-related infrastructure, ease of arranging competitively priced shipments, competence and quality of logistics services, ability to track and trace consignments and frequency with which shipments reach the consignee within the scheduled or expected time and places both the countries quite low. Although the new Integrated Border Check at Wagah – Attari would allow ten times more trucks to cross other logistics snags would have to be dealt with quickly. Special task forces with adequate powers should be formed for at least the first year to solve the problems and facilitate flows of goods and people.
* India, as the largest economy in the region, has to pursue a more vigorous process of dismantling “behind the border barriers” for realizing its potential. The maze of byzantine regulations and rules and the business processes for cross border-exchange have to be simplified and streamlined. For a country that has some of the most progressive entrepreneurs, eminent intellectuals, scientists and innovators, globally competitive human resources, it is not comprehensible as to why it cannot carry out these needed reforms that will help to realize its potential.
* Businessmen on both sides have outlined the requirement for opening new border points for trade with spacious loading zones for ease of truck and rail movement, modernization of rail transportation, a new shipping protocol and deregulation of air services. While both countries have very high mobile phone penetration they are not allowed to avail the roaming facility when visiting the other country. The 2006 Composite Dialogue between India and Pakistan had on its agenda the resumption of rail services between Khokrapar and Monabao, bus service between Srinagar and Muzaffarabad; religious visits to Lahore and Nankana Sahib; a new shipping protocol; the deregulation of air services; and joint registration of basmati rice. This agenda should

be revived and agreements reached to implement these measures.

**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.

**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 Fibre | 2 |
|  | 1209 |

1. A paper presented at the Woodrow Wilson Centre Conference on Pakistan-India Trade at Washington, D.C., on April 23, 2012 [↑](#footnote-ref-1)