India-Pakistan Trade Relations

A New Beginning

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January 2013

The complete liberalization of trade between India and Pakistan will be a long and arduous process, but Pakistan's granting of MFN status to India has been a good start. Higher levels of trade will bring economic benefits to both countries, but more so to Pakistan. Indeed, with India cementing its position as the region's engine of growth, Pakistan must hitch its wagon to the locomotive or risk getting completely left behind. The Pakistani government and the supposedly "India-centric" military have finally come to recognize and accept this reality.

Introduction

One of the more significant recent economic developments in South Asia was the revival of trade talks between India and Pakistan in 2011. A question frequently raised is why India and Pakistan trade so little with each other despite the existence of common history, language, culture, and long borders. Economic theory and evidence from around the world would predict that trade between the two largest economies in South Asia would be far greater than its current level of around $2.5 billion. While both countries are aware of the merits of trade, a variety of political and infrastructural—physical, legal, and regulatory—impediments have virtually paralyzed bilateral trade relations between the two neighbors.[i]

It is clear to most observers that Pakistan's economic development will depend to a large extent on normalizing relations with India to pave the way for South Asian regional economic integration. Facing diminishing marginal returns to traditionally growth-leading sectors, Pakistan is in need of larger and growing export markets to tap the potential of industrial hubs in the south and west (Baluchistan coastline and Karachi in Sindh), in the central belt (Multan, Lahore, Gujrat, Gujranwala, and Sialkot in Punjab), and in the north (Peshawar in Khyber Pakhtunkhwa). Trade with India, with its large and growing market, can be an important factor in realizing this goal. For India, trade with Pakistan is not only advantageous in itself, but would also facilitate trade with Afghanistan, China, Iran, and the Central Asian countries. Thus, for both countries, increased trade with each other would be a win-win outcome.

Even though both countries are members of the South Asia Free Trade Area (SAFTA), established in January 2006 as a successor to the South Asian Preferential Trading Arrangement (SAPTA)[ii], trade between the two countries is unnaturally small and the opportunity for gains from increased trade is correspondingly large.[iii] As can be seen in Figure 1, total trade (exports plus imports) between the two

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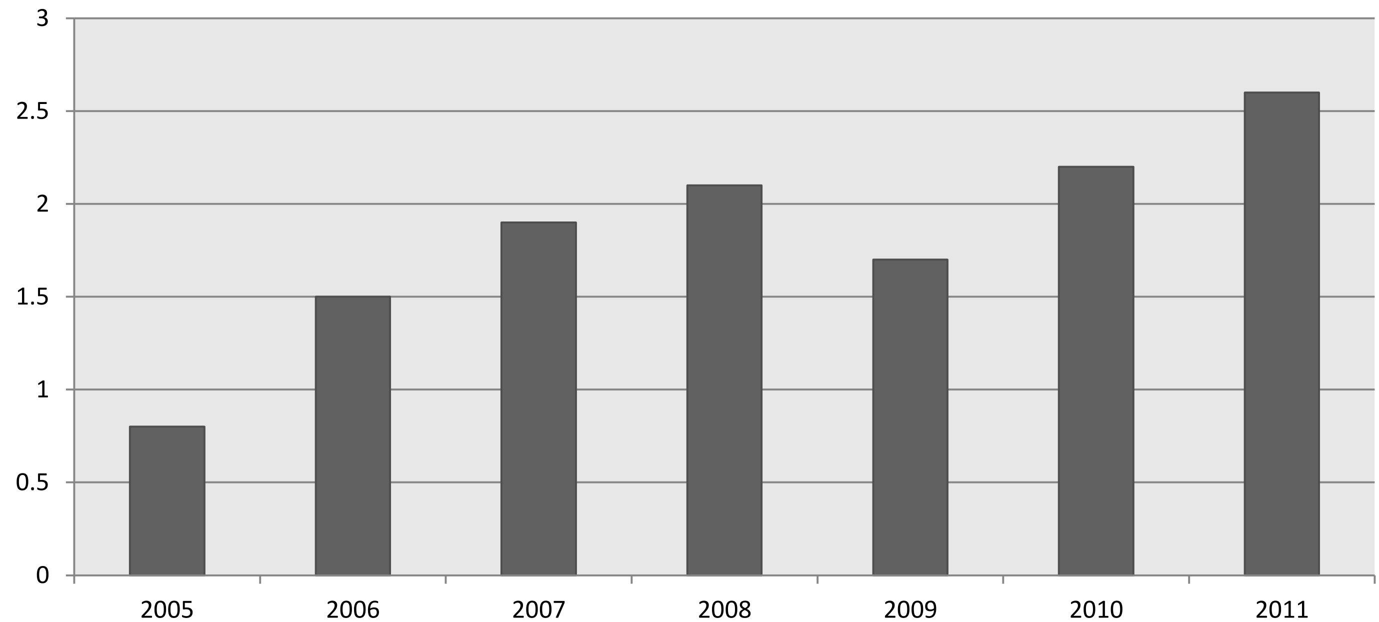
countries in 2011 amounted to a little more than $2.5 billion, up from a paltry $750 million in 2005.[iv] Still, Pakistan accounts for less than 0.5 percent of India's trade and India accounts for a little over 3 percent of Pakistan's trade, compared with the very large shares of bilateral trade following independence of the two countries in 1947.[v] Informal trade via third countries (such as the United Arab Emirates, specifically Dubai) is estimated at $2 billion to $3 billion per year, and this trade could obviously be undertaken bilaterally at significantly lower cost.[vi]

India most favored nation (MFN) status by the beginning of 2013, a status that India had granted Pakistan in 1996. Essentially this meant that as of 2013, restrictions on imports from India would have to be eliminated and the same tariff rates would apply to Indian imports as are imposed by Pakistan on imports from other countries.

Section 3 estimates the potential for trade between the two countries once the process of trade liberalization is underway. A number of studies have shown that trade could be significantly higher if the policy-determined and physical barriers were reduced. More specifically, the estimations in this paper indicate that total trade (imports plus exports) could eventually expand some 20 times its current level of $2.5 billion to $50 billion under normal trade relations. A trade level of $6 billion to $10 billion in the next five years is now the consensus estimate of the government, academics, and business people in Pakistan.

Figure 1: Bilateral India-Pakistan Trade ($ billions)



This paper examines key issues related to India-Pakistan trade relations from the Pakistani perspective. The paper first discusses in Section 2 the initiatives taken since early 2011 by the two countries to improve these relations. Meetings have been held between Pakistani and Indian government officials at various levels, and between business people from both sides of the border, to work out a common strategy for enhancing trade between the two countries. Inside Pakistan, there have been discussions involving the most important stakeholders—politicians, business people, and the military. These various meetings culminated in Pakistan's announcement that it would offer

Section 4 takes up the effects of Indian non-tariff barriers (NTBs) and other trade impediments on Pakistani exports. The aim is to identify the main obstacles that hamper trade in order to determine which ones are the most important and require immediate attention. It is worth noting that several such NTBs, notably related to visas, customs procedures, multiple standards, and ineffective dispute resolution, have been resolved or are near resolution. Other impediments to trade still need to be addressed, including in particular physical infrastructure such as roads, border crossings, and customs warehouses, as well as specific NTBs, including internal state taxes, subsidies, and sales taxes.

Trade liberalization almost always results in "winners and losers," and this issue is taken up in Sections 5 and 6 by examining the sectoral impacts in Pakistan of opening up trade with India. Two complementary approaches are taken in looking at this issue. The first (in Section 5) is a review of existing studies on the sectoral impact of trade with India, the most recent of which was undertaken by the government of Pakistan in 2011 in the context of discussions related to the granting of MFN. The second (in Section 6) involved direct meetings with the chambers of commerce in a number of major cities in Pakistan. The basic conclusions reached from utilizing the two approaches are as follows. First, Pakistan will gain from access to advanced technology and machinery from India. Second, it is likely that the pharmaceutical and automobile industries will lose out to more competitive Indian industries. Third, the agricultural sector could benefit if it is allowed to compete on a level playing field; at present, India's heavily subsidized agriculture makes Pakistani products uncompetitive. Fourth, certain sectors like textiles, electric fans, and tires will gain from trade with India because of its large market as well as Pakistan's geographical proximity to certain regions of India, as compared to some of the Indian states producing these products. Finally, there will be efficiency gains for the major industry clusters in Gujrat, Gujranwala, and Sialkot, as they will be able to achieve economies of scale with a large Indian market and land routes through India to other South Asian countries where Pakistani goods already have a competitive edge.

The final section of the paper lists some of the priority areas on which the two governments, in particular Pakistan, need to focus to create an environment for sustained improvement in economic relations.

Current Initiatives

Trade between India and Pakistan declined sharply after the two countries gained independence in 1947. Pakistan's decision not to devalue the rupee with respect to sterling in 1949 was a key factor in the fall in bilateral trade. Because of the devaluation issue, the Commonwealth, including India, imposed a trade embargo on Pakistan. As a result, Pakistan's trade with India fell dramatically, from 70 percent in 1947 to 18 percent in 1949. From then on, trade between the two countries became almost negligible, mainly due to political differences and the wars of 1965 and 1971. In 1996, when India granted most favored nation (MFN) status to Pakistan, trade between the two countries was a mere $180 million. That is, it was less than 1 percent of Pakistan's total trade and only a quarter of a percent of India's world trade.

At a meeting in April 2005 between Pervez Musharraf, then Pakistan's president, and Indian Prime Minister Manmohan Singh in New Delhi a number of trade-related issues were discussed and several key decisions were taken to move the process along in small, though meaningful, steps. [vii] However, most of the decisions were implemented very slowly, if at all, as political tensions, security issues, and domestic political opposition in both countries to any improvement in relations continued to create obstacles. Nevertheless, trade did pick up significantly following the meeting, reaching $1.5 billion in 2006 and crossing $2 billion in 2008 (see Figure 1). By 2010, bilateral trade was $2.2 billion, after a dip in 2009 in the wake of the Mumbai terrorist attacks in November 2008, and the total reached $2.5 billion in 2011.

After many false starts, it seems that the time may finally be right for India-Pakistan trade to take off. While territorial disputes, most importantly over Kashmir, have in the past precluded dialogue on other matters, distrust between the two countries has started to give way to meaningful discussions that appear well-crafted to ensure that neither side feels disadvantaged. Trade between the two countries seems a natural fit, and India has been arguing that trading relations could be considered a precursor to more general discussions on other issues. The fact that trade-related meetings have started once again at various levels suggests that the will to expand trade between the two neighbors is now there. Much will depend upon the ability of involved stakeholders to catalyze the nascent trade ties that exist between the two countries, while allaying the fears of both. Pakistan has historically been hesitant to encourage cultural and economic exchanges to avoid the domestic perception of having capitulated on very important national security issues, in particular Kashmir. It has therefore been consistently pushing for the so-called composite dialogue covering all outstanding issues of dispute.[viii]

There are three main factors that have basically led to a change in Pakistan's position on trade with India. First, the current elected government of the Pakistan Peoples Party, as well as all the other mainstream political parties, are supportive of a friendly and peaceful relationship with India and favor stronger economic and commercial ties. But the government has been constrained in moving forward by potential negative reactions from hard-line nationalists who question the government's commitment to the issue of Kashmir. Moreover, there has been a view that the military is opposed to any thawing of relations with India on any level, including on the trade front. However, the continued slide of the Pakistani economy since 2008 has led to a general recognition that Pakistan's economic development and future prosperity are closely linked to its neighbors in South Asia, and most importantly to India. This recognition undoubtedly emboldened the government to revive the talks on trade that were initiated at the Musharraf-Singh meeting in 2005, but were then broken off following the Mumbai attacks.

Second, the business community in Pakistan has been a strong lobby group for normalizing trade relations with India. Significantly, this group includes not only traders, traditionally more supportive of freer trade, but also medium and large industries where protectionist interests have historically been stronger. The Pakistan Business Council (PBC) has worked hard to garner support from political circles through talks at various forums with key players. It met with the main political parties in April 2011, then with President Asif Ali Zardari a few weeks later, and gained domestic political support for opening up trade with India. The PBC has played a central role in organizing talks between Indian and Pakistani business people. Meetings with delegations of Indian business leaders were held in November 2011 and February 2012, in Karachi and Lahore, to discuss how trade could be increased and in which particular sectors.

Third, the Pakistani military's views on increased economic integration of the two neighbors is obviously key to developing and improving trade ties.[ix] Ultimately, where both sides go from here will depend on how well the military is able to balance economic and security objectives. Until recently, the widespread perception was that the military was firmly opposed to trade with India. This led the pro-trade lobby to shy away from taking a public stand on the matter. But there have been recent signals from the military to political and business leaders that the subject is no longer a non-starter, and that it is willing to listen to the views of the PBC and others favoring closer trade ties with India if it will help the Pakistani economy. The military now feels that all avenues to improving the economy, including trade with India, should be explored, and accordingly it supports the granting of MFN status to India.[x]

In 2011 a major political breakthrough on trade began to take place. During the course of the year, Indian and Pakistani government officials held several high-level meetings aimed at improving trade relations: The respective secretaries of commerce met twice (in April and

November) and the ministers of commerce met in September in Mumbai. The two countries' prime ministers also discussed trade issues at the 17th South Asian Association for Regional Cooperation Summit in the Maldives in November 2011. And the Indian commerce minister, along with a delegation of Indian business leaders, was invited to visit Pakistan in February 2012 to continue discussions.

On November 2, 2011, the Pakistani government announced it was finally ready to grant MFN status to India, and thereby replace the positive list of items that could be imported from India with a negative list of items that could not be imported. The cabinet's decision was a turning point in trade relations between the two countries, and finally fulfilled Pakistan's obligation as a member of the World Trade Organization (WTO) to reciprocate India's granting of MFN to Pakistan.[xi] Following this decision and the visit of the Indian commerce minister, Pakistan's cabinet announced on February 29, 2012, that MFN status with India would become operational in 2013. In the interim, a negative list of about 1,200 items replaced the positive list of 1,946 items. In 2013, the negative list is to be further replaced by a small negative or "sensitive" list of items that would remain restricted. All other items are to be governed by the MFN requirements. Despite some initial protests from more nationalist segments against granting MFN status to India, Pakistani business people have overwhelmingly welcomed the decision, as have Indian business and government leaders.

There appears to be much optimism regarding this renewed interest in bilateral trade from most quarters. That is not to say there is no opposition. While consumers and the government will clearly benefit from higher volumes of legal trade between the two countries, some firms will face stiff competition that could threaten their survival. Industries currently benefiting from significant government protection are likely to lose. Indian goods are perceived as being more competitive than imports from other countries because transportation costs are much lower. Even the Small and Medium Enterprise (SME) sector, contrary to common perception, is likely to gain from trade, as this may resolve to a great extent its key constraint: the availability of high-quality, cost-efficient inputs. For example, a large number of firms in the SME sector rely on inputs such as steel and chemicals, both of which India produces far more competitively than the countries from which Pakistan currently buys.

Hence, it is expected that once protections are removed, more cost-effective backward linkages will be created that will allow firms to reduce their costs, making them more efficient and competitive internationally. Furthermore, it is important to recognize that any conclusions drawn on the basis of present conditions will not capture the dynamics inherent in trade. Investment would increase and could be channeled to create new "growth vents" around existing industrial hubs in Pakistan. Innovations could lead to the development of new products and product lines, and thereby bring about changes in comparative advantage. With Pakistan looking for new and ssustainable sources of growth, this could prove to be the boost that the economy needs. Opening up trade with India would also lead to better regional integration. Modernization of old trade routes in the subcontinent, such as the well-known and historical "Grand Trunk Road," and the development of newfound natural resources in the Central Asian republics could allow the region to realize its true potential. As a facilitator of regional trade, Pakistan could use its centrality in the regional product value chain.

The PBC and the Federation of Pakistan Chambers of Commerce and Industry (FPCCI) have proposed positioning Pakistan to benefit from the growing Indian economy by identifying areas of mutual benefit that are not limited to trade, but also in the transfer of knowledge and cross-border investment. Given the much higher level of GDP of India, there is a substantial pool of savings that Pakistan could attract if capital account liberalization occurs between the two countries. PBC findings show that in some areas, the cost of doing business is lower and policies are more investor-friendly in Pakistan. As such, increasing India-Pakistan trade may constitute a sustainable growth opportunity through increased flows of goods as well as direct investment in Pakistan by Indian firms.

Of course, opening up trade would create winners and losers. For example, while much of industry would benefit from the transfer of knowledge through joint ventures and imports of cheaper machinery, Pakistan's automobile and automotive parts industries may not be able to cover their losses, even after accounting for potential scale advantages from both a larger market in India and more land access to other SAFTA countries through India. The automotive parts industry fears that well-established Indian firms would be more competitive than their small and medium-size Pakistani counterparts (especially after protection is withdrawn upon liberalization), while India's non-tariff barriers (NTBs) would further increase the domination of its firms in the regional market. The business community recognizes that such costs may result from trade liberalization, underscoring the importance of a strategic step-by-step removal of trade barriers. In this context, the importance of identifying specific NTBs that are most onerous and finding appropriate mechanisms to compensate the losing sectors is obvious.

Overall, there is a clear realization that opening trade with India would allow producers in Pakistan access to a very large market that has been growing at an average of 8 percent per year. Pakistani consumers would benefit through positive trade creation effects, including lower prices and a greater variety of products. The agricultural sector would benefit from better technology and the availability of cheaper mechanized inputs. The government would earn more tax revenue as the trade flowing through legal channels increases. While entrenched and historically protected large firms that have become inefficient monopolies may lose out, their losses would be offset by the inroads that smaller and competitive firms in Sialkot, Gujranwala, Gujrat, Faisalabad, and Hyderabad can make in India. Furthermore, through India's cheaper land routes, such dynamic firms could access the markets of other South Asian countries.

Basically, the task now is to create vested interests in both countries to surmount the political obstacles, which could preclude trade ties mutually beneficial to the two countries as well as the region, and to prevent the liberalization process from being derailed. Pakistan and India could potentially function as the link between the resource-endowed countries of the Economic Cooperation Organization (ECO)[xii] and the labor-rich countries of the SAFTA. Moreover, Pakistan's strategic location could allow both regional trading blocs better access to China, the key player of the region. Conceptualized thus, by increasing trade with India and acting as a regional "connector," Pakistan would have better access to not one, but three key markets—India, other SAFTA countries, and ECO.

Trade Potential

A number of analysts have estimated how much India-Pakistan trade would be stimulated by the removal of existing barriers, with the expected gains in bilateral trade ranging from 10 to 20 times the current level.[xiii] Table 1 presents the actual-to-potential trade (APT) ratios for India, Pakistan, and the world, based on the estimates in Khan (2012), computed with respect to each other and selected partners over 1976-2005 and over the post-Uruguay Round period, 1996-2005.[xiv] The computed potential trade ratios greater than unity imply that the observed trade between countries exceeds the predictions of the gravity model, whereas computed ratios less than unity imply that the observed trade falls below the model's predictions. Naturally, the APT ratio of the world (i.e., all countries together) with respect to itself is always unity.

The primary interest here is the potential trade ratios calculated for India and Pakistan. During 1976-2005, the trade of both countries with the world and with most individual countries is generally less than predicted by the gravity model, used by Khan (2012), with imports exhibiting the greatest trade shortfalls (APT less than unity). The absolutely lowest APT ratios of the two countries are for their trade with each other. The APT ratio for India's exports to Pakistan is only 0.02, while that for Pakistan's exports to India is lower still, 0.01. Notwithstanding the widespread improvements for the period 1996-2005, the APT ratios for India-Pakistan trade remain the lowest reported in Table 1, climbing to no higher than 0.05. Expressed inversely in potential-to-actual trade terms, the potential of formal trade between India and Pakistan is roughly 20 times greater than recorded trade.[xv] This means that, at 2011 trade levels, total trade (exports plus imports) between India and Pakistan could expand from its current level of $2.5 billion to around $50 billion if the "normal" (i.e., average) relations estimated by the gravity model for trading partners were to hold for the two countries.

Against the backdrop of the long-standing animosities between the two countries, the empirical results here go a long way toward confirming that highly restrictive trade policies and practices, and other "behind-the-border" discriminatory policies and measures, significantly constrain official trade between India and Pakistan. These are discussed next.

Non-Tariff Barriers and Impediments to Trade

The granting of MFN status by Pakistan to India in January 2013 is reportedly contingent upon the removal of Indian non-tariff barriers (NTBs) placed on Pakistani goods.[xvi] It is a general opinion in the export community in Pakistan that NTBs will continue to be the main impediment to trade normalization even after MFN is granted to India.[xvii] Moreover, many traders feel that Indian NTBs are Pakistan-specific, an allegation denied by the Indian side, which argues that India discriminates equally against all trading partners. While it may be true that most NTBs levied by India are not meant to hurt Pakistan but rather help India, there is at least anecdotal evidence that in some cases NTBs are levied against Pakistan in an ad hoc manner.

All barriers to trade in goods apart from border tariffs are generally lumped together as NTBs. For simplicity, one may distinguish between NTBs that could be interpreted as impediments to trade and those that are more specific, such as price control and finance measures. The former broadly include lack of border infrastructure and traffic planning, inadequate port storage facilities, and inefficiencies that persist in the absence of cross-border transport agreements. They would also include visa difficulties as well as technical barriers to trade in terms of sanitary and phytosanitary (plant and plant product safety) measures. These general NTBs need to be differentiated from specific NTBs, such as para-tariff (surcharge) measures, internal state taxes, sales taxes and customs surcharges. And while para-tariff measures are non-discriminatory, their imposition is often arbitrary and discretionary. The various Indian NTBs are summarized in Table 2.

Recently, both countries have agreed to do away with four major NTBs listed in Table 2 that deal with visas (pact signed), tedious customs procedures as outlined in the Customs Cooperation Agreement (pact approved), multiple sanitary and phytosanitary standards under the Mutual Recognition Agreement (pact ready but not approved), and ineffective dispute settlement through the Redressal of Trade Grievances Agreement (pact approved). Furthermore, India has now allowed foreign direct investment from Pakistan, and it has been agreed that banks from both countries can open branches in the other by 2013. Talks have also begun in earnest on opening up the 11 historical trade routes between the two countries, instead of the existing single border crossing at Attari-Wagah. Similar advances must be made with regard to cargo loading/unloading capacities on both sides, and Free Trade Zones have been proposed in the border area that would lower transaction costs in goods and services markets. The benefits to both countries would be substantial once they cut down on NTBs (Indian side) and phase out the negative list (Pakistani side), as they would then have to abide by SAFTA terms and conditions, making possible even more gains from trade liberalization. Both countries would benefit, and it has been estimated that trade could reach $6 billion in the short run (one to two years) and expand to over $10 billion in five years.

A major impediment remains the lack of infrastructure in both countries necessary for expanded trade. On the Indian side, a recently opened goods-handling warehouse can potentially process 600 trucks a day, compared to the previous level of 200 to 300 trucks per day. This will substantially lower costs, which are expected to burgeon with growing trade volumes between the two countries in light of trade facilitation. This is a major concern for trade in perishable goods. The Integrated Check Post at the Attari-Wagah border crossing that was operationalized in April 2012 will also serve to make the movement of goods and services much easier.

It appears that while there are widely heralded attempts being made to dismantle "official" trade hurdles, other barriers are being added to maintain the status quo, specifically in those sectors where Indian interests are most threatened by Pakistani exporters, such as cement and gypsum.

It is important to note here that exporters remain only cautiously optimistic, despite the establishment of the Integrated Check Post. They argue, for example, that truck scanners that replace the physical inspection of goods at the post are not operational. Moreover, while the facility was created to increase trade by land between the two countries, Indian regulations passed in May 2012 prohibit the trucking of goods in vehicles with more than 10 wheels as well as those with over 40 tons capacity. Put simply, it appears that while there are widely heralded attempts being made to dismantle "official" trade hurdles, other barriers are being added to maintain the status quo, specifically in those sectors where Indian interests are most threatened by Pakistani exporters, such as cement and gypsum. Needless to say, removing such barriers would increase trade significantly. For the cement industry, which has been hit hardest by the new trucking regulation, it is estimated by Pakistani producers that the increase would be almost 90 percent from the 0.5 million tons exported to India over the 2011-12 period. Besides warehousing, advances must be made with regard to cargo loading and unloading capacities on both sides.

Winners and Losers: Sectoral Analysis

This section provides an overview of the sectoral analysis, i.e., the "winners and losers" issue, regarding the possibility of trade between India and Pakistan using three existing studies on the subject, with each employing a different method of analysis.[xviii]

The Pakistan Institute of Trade and Development or PITAD (2012) report, which was commissioned by the Pakistani Ministry of Commerce to define the negative list, uses the Revealed Comparative Advantage approach to identify the sectors that should be given protection. The results of this study are summarized in Table 3. Pakistan appears to have a revealed comparative disadvantage in about two-thirds of the 926 product lines looked at, including the automotive parts sector (302), iron and steel (105), pharmaceutical products (91), and minerals, chemicals, and polyester (93). The textile and garment sector (117) is the major contributor to the list of product lines in which the country has a comparative advantage. The report recommends that only 639 of the 926 products be put on the negative list, with most of them either finished goods or luxury and nonessential goods.[xix]

The Nabi and Javaid (2011) study takes the stakeholder's perspective on some of the major sectors of Pakistan, namely pharmaceuticals, automotive, tires, agriculture, and textiles. The report highlights that Pakistani manufacturers can greatly benefit from access to cheaper Indian machinery, raw material, technology, and expertise, all of which can help these sectors become more competitive. The access to a larger Indian market can help the automotive sector overcome problems of scale, while the textile sector can greatly benefit from the growing demand of the Indian middle class. Free trade in the agricultural sector can help mitigate supply shortages and the resulting price volatility, although subsidies provided by the Indian government are an important concern. The possibility of joint ventures, however, can help the Pakistani industry in general expand. All these benefits can be reaped only if tariff and administrative barriers to trade are negotiated and movement of both goods and people is facilitated by both countries.

The World Bank estimates the impact of liberalizing trade, i.e., granting India MFN status, on certain sectors of Pakistan.[xx] In the agricultural sector, the study predicts no trade taking place in wheat, while mutually beneficial sugar trade is possible for domestic deficit and surplus management. In the light engineering sector, Indian bicycles will be cheaper than Pakistani counterparts, while the Indian fan industry will not be competitive in Pakistan, allowing Pakistan to export fans to India. Intra-industry trade is also likely. Regarding the chemical industry, the study shows that if India is granted MFN status, three-fourths of Pakistan's chemical imports would then come from India and only one-fourth from the rest of the world. In the textile sector, the study analyzes cotton fiber, staple polyester, staple fiber, and cotton yarn, concluding that overall, no significant impact on the trade between the two countries is expected. The key factor therefore would be product differentiation in the exports of the two countries to each other, specifically in consumer fabrics and garments.

Business Sector Views

The support of business and industry is obviously crucial for the government in the opening up of trade with India. The Chambers of Commerce and Industry across the country reflect a diverse group of business leaders, representing both traders and manufacturers in the main clusters of industrial and economic activity. Their views on trade with India provide policymakers useful information on a variety of relevant issues. Accordingly, meetings were held with the Chambers of Commerce and Industry of Lahore, Karachi, Sialkot, and Faisalabad, as well as with the Federation of Pakistan Chambers of Commerce and Industry (FPCCI)—the apex body—in Karachi. The discussions with the chambers covered the following areas: general aspects of trading with India; non-tariff barriers imposed by India; the impediments to trade; and the sectoral impacts of trade with India.

General Views on Trade with India

Overall, the FPCCI and the regional chambers of commerce are extremely positive about trade with India and see it as a major opportunity for Pakistan. Many members of Karachi Chamber, which represents 17,000 businesses, have been trading with India for several years. They stated that they have not faced any critical hurdle in trading with India in their individual cases; however, they say some barriers are inevitable when trade fully opens up. While some sectors are skeptical of this change in the trading regime, the majority of FPCCI members argue that this is due to their own entrepreneurial weakness. Basically, they see better India-Pakistan trading relations as a critical step in developing SAFTA as a strategic trading bloc. The private sector in Karachi views regional trading as the way forward for improving market access for Pakistani products and hence believes that unless Pakistan and India improve trade relations, this regional trade will not emerge. In light of this opportunity, the Karachi Chamber is working with the Bombay Chamber in Mumbai to establish a joint Karachi-Bombay Chamber of Commerce and Industry to improve business ties.

Generally, on the issue of MFN and the consequent liberalization of India-Pakistan trade, there was a clear divergence of views between the manufacturers and traders. While some in the manufacturing community were cautious and circumspect about the potential gains from trade, traders overwhelmingly were much more confident and enthusiastic about the prospects of improving trade ties with India.

Non-Tariff Barriers

It has been the experience of Pakistani exporters that the effectiveness of Indian non-tariff barriers (NTBs) varies based on the need for products from Pakistan. If there is demand from the Indian side, the difficulties of exporting go down automatically, and as the demand falls off NTBs appear. This issue needs to be addressed by developing a system of consistent treatment over a longer time period. This is important to trigger more serious interest and investment by Pakistani exporters in the trade potential with India.

The Karachi Chamber has argued that the NTBs faced specifically by Pakistani exporters to India resulted from lack of reciprocity by Pakistan in not extending MFN status to India back in 1996. When India granted MFN to Pakistan in 1996, within six months Pakistan captured 30 percent of the Indian yarn market. Fearful for its business, local industry in India started lobbying for protection and the Indian government reverted to using NTBs to check the surge of Pakistani products. In the case of yarn, for example, a new requirement meant that the containers had to be checked by sniffer dogs. However, the dogs were not directly available at the port and it would sometimes take weeks to get them there to inspect the shipment. Such delays just added to costs, rendering the products less competitive. As a result, over time these exports of yarn completely stopped.

Another key NTB on textiles, which are Pakistan's major export, is how Indian customs authorities calculate the import duty. For example, duty on fabrics is charged either by weight or value, whichever way the rate is higher. As Pakistan's fabric is typically of slightly lower quality and therefore has less value than Indian fabric, but has much more weight, the effective duty is larger, making exports to India in many cases infeasible.

India has also imposed export bans. An example, given by the Sialkot Chamber, was the 2011 cancellation of 1.5 million bales of cotton already booked by Pakistani importers. When international prices of cotton skyrocketed during the year, Indian exporters were losing out and pushed the national government to issue a ban on cotton exports. This halted the shipment of the 1.5 million bales to Pakistan, where there was already a shortage.

The FPCCI has highlighted field-level or lower bureaucracy on both sides of the border as a major NTB. According to the federation, the mind-set of field-operating customs officers and other government officials is excessively bureaucratic and negative about trade between the two countries, resulting in undue delays. For example, members of the federation stated that at the Lahore dry port a bribe of up to 50 rupees per kilogram is sometimes required to clear goods, even those on the positive list. Specific high-quality dyes used by the Pakistani textile industry are available at much lower relative prices from India, but officials at the Lahore dry port create unnecessary problems in importing them.

The major concern of the agricultural sector is India's large input subsidies to its farmers, which substantially reduce the costs of production. These subsidies result in significantly lower prices for urea fertilizer (urea in India costs around 450 Pakistani rupees per 20 Kg bag, whereas it is 1,800 rupees per bag in Pakistan), as well as for electricity and diesel, making Indian farmers much more competitive. In the presence of such large subsidies across the border, Pakistan's agriculture sector believes strongly that trade in agricultural and food items would go against its interests. Here the need for effectively using relevant WTO rules on trade in the presence of subsidies was stressed.

Impediments to Trade

An important issue highlighted by the chambers in Punjab (Lahore, Faisalabad, and Sialkot) was the lack of infrastructure at both sides of the Attari-Wagah border, which is a binding constraint to an increase in trade. With the border lacking appropriate storage facilities and capacity to load and unload cargo, an increase in truck traffic would come at a very large potential cost and risk to traders on both sides. Thus, with the expected rise in trade in the coming years, business leaders underscored the need for a major expansion and upgrading of trade-related infrastructure at the border. Basically, the infrastructure on both sides is not yet up to the mark where it can support open trade and the expected volumes. The clogging of produce at borders will act as a key trade impediment on both sides. In future negotiations, a careful review should be conducted to develop a strategy to open more crossings between Pakistan and India. For example, opening up the Munabao-Khokhrapar border could trigger a significant increase in exports from Sindh to India. Over the longer term, opening up the border at Sialkot would improve logistics significantly. And in general, railways on both sides need to substantially improve their quality and extent of service.

Finally, until now obtaining business visas has been problematic. The chambers argued that multi-city and multiple-entry visas should be issued to business people, which the two governments have now agreed to do.[xxi] Also, the lack of telecommunications connectivity is a major hurdle. Pakistani mobile phones do not work in India. This is a critical barrier, as getting mobile connections for Pakistani business people traveling to India is not easy.

Winners and Losers

Generally, the chambers felt that it was extremely difficult to predict which sectors would gain and which would lose out. It was natural to expect that some would succeed while others would not, and that the probable losers might not be competitive and sustainable anyway. Competition is likely to increase in sectors where cheaper and better quality inputs can be imported from India. Obvious gainers for Pakistan would be textiles and leather, which can gain from cheaper imports of chemicals from India. The business leaders saw much potential for exporting agricultural machinery from Faisalabad to India, as there is a huge demand for these products in India and Pakistan's engineering skills in this sector are quite competitive.

The main losers from opening up trade with India would be the automotive parts, automobile, and agricultural sectors. Agriculture cannot compete, as India is currently offering large financial and other subsidies to its agricultural sector. As such, some protection should be provided to the local agricultural industry, one that justifies the argument of a level playing field. The chambers largely agreed that the automobile industry in Pakistan had a very strong lobby and would go for maximum protection even if trade is fully open. However, many members held the view that the automobile sector should not be given further protection, as it has engaged in massive rent-seeking for many years behind high tariff walls.

Furthermore, the chambers strongly emphasized that government policy should be carefully designed and should not have adverse impacts such as those that occurred under the free trade agreement with China. Possibilities include a temporary negative list that would prohibit certain imports so vulnerable sectors would be protected until they had time to adjust.

Conclusions and the Way Forward

It is possible that 2013 could be a watershed year for India-Pakistan economic cooperation, as well as a game-changer for Pakistan's future economic development. As shown by various studies, the potential for trade between the two countries is huge, perhaps twenty-fold or more from the current level. There is no doubt that increasing trade would significantly raise GDP and household incomes in both countries. While reducing trade barriers generally has the support of business people on both sides of the border, it is critical to build broader constituencies in each country for greater bilateral trade.[xxii] The success of short-term "confidence building" measures and the resulting growth in trade would give a major impetus to the creation of vested interests that would support more far-reaching liberalization of trade between the two countries.

Once India receives MFN status from Pakistan, the countries will have to implement a new trade regime. Future steps to promote India-Pakistan trade should include:

- Reaching agreement on non-tariff barriers (NTBs). India has argued that its NTBs are non-discriminatory and apply equally to all countries. Pakistani officials and exporters argue that the NTBs are applied selectively and in an ad hoc manner against Pakistani exports to India. The two countries will need to discuss specific NTBs, bringing in the experience of exporters, and reach a mutually acceptable resolution on which NTBs need to be eliminated or changed.
- Developing and implementing a dispute resolution framework. At present, many Pakistani business people feel they have limited recourse in settling disputes with their Indian counterparts. While both India and Pakistan have access to the dispute settlement mechanisms of the WTO and SAFTA, and the Redressal of Trade Grievances Agreement will allow government-to-government negotiations, there is still opportunity for an informal private party dispute settlement method as well. Such a framework could provide a fast-track process to enable aggrieved industries, exporters, and importers to efficiently resolve trade disputes that are relatively small or minor. This informal dispute resolution method could be administered by the newly created India-Pakistan Joint Chamber of Commerce.
- Developing the physical infrastructure required to facilitate two-way trade. The quality of the road network is low with few regional linkages, and rail networks between ports and markets are limited. There is only one main border crossing at Attari-Wagah and it lacks adequate customs and warehousing facilities. Pakistani ports need to be expanded to handle the expected increase in cargo. Without significant improvements in infrastructure, the goal of doubling or tripling trade in the next few years will not be realized. It is in the interest of both India and Pakistan to identify the physical bottlenecks and work together to reduce or eliminate them, possibly through public-private partnerships, which have been successful in developing infrastructure in other countries.
- Opening up trade in services. Although neither India nor Pakistan explicitly restricts services trade, at present it is virtually nonexistent. The reason is the restrictions placed on foreign nationals entering and providing services in the Indian market. In response, Pakistan put similar restrictions in place, even though they have no legal basis. The potential for the services trade, including for example in information technology, financial services, medical services, education, and tourism, appears to be substantial. There is now a tentative agreement on cross-border banking, with each country being permitted to open bank branches in the other starting in 2013. Meanwhile, the partial easing of visa restrictions should allow for larger tourist flows. Similar agreements are needed on student exchanges and travel for medical treatment. India has first-rate technical schools and medical facilities that are as yet unavailable to Pakistanis.

The complete liberalization of trade between India and Pakistan will be a long and arduous process, but Pakistan's granting of MFN status to India will be a good start. Higher levels of trade will bring economic benefits to both countries, but more so to Pakistan. Indeed, with India cementing its position as the region's engine of growth, Pakistan must hitch its wagon to the locomotive or risk getting completely left behind. The Pakistani government and the supposedly "India-centric" military have finally come to recognize and accept this reality.

Trade will not, of course, solve all the problems between the two countries, but it could be an important catalyst in the lowering of tensions. And a lowering of tensions between India and Pakistan—an inevitable benefit of strengthened economic ties—would improve the security climate for investment and economic development in both countries. It is clearly in the interest of both countries, and the world for that matter, to find a political resolution to problems in the India-Pakistan relationship, and increased trade can well be the starting point for achieving this objective.

[i] For a general discussion of the advantages of closer economic relations between India and Pakistan, see Kemal et al. (2002), State Bank of Pakistan (2006), Panagariya (2007), and the papers contained in Naqvi and Schuler (2007). Khan (2009) explicitly examines and lists the constraints on India-Pakistan bilateral trade.

[ii] Both SAFTA and SAPTA are part of the South Asian Association for Regional Cooperation (SAARC), formed in 1985. The original SAARC members were Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka. Afghanistan joined SAARC in 2007.

[iii] As noted by the Confederation of Indian Industry (2005), Nabi and Nasim (2001), and Taneja (2007), among others. A very useful description of Pakistan's trade relations with its South Asian neighbors is contained in Hufbauer and Burki (2006, Appendix A).

[iv] By way of comparison, India and Sri Lanka have had a free trade agreement (FTA) since 2000, and total Indian–Sri Lankan trade is about $4 billion, even though Sri Lanka's GDP is roughly a quarter that of Pakistan's. Also, Indian trade with Bangladesh, which has half the size of Pakistan's GDP, reached $3.5 billion in 2010.

[v] At that time, 70 percent of Pakistan's trading transactions were with India, while 63 percent of Indian exports went to Pakistan.

[vi] On the extent of informal trade between India and Pakistan, see Khan et al. (2007). Anecdotal evidence suggests that such trade could be much higher, possibly even over $5 billion a year.

[vii] See the Joint Communiqué (2005).

[viii] India, on the other hand, has made several overtures to Pakistan to separate trade from the composite dialogue.

[ix] See, for example, Murshed and Mamoon (2008).

[x] Interviews in 2011 with the Chief of General Staff, Lt. Gen. Wahid Arshad, the Vice Chiefs of General Staff, and the Directors General of Military Operations and Military Intelligence.

[xi] For a discussion of the granting of MFN, see Khan (2011).

[xii] ECO includes a number of Central Asian countries, Iran, and Turkey.

[xiii] For example, Hassan (2001), Rahman et al. (2006), Hirantha (2004), and Batra (2004).

[xiv] Khan uses a variant of what is called a "gravity model" for this exercise. This type of model has become the "workhorse" of international trade analysis to determine the trade potential between countries.

[xv] If the calculation of potential-to-actual India-Pakistan trade is carried out more precisely using the average of the APT ratios reported in Table 1 (0.035), then potential trade between India and Pakistan would be 29 times greater than observed trade. This estimate is nearly identical to the Batra (2004) base estimate of 27 times greater.

[xvi] There has been no official statement from the government of Pakistan indicating that this is a precondition.

[xvii] This is discussed in more detail in Section 6 below.

[xviii] The three sources are as follows: PITAD (2012), Nabi and Javaid (2011), and Naqvi and Schuler (2007).

[xix] The negative list was later expanded to cover 1,200 items after heavy lobbying by the pharmaceuticals and automotive industries.

[xx] See Naqvi and Schuler (2007).

[xxi] The new visa regime for business people and senior citizens was signed by President Zardari at the end of November 2012.

[xxii] Earlier fears in Pakistan that Indian exports would overwhelm domestic manufacturing have eased over time as Pakistani business leaders realized they can compete in a number of areas, such as agro-industry products, textiles, and surgical instruments, if there is a level playing field.

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