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INDO-PAK TRADE RELATIONS

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Abstract

With the trade normalization process between India and Pakistan gathering momentum since November 2011, new opportunities for enhancing bilateral trade have opened between the two countries. This study estimates the trade potential between India and Pakistan, and examines how this potential can be realized. Using the Trade Possibility Approach for all items traded, followed by selecting only those items in which the countries have a Revealed Comparative Advantage (RCA) to export, the trade potential between India and Pakistan is estimated to lie between US$10.9 billion and US$19.8 billion. Of the US$10.9 billion trade potential, India's export potential accounts for US$7.9 billion and import potential US$3 billion. With a large number of items belonging to the negative or sensitive lists, the study estimates the trade potential accounted for by these items. Sector wise analysis depicts that bilateral trade shall receive a boost if the textile sector is liberalized in both countries, with Pakistan liberalizing its automobile sector too. In the services sector, trade possibilities have been identified in Information Technology (IT), Business Process Outsourcing (BPO), health and entertainment services. The study finds that this trade potential remains unrealized largely due to impediments in transport and transit facilities, restrictive visa regime, continuation of large informal trade flows, and presence of 'perceived' non-tariff barriers to trade between India and Pakistan. As the Foreign Direct Investment (FDI) regime between the two countries is liberalized, the study identifies sectors which hold potential for investments, and are likely to deepen the trade linkages between India and Pakistan.

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Introduction

Contiguous countries around the world share a congenial trading environment, with high values of bilateral trade being in line with the 'Gravity Model' theory of international trade, owing to lower inter-country distances. However, trade between India and Pakistan has

always been inextricably linked to the political relations the two countries share, than being merely governed by economic factors. Following the independence and partition in 1947, Indo-Pakistan trade fell drastically; and came to a standstill for almost nine years in the aftermath of the war in 1965. A protocol on resumption of trading relations was signed in 1974 on a list of mutually agreed items. In 1996, India accorded Most Favored Nation (MFN) status to Pakistan thereby offering Pakistan the same trading regime as it offers to any other country in the world. Pakistan, on the other hand, continued to allow imports of a limited number of items from India, collectively known as the positive list; although the number of items on the list has increased gradually. The grant of MFN was linked to the resolution on the Kashmir issue. Moreover, India stopped trade via the air and land routes between 2001 and 2004 following the attack on Indian parliament in December 2001. In 2013, for the first time since 2004, cross border trade was altogether stopped following the incidence of cross border firing; with trade resuming within a few days' time. Restriction on trade had been on several other counts as well, with the major ones being:

a) A restrictive maritime protocol until 2005 which allowed only Indian and Pakistani flagged vessels to carry cargo between the two countries, and not permitting the same vessels to carry consignments to a third country from the ports of either
b) Presence of only one rail route for cargo movement between the two countries
c) Absence of road-based trade route until 2005.

This restrictive trading environment resulted in large informal trade flows between India and Pakistan, with most of the trade taking place via third country ports such as Dubai. The process of trade normalization was set in motion in 2004 during the Commerce Secretary level talks on Commercial and Economic Co-operation between India and Pakistan. In this comprehensive dialogue, trade negotiations were to be discussed along with a dialogue on several other issues. This was the first step towards delinking trade negotiations from political issues. Since 2004, any major political event between India and Pakistan has neither met with any major impact on trading relations nor an imposition of a ban on trade. Rather, bilateral trade has only been rising over the years. In 2004, as members of the South Asian Association for Regional Cooperation (SAARC), India and Pakistan signed the South Asian Free Trade Agreement (SAFTA). The members of SAFTA include four least developed countries (LDCs) –Nepal, Bhutan, the Maldives, and Bangladesh; and three non-least developed countries (NLDCs) –India, Pakistan and Sri Lanka. SAFTA, as all other regional agreements under the WTO, required members to offer MFN treatment to each other.

However, even after SAFTA was ratified in 2006, Pakistan did not accord MFN status to India and continued to trade on the positive list, allowing import of only 137 items from India via road, thereby making the route more restrictive. Thus with the two largest SAARC countries not trading under MFN rules, SAFTA has failed at helping normalize trade relations between India and Pakistan. The bilateral trade dialogue that had started in 2004 continued for four more rounds of talks until 2007 and resulted in three major outcomes- expansion of the positive list, opening of the road route in 2005, and amendment of the restrictive maritime protocol.

As part of the Confidence Building Measures, in October 2008 the two governments permitted trade and travel across the Line of Control along Jammu and Kashmir. Following the Mumbai attacks in November 2008, the composite dialogue was stalled. It resumed after a hiatus of three years. During these three years, however, no proactive measures were taken to block trade such as those initiated in response to the Parliament attack in 2001.

Trends in Bilateral

Trade Bilateral trade between India and Pakistan increased by more than 9 times between the years 2000 and 2011.3 Total trade between the two countries was US$ 1.97 billion in 2011, of which India's exports to Pakistan were US$ 1.66 billion and imports US$ 313 million. Despite exporting only on the positive list, India has always had a trade surplus with Pakistan; with the trade balance as a proportion of its total trade with Pakistan increasing from 55 to 68 percent between 2000 and 2011. However from 2009-12, the average annual rate of growth of imports from Pakistan has been 23 percent while that of exports has been just 9 percent, signaling some reversals in the trend.

Table 1: India's Trade with Pakistan (US$ million) 2000 and 2011

Trade	US $ Million (Excluding Mineral Fuels) (1)		US $ Million (Mineral Fuels) (2)		US $ Million (Including Mineral Fuels) (3)=(1)+(2)	
	2000	2011	2000	2011	2000	2011
Export	162	1,659	0	19	162	1,678
Import	47	313	22	39	69	352
Total Trade	209	1,972	22	58	231	2,030

In 2011, India's top 3 exports to Pakistan at the HS-21 classification of items included chemicals, textiles and vegetable products accounting for 68 percent of total exports to Pakistan.4 India's top 3 imports included mineral products, vegetable products and textiles accounting for 59 percent of total imports. At a disaggregated level, (HS-6 digit

classification) top commodities exported from India to Pakistan that year included, cotton, oil-cake, xylene, tomatoes, woven fabrics, chickpeas, polypropylene, rubber tyres, tea, fruits, and iron and steel containers. Cotton alone accounted for 16 percent of exports. Dates were the most important item being imported from Pakistan, accounting for 19.8 percent of total imports in 2011. Other items included cement, gold, light petroleum, lead, copper, petroleum oil, cotton yarn, disodium carbonate, gypsum, terephthalic salts and vinyl chloride.

Trade Potential in Goods

Several estimates have been made to predict the trade potential between India and Pakistan. The most popular econometric method is the use of gravity models in which bilateral trade is explained as being directly proportional to the product of GNP of the trading partners and inversely related to the distance between them. Various gravity model estimates range between 0.5 times and 27 times of actual trade. While these estimates are useful, the model has some weaknesses, particularly in the context of geographically contiguous countries such as India and Pakistan, where despite lower inter-country distances, transport and other transaction costs of trading are very high. Moreover, any econometric model would be limited in its use when existing bilateral trade is limited to the positive list.

The results of this exercise show the existence of an estimated untapped bilateral trade potential of US$ 19.8 billion in 2011, which is 10 times larger than the current US$ 1.97 billion trade. Of this export potential accounts for US$ 16 billion, and import potential US$ 3.8 billion. The potential in mineral fuels is another US$ 10.7 billion of which export potential accounts for US$ 9.4 billion and import potential US$1.3 billion.

When the analysis is extended by computing Revealed Comparative Advantage (RCA) for all the items in which trade possibilities exist, lower estimates of trade potential are obtained. This analysis includes only those items in the trade potential exercise in which the partner country is globally competitive. The intuition behind this is that items with a revealed comparative advantage to export to the rest of the world are most likely to be traded between India and Pakistan if there are trade possibilities.

Using the RCA approach, the total trade potential excluding mineral fuels falls to US$10.9 billion with the export potential accounting for US$7.9 billion and import potential accounting for US$3 billion. The trade potential from mineral fuels remains almost the same at US$ 10.4 billion.

India's Trade Potential with Pakistan (Trade Possibility Approach) 2011

Trade Potential	US $ Million (Excluding Mineral Fuels) (1)	US $ Million (Mineral Fuels) (2)	US $ Million (Including Mineral Fuels) (1)+(2) =(3)
Export Potential	15,966	9,392	25,358
Import Potential	3,846	1,290	5,136
Trade Potential	19,812	10,682	30,494

Source: UN ITC-WITS database

Trade Potential	US $ Million (Excluding Mineral Fuels) (1)	US $ Million (Mineral Fuels) (2)	US $ Million (Including Mineral Fuels) (1)+(2) =(3)
Export Potential	7,874	9,062	16,936
Import Potential	3,019	1,289	4,308
Trade Potential	10,893	10,351	21,244

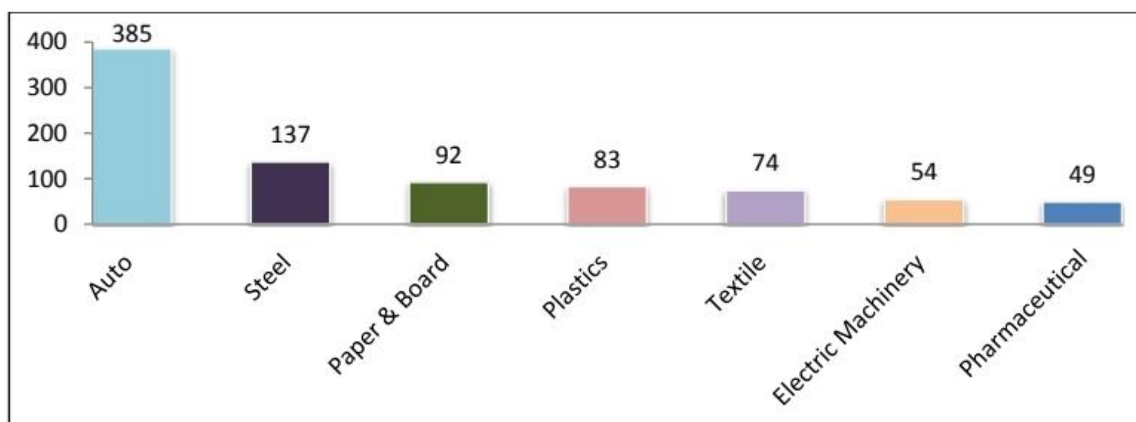
Source: UN ITC-WITS database

However, what is interesting is that when we calculate the export potential after including only those items for which India has a comparative advantage to export to the world, 60% of the difference in estimates of export potential obtained in the two approaches is on account of items on Pakistan's negative/sensitive lists. The inference that can be drawn is that India is not competitive in a significant proportion of items on Pakistan's negative/ sensitive lists, hence negating any rationale for these items to remain on Pakistan's negative/sensitive lists. Similarly, 68 % of the difference in import potential that is observed after including only those items where Pakistan has a comparative advantage to export to the world, is accounted by items on India's sensitive list for non-LDCs. In the rest of the paper we report results obtained from the RCA approach.

Negative and Sensitive Sectors

Pakistan's negative list of 1209 items is specified at the 8-digit level of classification followed by Pakistan Custom Office. This classification differs from the Indian classification at the same level of disaggregation. Analysis of the 1209 items indicates that auto components account for 32% of the items, followed by steel and paper products accounting for 11% and 8% respectively.

Number of Commodities on Pakistan's Negative List
(Based on Pakistan Customs Classification-8 Digit)



Source: Ministry of Commerce, Pakistan

In order to assess the potential in these items, the codes were collapsed to the HS-6 digit level and then re-classified according to Pakistan's customs classification. However, it needs to be mentioned that in the process of aggregation, some products which were not on the negative list at the 8 digit level, got included as well. Hence, at the HS-6 digit level, there were 788 items on Pakistan's negative list. Five categories, namely auto, electrical machinery, textiles, steel and pharmaceuticals accounted for almost 90% of the export potential on the negative list within which, auto alone accounted for around 30% of the export potential on the negative list. In addition, India's export potential in items that are included in Pakistan's negative list is largest in automobiles (included largely in the category vehicles, aircraft, vessels and transport) accounting for 12% of India's total export potential to Pakistan.

To identify specific commodities on Pakistan's negative list that are 'vulnerable' to competition from imports, paired RCA's were computed for every item traded between India and Pakistan. Vulnerable items identified through this exercise were those in which India had RCA>1 but Pakistan had RCA<1. Thus in the automobile sector which accounted for the highest export potential on the negative list, out of a total of 167 items, only 35 were vulnerable as these were items in which India is globally competitive but Pakistan is not. Similarly in textiles, out of 74 items on the negative list, Pakistan is vulnerable only in 25, or 34 percent of the items.

India's export potential in items that are included in Pakistan's sensitive list under SAFTA is largest in automobiles (included largely in the category vehicles, aircraft, vessels and transport) accounting for 37% of export potential of sensitive list items and 12% of India's total export potential. However, out of 70 items on the sensitive list in this category, Pakistan is vulnerable in only 19 items. In terms of number of items, textiles sector was the

largest accounting for 24% of total number of items on the sensitive list. But these accounted for only 4% of India's export potential for items on Pakistan's sensitive list under SAFTA. Moreover, of the total 224 textile items on the sensitive list, Pakistan is likely to face competition in only 41, or 18% of the items.

It can hence be inferred that while Pakistan considers its automobile sector most susceptible to competition, India fears competition in the textile sector. However, the tendency for both countries has been to protect several tariff lines in which neither partner is competitive.

On the other hand India's textile and clothing sector has been one of the most protected sectors in India. Until 2005, readymade garments were reserved for exclusive manufacture by small scale firms; large firms were not permitted to manufacture these items. To protect the domestic industry, textiles and readymade garments were also subjected to high import duties and specific duties which were applied in quantitative terms and not on ad-valorem basis. In fact some of the ad-valorem rates exceeded 300 percent (USTR 2012). In 2005, the readymade garment items were removed from the reserved list thereby allowing large firms to enter into manufacturing. However, these items continued to be on the sensitive lists of India's free trade agreements even though the rationale for protecting the industry was no longer there. It was only in 2008 that India removed 164 textile items from the sensitive list for LDCs under SAFTA and offered duty free access. In 2011, all textile items were allowed duty free access from LDCs. Sri Lanka was offered duty free access to 215 textile items under the India-Sri Lanka Free Trade Agreement in 2008. Similarly, a complex system of subsidies and taxes oriented the mill sector (spinning and yarn) powerfully towards the small-scale power-loom based weaving sector, which in turn was oriented primarily towards domestic consumption.

Further, it needs to be noted that prior to 1996 even when trade between the two countries was limited to a handful of items on the positive list, agriculture was part of this positive list, as it was not only an important means of overcoming short-term fluctuations but was also important for maintaining domestic price stability. At the time when Pakistan's positive list expanded to 1963 items, 156 agricultural commodities formed a part of this list.

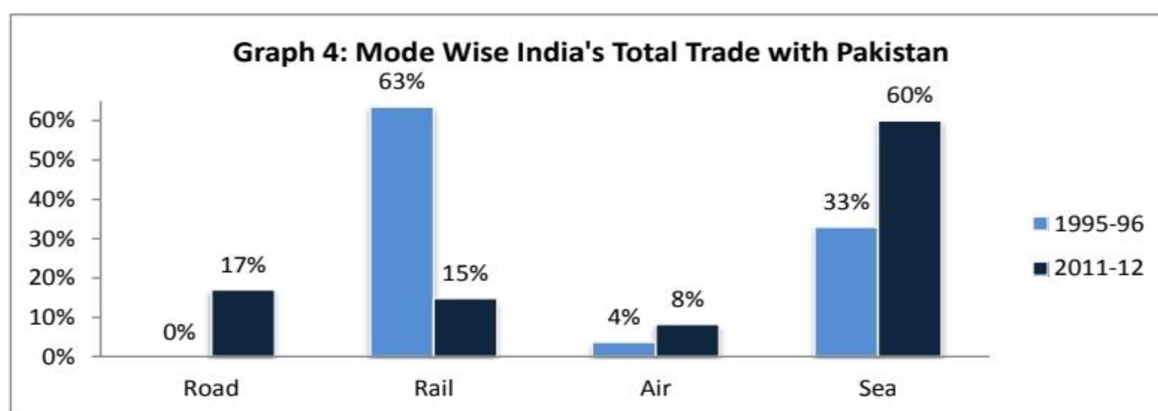
While Pakistan may have genuine concerns regarding any adverse impact on its agriculture sector due to a surge in agricultural imports from India, the solution should be to seek safeguards within the WTO system and under SAFTA, rather than imposing a total ban on agricultural commodities from India.

Transport and Transit

Most discussions and studies on the transport issue have focused on the impediments related to the land route. While the sea route has always been operational, it went unnoticed due to the restrictive maritime protocol. This protocol allowed only Indian and Pakistani flagships to carry cargo between India and Pakistan. This arrangement restricted competition from foreign vessels, and therefore resulted in high sea freight rates being charged by Indian and Pakistani vessels. The amendment of this protocol in 2005 brought sea trade between the two countries under global maritime arrangements, leading to greater competition, and therefore, to a considerable reduction in costs for sea-based trade between Mumbai and Karachi.

It is not surprising that in 1995-96 when the road route was closed, trade by rail accounted for 63 percent while that by sea accounted for 33% of the total trade between India and Pakistan. By 2011-12 the share of different modes in total trade between the two countries changed substantially due to the opening of the road route and the liberalization of the sea trade. The share of trade by rail fell to 15 percent, while that by sea increased to 60 percent. Share of trade by road increased from zero percent in 1995-96 to 17 percent in 2011-12. Moreover, what is striking is that for both exports and imports, apart from a few commodities like dry dates and cements, most of the top commodities are traded via a single mode of transport, either road, rail, sea or air.

Mode Wise India's Total Trade with Pakistan



Source: Directorate General of Foreign Trade: Ministry of Commerce, India

The opening of the road route between India and Pakistan after 58 years was a historic move. India and Pakistan share a 2912 kilometer long border. The significance of this move can be better understood when compared with cross-border transport protocols that India has with Nepal. India and Nepal have the most liberal transport protocol which permits trucks

from the two countries to move into each other's territories. However, in practice, goods from trucks of one country are offloaded and loaded on to the other country's trucks at the border. This is because when trucks move from one country to the other, the local mafia extorts money from the foreign trucks. Thus, transshipment continues to occur because these informal payments are higher than the cost of transshipment. Hence there is a need to strengthen institutions at the border for effective implementation of policies. On the other hand, the opening up of the road route between India and Pakistan has met with relatively little opposition. Indeed, the institutional framework supporting trade between the two countries is strong enough to counter lobbyists and interest groups that may have resisted such a change. This raises immense hopes for successful implementation of further trade-facilitating measures at the land border between India and Pakistan.

Amritsar and Lahore are the two major cities on either side of the border separated by a distance of only 54 kilometers. Hence, the transport costs for goods moved via land route between northern India and northern Pakistan could be substantially lower than the sea route. Recognizing the importance of the land route, India opened an Integrated Check Post (ICP) at Attari in April 2012, with new facilities including a trade gate that would house all trade activities under one unit including warehousing and other facilities. Timings for trade were increased to 12 hours every day for all days of the week.

In a short span of just six months – between April and October 2012, the warehouse has reached full capacity. This in turn limits the entry of trucks from across the border. The question is whether these facilities will be able to bear additional cargo load which is likely to occur for two reasons- Pakistan's move to normalize trade on the road route by allowing all items to be imported from India via road, instead of the existing list of only 137 items; and a likely shift in trade from the sea to road route due to lower transaction costs in the latter. The ICP, when conceived by the Indian government clearly did not envisage such a paradigm change in trade between the two countries. The trade would increase further if the two governments agreed to move containerized cargo by road. Allowing these trucks to move in each other's territory is yet another measure that would reduce transaction costs further. The two governments are also considering opening up of new road routes. The option of opening the Munabhao- Khokhrapar road route was discussed in the seventh round of talks between the two governments.

The ongoing bilateral dialogue between India and Pakistan has so far not addressed the issue of transit. India has not allowed Pakistan to access Nepal, Bangladesh, and Bhutan

through its territory. Similarly, Pakistan has not given any transit rights to India to access Afghanistan for its exports. However, Pakistan offered transit rights to Afghanistan's exports through its territory to reach the Indian market in 1948. In July 2010, Afghanistan and Pakistan signed an amended transit trade agreement, the Afghanistan-Pakistan Transit-Trade Agreement (APTTA), which provides for an increased number of transport routes available to trucks from Afghanistan and Pakistan. However, the APTTA does not allow India's exports to Afghanistan through Pakistan via the land route. In order to increase their gains from the trade normalization process, India and Pakistan must put this transit issue on their dialogue agenda. This would also have huge implications for reviving the Afghan economy. Afghanistan can gain little through trade given its limited export capability but it can take advantage of its geographical location by converting into a logistic hub and offering a whole range of logistic services that could help transport goods between South and Central Asia. It follows that India should also allow transit facility to Pakistani goods for accessing the Nepal and Bangladesh markets.

There is need to develop a long term vision and plan for road and rail cargo movement by the land route. Limiting the opening of the land route to just the land border is not enough. Freight costs are often determined by the freight trade balance between two countries. Since India has a trade surplus with Pakistan, India's cargo trucks/wagons moving back from Pakistan will not be fully loaded, with empty wagons adding considerably to transaction costs. However, if the trucks/wagons are allowed cross- border movement and multimodal-transportation is permitted, cargo balancing could be achieved by linking the sea ports of Mumbai and Karachi through the land route, with the sea ports largely connecting the rest of the world. Similarly transit through Pakistan can link Indian sea ports with Afghanistan and to rest of Central Asia through Pakistan.

Foreign Direct Investment

Investment flows play an important role in deepening trade linkages, and raising market access between the countries involved. For several years India did not permit FDI inflows from Pakistan. In a move to normalize economic ties between the two countries, in August 2012 the Department of Industrial Policy and Promotion (DIPP) India announced changes in the Consolidated FDI Policy to allow investment from Pakistani firms and individuals in all sectors- except defense, space and atomic energy- through government route. Following this, India recently removed Pakistan from the negative list under the

Foreign Exchange Management Act (FEMA), paving the way for investment from Pakistan. The FEMA regulations have also been amended to allow Indians to invest in Pakistan.

In 2011, Pakistan's total outward FDI flows were only US $62 million. While country and sector-wise break-up of FDI outflows from Pakistan is not available, data from Board of Investment in Bangladesh indicates that Pakistan has invested in textile firms there. Pakistan has also invested in Sri Lanka in the food processing and construction sectors. In the Indian context, the possible sectors attracting FDI could be textiles and cement. A bilateral investment treaty between India and Pakistan in near future will help boost both the safety of investments and investor confidence. Considering that due to inhibitions the business interest may not be forthcoming immediately, an interesting solution offered by businessmen has been to set up joint ventures between India and Pakistan without physically locating in each other's countries. Investment ventures set up in this manner could pave the way for raising investor confidence in the future. During the course of our industry consultations, sectors with potential for investment were identified to be agriculture, fertilizer, drip irrigation, tissue culture, seeds, herbal extracts, biotechnology, mining and mining equipment, dairy and livestock, tourism and tourism infrastructure, textile machinery, heavy engineering and earthmoving machinery, and entertainment.

Conclusion

The trade normalization process will unleash trade opportunities for both India and Pakistan. Even though the automobile sector in Pakistan and the textile sector in India have resisted trade liberalization, there is no rationale for holding back the process which shall inevitably benefit both the countries.

India and Pakistan need to work together in several areas to be able to realize the untapped trade potential. So far only incremental steps are being considered by the two governments to improve cross-border movement of goods. A comprehensive and integrated international land transport policy needs to be put in place not only to provide rail and road services connecting the two countries but also linking sea ports through land borders to enable connectivity with the rest of the world as well.

India should continue to lower its non-tariff barriers as part of its ongoing reform process. In addition, a more concerted effort needs to be made to facilitate businessmen in overcoming their apprehensions about entering each other's markets and selling their products along with their country labels across the border fearlessly. The unprecedented number of exhibitions and fairs held in India and Pakistan, displaying each other's products,

has been met by an overwhelming response from consumers; providing support for such efforts to continue.

While the removal of restrictions on FDI flows has opened up new investment opportunities, businessmen from India and Pakistan are reluctant to invest due to fear of a possible disruptive political event. Investors also fear becoming easy targets for those who oppose their presence. Businessmen willing to invest could enter into joint ventures without physically locating in each other's territory, as the first step to entry, till legal systems safeguard investments and there is improvement in investors' confidence.

For a liberal visa regime to be in place, electronic 'smart systems' should be used to screen visa applications and track physical movement of people, while avoiding undue harassment to genuine traders. Telecommunication channels also need to be opened up to foster people-to-people contact and reduce business costs. The existing communication system between India and Pakistan does not permit travelers to use their mobile phones in the other's country. Buying local SIM (Subscriber Identity Module) cards too is not an easy option, involving a lot of paper work for those travelling. As a result, visitors and businessmen have developed informal mechanisms of procuring local SIM-cards through friends and relatives. The issue of improving telecommunication between the two countries was raised in the 7th round of talks and is expected to be a part of the trade normalization process.

India and Pakistan need to constantly engage with one another to understand each other's regulatory regimes. As new businessmen enter into trading relations, it is important to have forums that bring buyers and sellers together. Guaranteed payments are essential for building new and lasting business partnerships, for which banking channels would need to be improved. An innovative dispute resolution system should also be put in place. For many years, Dubai has provided as a facilitator for trade and guaranteed payments between India and Pakistan. Thus, a third country wherein India and Pakistan share mutual trust could provide for an effective dispute resolution mechanism. Moreover, it is important for the business communities to create multilevel channels of communication which can reduce misconceptions, bridge information gaps, and generate a significant change in the business environment of the two countries. All such holistic measures could help in realizing the untapped trade potential between India and Pakistan.

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