MICRO-ECONOMIC FOUNDATIONS OF ECONOMIC POLICY PERFORMANCE IN PAKISTAN

ISHRAT HUSAIN❖

The topic of this Conference "Micro-Economic Foundations of Economic Policy Performance in Asia" is both relevant and timely for South Asian Policy makers and researchers. I am pleased that I am able to share my thoughts with this august gathering about the microeconomic policy reforms in Pakistan with which I was associated for the past eight years. Having the interests of a researcher and academic at the same time I have chosen to present an analytical narrative of Pakistan's reform episode. The questions that I wish to explore this morning are:

(a) Why did Pakistan decide to opt for unilateral trade liberalization?
(b) What was the content, sequencing and phasing of policy reforms?
(c) What has been the impact of these reforms on growth and poverty in Pakistan?
(d) What are the generalized lessons that can be learnt from this reform episode?
(e) What is the way forward for the future?

Pakistan's decision for unilateral trade liberatlization

There were at least three compelling reasons for the announcement of Economic Reforms package of 1991 by the then Prime Minister Nawaz Sharif and his political party. Coming from a private sector business family and having suffered himself and witnessed the adverse impact of nationalization of industries on the overall economy, he was able to convince his party that the only way Pakistan can grow and prosper was by pursuing a policy of liberalization, deregulation and privatization. The Government took a number of impressive steps to initiate these reforms including the promulgation of an Economic Reforms Order that provided the legal cover to these reforms. The main motivating factor was the set back to Pakistan's economy that occurred in the after math of the Socialist experiment in 1970s. The collapse of the Soviet Union and the discrediting of the Socialist economic model fortified the hands of the reformers within Pakistan. The Thatcher – Reagan aura prevailing at that time must also have implicitly influenced the thinking of the political leaders.

The second factor was an intellectual reawakening that inward looking import substitution industrialization strategy buttressed by state control and centralized planning had failed in actual practice. Many studies particularly by OECD, World Bank and other

❖ Keynote address delivered at NCAER – EABER Conference on "Microeconomic Foundations of Economic Policy performance in Asia" hold at New Delhi on April 3-4, 2008

Western academics showed through empirical cross country analyses that this strategy had done more harm than good. As Pakistan was also receiving Structural Adjustment Credits from the World Bank and assistance from the IMF the pressure from these multilateral financial institutions which advocated pro-market and pro-private sector reforms also played a role in shifting the paradigm.

Third, it appeared that the outward-oriented strategy appeared to have worked quite well in the newly industrializing countries, the ASEAN Countries and China. It was believed that these success stories emanating from Asia were shaped by open markets, integrated financial systems, increased mobility of labor and rapid diffusion of technology. Encouraging the private sector by withdrawing state intervention in micro management of their businesses, reducing the burden of overbearing government regulation and opening the domestic markets to international competition was perceived as the policy framework that turned around the economies of these East Asia countries. Pakistani decision makers therefore felt comfortable that their instincts for reforms in this direction were substantiated by hard and solid evidence from other countries that had successfully carried out these reforms.

A combination of fortuitous circumstances – disenchantment with past policies, evidence of success in other Asian countries, the pressure from external donors and a strong political will be the newly elected government – muted the resistance to this major policy shift. A broad consensus was reached that unilateral trade liberalization was in the best interests of the country.

Content, Sequencing and Phasing

The major reforms introduced in early 1991 were centered around privatization of state owned enterprises including banks, power utilities, telecommunications, deregulation and relaxation of controls on foreign exchange and investment and liberalization of foreign trade. The private sector was allowed into fields such as power generation, highway construction, airlines, shipping and banking. Foreign investors were allowed to own upto 100 percent of equity in almost all the sectors of the domestic economy on a fully repatriable basis. Industrial licensing was abolished and investment approval and allocation system by the Government for private enterprise was discontinued. Foreign exchange accounts in domestic banks were allowed for both residents as well as non-residents.

The implementation of these reforms proceeded in fits and start in the decade of the 1990s due to political instability, frequent changes in government and exogenous shocks to he country. The pace was accelerated since 2000 and impressive strides have been made in many sectors.

Pakistan's trade liberalization reforms have received accolades from international businesses as well as multilateral financial institutions. According to a World Bank study "Pakistan's recent reforms have been substantial. Its trade regime is now one of the more open in South Asia. It has the lowest applied average tariff rates of the three large South Asian economics. Pakistan reached this position by reducing the number of tariff band to 25 percent. Unlike Sri Lanka and Bangladesh, and indeed most countries around the world, Pakistan has not shied away from opening its agriculture sector. In addition, the government eliminated quantitative restrictions, regulatory duties and other para tariffs and several other measures that restricted trade in the past. Finally, it reduced the number of statutory regulatory orders (SROs) and the exemptions granted under these orders. Ordinary custom duties are now the principal instrument of trade policy. Improvement in Pakistan's incentive structure and export environment surely contributed to its strong export performance in recent years."

Maximum tariff has been reduced to 25 percent from 80 percent in 1995 with simple average applied rate of 15% compared to 51% in 1995. The average import weighted tariff in 2006-07 has been around 8%. The number of regulatory duties has considerably declined. Virtually all tariffs (99.3%) are ad-valorem and revolve around only 6 slabs including zero. Local content requirements have been eliminated in all sector and the policies have been brought in compliance with TRIMs agreement. Imports from India are, however, allowed on a positive list which is expanding. These imports on positive list are subject to MFN applied tariff or preferential tariff under SAPTA or SAFTA agreements.

State trading has been restricted and all public sector corporations engaged in trading activities have been disbanded except one i.e Trading Corporation of Pakistan (TCP). TCP intervenes selectively to cope with domestic demands of essential commodities under the express decision of the Cabinet.

The number of concessionary notifications in tariffs (SROs) has been reduced substantially. The policy of autonomous liberalization has continued unabated and the scope of tariff binding has risen to 98.7% of tariff lines. Custom clearance systems and international trade related procedures have been streamlined to bring them at par with international best practices and make them compliant with international standards and conventions.

Export facilitation and promotion have been the main focus of Export Policies although in last three years direct subsidies have been provided as grants for Research and Development to a few selected items.

The impact of these measures can be seen in the doubling of Pakistan's exports in US dollars terms within a period of five years and the tripling of Pakistan's merchandise imports. IT would be fair to surmise that as a result of the trade policy reforms, anti export bias in manufacturing, agriculture and for services has declined substantially. But relative to other countries Pakistan has still a long way to go.

Despite protestations from the rent-seeking businessmen for protection, there has been no reversal in the main thrust of liberalization although I believe that further reduction in maximum tariff rate could have been effected in the last few years so that the average tariff rate reached single digit. There was some slow down in the reform process during 2007 but I expect that the induction of new government will allow resumption of this interrupted journey.

Telecom sector has been totally transformed by deregulation, dismantling the monopoly of the state telecom company and allowing new entrants from the private sector. Tele-density has increased from 4 percent in 2003 to over 50 percent. The number of mobile subscribers has increased from 8 million to over 72 million. Unprecedented amount of foreign investment flowed into the sector and many leading international companies such as China Mobile, Singtel, Telenor, Orascom are main service providers. Competition has brought down the prices significantly to the businesses and consumers

Financial sector reforms have resulted in a dramatic shift in ownership and control of banking asset from state owned banks to private sector. 80 percent of the banking assets are now owned and managed by the private sector including large international banks. Profitability has risen manifold, capital base is strong, quality of assets has reached international benchmarks, the number of bank borrowers has multiplied six fold. Neglected sectors such as agriculture, SMEs, mortgages microfinancing are being served by the banks. The relaxation of credit constraint that was keeping the industrial capacity underutilized and small farmers away from modern farming practices has helped in achieving higher growth rates. However, the privately owned banking sector has to be regulated by a strong watchdog to ensure financial stability in the system. A totally restructured Central Bank with core competencies, information technology tools and the state of art prudential regulations is performing this task.

Foreign exchange regime in Pakistan is open and liberal. Current account is fully convertible while capital account is partially convertible. There are no restrictions on inflows of foreign direct investment for any sector of the economy. Foreign registered investors can bring in and take back their capital, profits, dividends, remittances, royalties etc. without any prior approval. Exchange rate is determined in the inter-bank foreign exchange market through the interaction of supply and demand. The Central Bank intervenes only to smoothen excessive volatility in the market. Consequently, Foreign investment flows in 2006-07 amounted $ 8 billion or over 5 percent of GDP.

A new Competition law has been legislated and Monopoly Control Authority working since the sixties has been replaced with the Competition Commission. This is one of the key “second generation” reforms. It will prohibit abuse of market dominance, certain types of anti-competitive agreements, deceptive market practices and mergers or under takings that substantially reduce competition.

The Musharraf Government decided in 2001 that policy making and regulatory functions in the Ministries should be separated and independent quasi-judicial regulatory bodies be formed for various sectors. So far such regulatory bodies have been set up for Electricity, Oil and Gas, Environment, Tourism, Electronic Media, Engineering, Legal, Maritime, Transport, Architectural, Accounting and Higher Education Services. These bodies have been placed under the administrative jurisdiction of the Cabinet Division and not under the concerned ministry.

Pakistan has upgraded its regime for the protection of intellectual property rights in line with its commitments in the agreement on TRIPS. An integrated umbrella in the form of “Intellectual Property Organization of Pakistan” has been established for dealing with all aspects of IPRs.

One of the reasons for lackluster implementation other than frequent changes in political regimes in the 1990s has to do with the phasing and sequencing of these reforms. In a country that had traditionally depended on custom duties as a major source of tax revenues it is neither politically feasible nor technically advisable to reduce the tariff rates in absence of other alternative sources of revenues. Tax collectors and tax payers had a fairly cozy relationship in the custom duty driven tax regime and resisted all moves for tariff rationalization by flagging the red herring of likely drop in revenues. Over invoicing of exports to reap refunds and rebates, under invoicing of imports to reduce tax incidence, misdeclaration of value or the category of goods to fall in the lower slab and other similar tactics enriched both the tax collectors and tax payers. The ease of collection process and the generation of a certain amount of tax revenues with some modest increase every year made the governments of the day complacent that the system was functioning smoothly and did not need to be tampered with. Fiscal deficits were quite high to begin with and risk could not be taken by substituting a guaranteed stream of revenues by an untested and uncertain system.

Trade policy reforms could not produce the desired results and the switch from custom duties could not take place unless fiscal policy reforms, reforms of public enterprises, privatization and financial sector reforms were also undertaken. Value added taxes on imports and domestic consumption, universal self assessment and improvement in income tax system, tax simplification that were undertaken in the 2000s were able to diversify tax revenue collection. Thus reliance on custom duties as the major source could be reduced and tariff rates brought down significantly.

Fiscal policy reforms were aimed at curtailing unproductive expenditure and raising revenues. Taxation reforms have focused on simplification of tax laws and procedures, introduction of universal self assessment system in all taxes and promotion of a culture of tax facilitation, ,broadening the tax payer base, intelligent use of IT tools, Human resource development and Business Process reengineering.

On the expenditure side, subsidies provided by the government to meet the financial losses of the public enterprises were cut down by strengthening the management, granting them operational and financial autonomy and holding them accountable for results. Privatization of loss making enterprises also helped public finances positively. For example, nationalized commercial banks were a constant drain on the exchequer. After privatization the same banks are now yielding significant revenues in form of dividends and taxes. Banking sector, after reforms, has become one of the major tax paying sector in the country. The reduction in these subsidies led to savings in recurrent expenditure.

Financial sector reforms whereby the Government can issue medium to long term investment bonds have allowed the financing of long gestation development projects through this mode of borrowing rather than short term T-bills. The revenue generation stream from these projects can then match the maturity of the debt instruments.

It is obvious from the above discussion that Trade Policy Reforms could be successfully implemented only when the sequencing and phasing of other complementary reforms are carefully planned and that the probability of slippages is minimized. Credibility of reforms would be enhanced if there are no reversals. It also became apparent that the fear of the revenue authorities about the likely fall in total tax revenues as a consequence of lower tariff rates were highly misplaced. The leakages that were accruing to the unscrupulous tax collectors were diverted to the government revenues as the risk return relationship of tax evasion changed drastically under a liberalized trade regime. Second, the volume of dutiable imports expanded significantly due to the growth in the economy. The cumulative impact of both these factors was a Laffer curve predicted outcome whereby lowering of tariff rates generated higher custom duty collection.

Impact of Reforms on Growth and Poverty in Pakistan

Pakistan has been one of the fastest growing economies in Asia for last five years. Economic growth rates have risen from 1.8 percent in 2000/01 to average 6-7 percent a year. For Pakistan these rates are not spectacular but a reversion to mean. It may be recalled that the average annual growth rate of GDP over 60 year period of Pakistan has been 5.2 percent. Manufacturing sector output growth was over 15 percent, exports have doubled in US dollar terms in 5 years and an open trade regime has allowed imports to triple. Tax revenues have risen by 14 percent a year reducing fiscal deficit which used to average 7 percent a year in the 1990s to average 4 percent. External debt burden has been halved from 52% of GDP to 26% GDP and is projected to be on a declining path. The country's capacity to service its debt has considerably improved as debt servicing ratio which used to preempt almost 60 percent of public revenues is now down to 28 percent. Poverty incidence has fallen from 34 percent to 24 percent according to official estimates while 29 percent according to the World Bank. Unemployment rate is down to 6.5 percent from 8.4 percent

Despite these recent achievements there are a number of structural weaknesses in the economy. The dependence on a narrow band of low tech resource based manufactured exports to a few destinations, weak human development indicators, low average schooling of labor force, low domestic savings rate, energy shortages and poor governance are some of the constraints that have to be tackled on a consistent basis to fill in the gap that exists between the country's potential and actual output.

The year 2007 has not been a particular good year for Pakistan's economy. Political turmoil, the confrontation between the Executive and the Judiciary, International oil and commodities price hikes and inaction by economic managers have created stresses on the economy. Inflation rate has risen to 8 percent while food inflation is in double digits. Current account deficit has risen to over 5 percent of GDP. Fiscal deficit is likely to exceed the target. Energy shortages and more important wheat flour shortages in the early part of 2008 have made life hard for the businesses as well as the ordinary citizens. The uncertainty associated with the transition of power also slowed down flow of foreign investment into the country. It is expected that the incoming government will take decisive actions to tackle these issues and provide some relief for the poor. The economy has temporarily derailed from its tracks but there is no reason as to why it cannot be put back on the track with skilful management.

A study carried out by an independent research institute – the Social Policy Development Centre (SPDC) - using both partial equilibrium and the general equilibrium impact of trade liberalization and the simulations for the future concludes that, contrary to popular beliefs and perceptions, the process of trade liberalization in Pakistan does not appear to have had a significant adverse impact on poverty and income inequality. The results of the study indicate that trade liberalization has, if anything, reduced poverty and inequality although only modestly so on balance. The main channels of transmission leading to this outcome are growth, productivity, investment and price stability. Foreign direct investment that has come into Pakistan does appear to increase income inequality as it is highly skill and capital intensive and does not use much of the abundant factor of production i.e labour. This finding that FDI increased income inequality is also consistent with a recent IMF study on the impact of FDI flows to developing countries. Also some industries do seem to have suffered from trade liberalization but such restructurings in the transition period are a natural consequence of trade liberalization. An interesting and highly unique insight gained from the study was that trade liberalization has had some adjustment costs associated with it, in particular costs related to fiscal adjustments. Had the lower government revenue collection arising from a reduction in import tariffs been fully neutralized by other modes of direct and indirect taxation and development expenditures not fallen the impact of trade liberalization on poverty and income inequality would have been larger. Thus, trade liberalization policies should only be pursued in conjunction with government revenue-neutral policies.

It should also be realized that Pakistan's competitors have continued on path of liberalization while we seem to have stalled. According to WTO, simple average of applied tariff rates for Asean Countries ranges between 4 to 8 percent and these rates are being further reduced. More than forty percent of tariff lines of Pakistan have tariff rates exceeding 15 percent. Further reforms in tariff reduction will have to be carried out if Pakistan's exports are to grow. There is ample evidence to show that reduction in tariffs boosts exports since the tariffs act as an implicit tax on exports. Chile's exports in 1999 were $ 15.6 billion. By freeing up its imports from tariff duties (97% of its imports are now duty free) Chile's exports have jumped to $ 58 billion. Using the conclusions of the study by Stephen Tokanick it can be inferred that Pakistan could achieve a 16% increase in exports by removing its import tariffs. Pakistan's industry is still twice as much protected as Indonesia's and one and a half times as much as Sri Lanka. This high level of protection induces inefficiencies and makes Pakistani products less competitive in world markets. The increasing tendency of entering into bilateral free trade agreements and regional trading blocks would per force move towards zero or minimum tariff rates.

Lessons from Pakistan's experience

What are the generalized lessons learnt from the experience of policy reform implementation undertaken in Pakistan in the current decade?

Although the contours of these reforms were drawn in 1991 the pace of implementation picked up only after 1999. This became possible because the period 1999-2007 was characterized by continuity of the political regime compared to the period 1990-99 during which governments were dismissed or replaced five times and fresh elections were held three times. None of the major political parties differed on the broad thrust of the economic policies or reforms to be undertaken they remained mostly preoccupied with the issues of gaining and sustaining political power rather than implementation of economic reforms. The first lesson I would venture to offer is that domestic political stability is an indispensable prerequisite for continuity and consistency of economic policies and sustained implementation of reforms. The external shocks to the economy were almost identical in their intensity and penetration in the two periods. But what distinguished the performance was the response capacity to meet those shocks.

Economic policy makers have to make tough choices and trade-offs and select ingredients of different policy options to meet the objectives they have set for the economy. These policies affect the economy as a whole in a beneficial manner over time but hurt many groups or individuals in the process. For example, the objective of aggregate GDP growth may be attained but the initial benefits of this growth may be captured by those who already own capital, land and financial assets, those who run their own businesses or those who are already employed. Thus the consequences of this policy will affect various segments and classes of population in an uneven manner. It is the responsibility of the policy makers to inform the political leadership and communicate to the public at large as to what particular mix of instruments they are planning to use, what will be the intensity, magnitude and duration of this particular mix and what the consequences are likely to be. A neglect to communicate creates its own momentum of uncertainty that hardly helps the reform process.

The second lesson is that an effective communication strategy to inform the general public about the rationale and the consequences of the policies adopted is absolutely essential.

Even if an effective communication strategy is put in place, there is another reason as to why the impact of apparently benign looking policy reforms is not felt by a large number of target population i.e due to lack of coordination among different implementing agencies within the government. The turf battles, the silo-like vertical decision making process, the concealing of vital information and data from each other, the sense of one-upmanship, and the feigned attempts to please the bosses at the expense of other competing ministries are in fact kiss of death for both policy formulation as well as implementation. The subsequent blame game and pass-the-buck syndrome for the failures due to this lack of coordination and internal inconsistencies are hardly acceptable to the public-at-large or the political bosses themselves. Every ministry or organization responsible for the policies ends up appearing in a bad light.

It is hardly realized by those engaged in these bureaucratic turf battles and clash of egoes that in actual fact it is the policy mix rather than stand-alone, isolated or uncoordinated policies that will make the difference. The right policy mix requires timely cooperation, synchronization and collaboration among various ministries and agencies . Confrontational and adversarial attitudes are counter productive and would invariably result in poor policy formulation and even greater disasters during policy implementation. The expected benefits of policy reforms are thus dissipated creating further disenchantment and disillusion in the country. *The third lesson is that bureaucratic in fighting among the government ministries and agencies and turf battles are inimical to favorable outcomes of policy reforms as even well thought out and formulated politics are implemented unevenly and in a haphazard manner. Coordination and harmony among various implementing agencies in critical to success.*

The choice of the appropriate policy instruments would differ according to the objective assigned by the politicians. In a low inflationary low growth that characterized Pakistan in 1999-2002 period liberal monetary policy produced the desired results. Growth picked up, un employment rate dropped, poverty began to decline but inflationary pressures intensified. The policy makers therefore had to change the gears and pursue a contractionary monetary policy in the post 2004 period. The consequences of these reforms and the set of winners and losers under each of these two sub-periods of reforms were different. In the post 2004 era the fixed income groups and the poor suffered much due to high inflation rates. As monetary policy was tightened, nominal interest rates also shot up arousing the wrath of the earlier business community which was the main beneficiary of the liberal monetary policy regime. This simultaneous hue and cry by the losers from both ends of the spectrum raised doubts about the efficacy of reforms themselves. Rising international oil, food and commodity prices did not help the situation but in fact made it worse. The political fall out of such hue and cry could be disastrous for the sustainability of reforms. Dealing with the losers in a responsive manner is critical at implementation stage. *The fourth lesson is that policy objectives do not remain static and as domestic and external conditions change the policy objectives have to be modified. The losers under one set of policies can become the winners under a different set but they remain muted. So there are no permanent winners or losers under economic policy environment.*

In Pakistan which is a Federation of four provinces in which one province enjoys absolute majority of the population the macro economic policy reforms such as trade liberalization, financial sector restructuring, exchange rate policy, taxation reforms can be readily carried out by the Federal Government. But the second generation reforms where state institutions are involved in delivering public goods and services cannot succeed unless the provincial and local governments are in synch with the Federal Government. There are many instances where the Federal Government has encouraged investment in infrastructure or social sectors in the backward districts of the country but lack of cooperation by the local government functionaries has not allowed such investment to materialize. Law and order, security of property and lives, enforcement of contracts, labor laws, land allocation etc. are functions that are absolutely crucial for an investor to do business successfully. But all these functions fall under the purview of the Provincial and Local governments and the Federal Government cannot do very much except exhortation. The Devolution Reforms of 2001 which transferred some of the functions from the provincial governments to District governments have met fierce resistance in their actual implementation by the politicians as well as the bureaucrats. Consensus building among all affected stakeholders, striking compromises and safeguarding the interests of all those adversely affected by the reforms may slow down the pace but would lay the foundations for institutions that can deliver the results on a sustained basis. *The fifth lesson is that in the case of a Federation such as Pakistan a centralized approach to design and then push the reforms to the provinces and lower tiers of governments for implementation does not work beyond the first generation of macro-economic policy reforms. The benefits of the reforms will accrue only if proper institutions are involved at all tiers in the formulation and implementation process.*

Way forward for the future

How can Pakistan move ahead? I must admit that I am , by no means, fully satisfied with the trade policy reforms as much more needs to be done to liberalize further. This can be done by bringing down maximum tariff rate gradually from 25% to 15%, by reducing tariff dispersion and tariff escalation, by closing loopholes created by special exemptions other countries have not stood still. Tariffs in Pakistan, though lowered, remain high relative to East Asia, Latin America and ECA Regions. Remaining competitive in an integrated world economy is a very dynamic process. In the present world of globally fragmented supply chains the production process is broken into different stages and located in whichever country has the greatest comparative advantage in that particular activity. Tariff dispersion, tariff peaks and tariff escalation have to be rationalized so that Pakistan can participate in these supply chains according to its comparative advantage. FDI has spurred exports and integration in many countries but has by passed Pakistan's manufactured export production. It appears the returns on producing for domestic markets remain relative higher.

I must also underscore that trade policy liberalization per-se may not be sufficient and that there are other complementary policies such as improvement in the functioning of labor markets, in governance, availability of skilled and technical manpower, reliable and well functioning infrastructure facilities such as power, gas etc. that need reforms, investment and institution building. Too frequent changes in trade policy may undermine business community's long term decision making calculus. Therefore, while the road map and direction may be set for long term the present ritual of Annual Trade Policy cycle can be easily dispensed with.

Pakistan can benefit from greater trade and economic interactions with its buoyant neighbours China and India. Although China and Pakistan have entered a Free Trade agreement the trading relations between India and Pakistan have suffered a lot due to the historical political tensions. Pakistan has not accorded MFN status to India and operates on the basis of a positive list of goods and commodities that can be directly traded. The Pakistani authorities insist that non-tariff barriers imposed by India in the name of phyto-sanitary, environmental, safety, technical health and other standards should be removed. The more important barriers that need to be dismantled have to do with visa restrictions, trade facilitation, banking services, customs procedure harmonization, telecommunications, trading routes, transport links. The dismantling of these barriers will reduce the inefficiencies in the movement of goods and consequently the transaction costs of direct trading between the two countries. Despite the presence of high non-tariff barriers in India the gains from granting MFN status to India are considerable. Pakistan will not only be able to increase its exports by capturing share in a big market it stands to save substantially by substituting some of its imports from the rest of the world with India.

In fact, a study by SDPI has demonstrated that the likelihood of directing he informal trade taking place between India and Pakistan to legal channels is low under an MFN regime as existing tariffs would more than offset the net transaction costs incurred on the informal trade routes. It would take a substantial tariff reduction and a lowering of formal transaction costs to redirect informal trade to the more direct routes.

A study by Taneja estimated that the informal trade between India and Pakistan was about $ 2 billion annually in the early 2000s. By now this volume would have at least doubled. A State Bank of Pakistan study in 2005 estimated that on the basis of existing pattern of Pakistan's trade with the rest of the world and price structures, the total trade potential between Pakistan and India could be five times more than the actual trade that was taking place through formal channels. The potential exports from Pakistan to India could rise to around $ 2.5 billion (2004 instant prices) while the size of potential imports from India was about $ 2.7 billion. Allowing imports of items such as auto parts, light engineering goods, transport equipment, I.T. entertainment could result in savings in Pakistan upto $ 900 million.

South Asia is the least integrated region in the world. Attempts for promoting Regional trade through South Asia Preferential Trade Area(SAPTA) established in 1995 and South Asia Free Trade Area (SAFTA) that became operational since January 2006 have not borne much fruit. Under these arrangements direct trade in products like steel, aluminum, textile machinery, chemical products, pharmaceuticals will benefit both India and Pakistan as it is diverted from third countries. Sri Lanka can gain by purchasing cement and shipbuilding from Pakistan and India rather than South Korean.... According to some studies, the complete elimination of tariffs under SAFTA may increase the intra regional trade by 1.6 times of the existing level.

Studies have shown that SAPTA process has contributed very little in stimulating intra regional trade as it did not result in deep tariff cuts, the coverage of goods subject to preferential tariffs was not wide, some actively traded goods were left out from preferential tariffs and non tariff barriers were not considered for removal. As a result of this slow progress many countries have resorted to bilateral free trade agreements.. India-Sri Lanka, India-Nepal, Pakistan-Sri Lanka Free – trade agreements have become operational.

The South Asia Force Trade Area (SAFTA has also not been able to make much headway so far. Outside the MFN status issue for India by Pakistan and the Pakistani representation about NTB barriers erected by India Customs cooperation, Arbitration Mechanism for resolution of disputes, avoidance of double taxation, promotion and protection of investments are some of the ancillary issues that are holding up progress. Despite reduction of average tariffs, distortions will prevail in the form of high tariffs in particular products in some countries. The list of products on negative list and lack of clarity on the removal of NTBs provides ammunition to the policy makers to use them as a tool for foot dragging.

The argument that rigid factor markets in SAARC member countries make it difficult to restructure industries that will be hurt as a result of trade liberalization does not hold much ground.. If the countries are able to do so unilaterally why should they see this as a problem for liberalization under SAFTA.

I agree with the editors of the Economic and Political weekly when they say “It is for India to ensure that smaller members of the region have a growing stake in regionalism…. This responsibility India has not taken seriously”

But there are many other avenues of economic cooperation in the region besides trade which can result in win-win situation. India’s growing global economic position can have positive spill over effects for Pakistan, Bangladesh, Sri Lanka. in areas such as Information technology enabled services(ITES) and Business Process outsourcing(BPO), investment ,energy, and irrigation water.

India’s growing share in world ITES-BPO services market, Research and Development services and other knowledge based services sub-sectors can act as a magnet for other South Asia countries. The large pool of English speaking, educated. IT savvy youth available in Pakistan, Sri-Lanka, Bangladesh can supplement the Indian knowledge workers particularly at the lower end of the value chain. The shortages being felt by Indian companies and the rising wages can be offset by dipping into this large pool of employable workers. The Indian companies can train and mould them to suit their requirements and continue to obtain more outsourcing business from the advanced countries. The established brand name, the marketing prowess and the management skills in aggregation and integration available in India can be blended with the pool of trained workers in other countries to create a win-win situation. Indian workers can move to more high-end and high-skilled areas and value-added end of the production cycle. The standardized information processing packages, software platforms and programs, computer aided training kits have made this mobility possible., Pakistan has invested heavily in its tertiary education in the last six to seven years and there has been a manifold expansion in the number of institutions which can supply the manpower required by ITES-BPO companies in India for augmenting their exports. A top Tata consultancy services executive told me that he did not find much of a difference in the raw material of fresh IT graduates produced in Lahore and Bangalore. All he wanted to do was to train these young men and women in the particular mould of TCS skills and culture.

A SAARC Investment area can provide the nexus between trade and investment and attract foreign investors to make location decisions within the region free from cross-border frictions. Large bilateral trade deficits can be financed by investment flows on the capital account. In the world where horizontal and vertical linkages in the production processes have become important and the assembly of final product from components and parts fabricated elsewhere are common place South Asian industries will be able to meet competitive pressures if a common investment area is set up within the region.

Energy shortages in the two big countries of the region co-exist with abundant supplies available in other countries. Nepal, Bhutan and Bangladesh can meet the energey demands of India at law costs but these projects have been talked about for long but no tangible progress has been made so far. Industrial and agricultural development in India and Pakistan would be stalled and economic growth rates slow down if hydroelectric, natural gas, renewable energy sources available within the region are not tapped. Integrated energy market within the region with a network of grids, pipelines, transmission lines will be economically feasible only if appropriate pricing, delivery and institutional arrangements are put in place. A bunch of inefficient and bankrupt electricity supply companies or board owned and controlled by the public sector selling below the market cost of generation, transmission and distribution cannot make such market happen. The sale of these public monopolies to private sector would be even more disastrous. Only contestable market and vigilant regulatory body can make this happen.

India and Pakistan rely on irrigation. Both these countries as well as India and Bangladesh share common river systems. The Indus Basin works in the 1960s created an acceptable division of water rights between India and Pakistan. But the population pressures have put both countries in likely water stress category. Efficiencies and equitable distribution of benefits can be achieved if the irrigation systems commanded by common rivers can be managed on a pan-territorial basis. Game playing whereby dams, reservoirs, storages, diversions are mindlessly put to stake the claims by one party or the other is only going to further muddy the waters.

To conclude, let me say that the thrust of policy reforms in Pakistan has broad political support from all major parties and these are likely to continue. The only difference would be that these reforms would be accompanied by greater sensitivity and attention to the issues of poverty, employment and income and regional inequities. As the credibility of Indian policy reforms was enhanced when the BJP Government continued the policies of Congress after coming to power in the late 1990s I am sanguine that the change in the government in Pakistan in 2008 will have the same effect.

Summary of Trade Regime in Pakistan 2006-07

Exchange Rate	Unified.
Exchange Rate determination	Free float
Payment Convertibility	
Current Account	Yes
Capital Account	
Import restrictions	
General Import licencing	No
QRs on imports	abolished
State import monopolies	None
Tariff structure	
Top normal Custom duty rate (CD)	25
Other normal protective taxes	-
Top normal protection rate	25
Average custom duty rate	14.5
Import weight average tariff rate	8.0
Number of normal CD slabs	6
Number of CD slabs > normal	7
Range of CD slabs >	25.90
% of ad velum tariff slabs >	0.1
% of tariff lines with specific duties	0.7
Use anti dumping	yes
percent tariff lines bound at WTO	98
Average of bound tariff rates.	61.3
Export policies	
Export QRs	None
Export taxes	No
Direct export subsidies	6% for R & D
Indirect export subsidies	Yes
Trade openness	
Trade GDP ratio %	34

REFERENCES

1. Berg, A and A. Krueger (2003), "Trade, Growth and Poverty: A Selective Survey" Washington D.C. IMF Working Paper 03/30.

2. Din, Muslehud E. Ghani and O. Siddique (2003) "Openness and Economic Growth in Pakistan" Pakistan Development Review 42(4): 795-807

3. Dollar, D and A Kray (2002) "Growth is Good for the Poor" J. of Economic Growth 7(3): 195-225

4. Edwards, Sebastian (1998), "Openness, Productivity and Growth; what do we Really Know?" Economic Journal 108(147) 383-98

5. Frankel, J. and D. Rome (1999) "Does Trade Cause Growth?" AER 89(3): 379-99

6. Green away D, W. Morgan and P. Wright (1997) "Trade Liberalization and Growth in Developing Countries. Some New evidence" World Development 25(11): 1885-92

7. Harrison, Anne (1996) "Openness and Growth: A Time series cum-country Analysis for Developing Countries" J. Development Economics 48(2) 419-447

8. Husain Ishrat (1999) Pakistan. "The Economy of an Elitist State" Karachi, Oxford University Press.

9. Husain Ishrat (2003) "Pakistan's Export Competitioness in Global Markets" in Key Issues in Pakistani economy (Karachi), State Bank of Pakistan).

10. Husain Ishrat (2003) "Economic Management in Pakistan 1999-2002" Karachi: Oxford University Press

11. Iqbal, Zafar and G.M. Zahid (1998) "Macro economic determinants of Economic growth in Pakistan" Pakistan Development Review 37(2): 125-48

12. Khan, Shaheen Rafi et al (2005) Quantifying Informal trade between Pakistan and India(Islamabad, SDPI)

13. Kemal, A.R.: et al (2002) "Exports and Economic Growth in South Asia" A Study prepared for the South Asia Network of Economic Research Institutes.

14. Kemal A.R. et al (2003) An assessment of the impact of Trade Liberalization in Welfare in Pakistan (Islamabad: MIMAP, Technical Paper Series 16, PIDE)

15. Khan, Ashfaque (1998) "The Experience of ?Trade Liberalization in Pakistan" Pakistan Development Review 36(4) 661-83

16. Khan, A.H. et al (1995) "Exports, Growth and Causality" Pakistan Development Review 34(4): 1001-1012

17. Khan, M.A and A. Qayyum (2007) "Trade Liberalization, Financial Development and Economic Growth:" Pakistan Institute of Development Economics Working Paper 2007:19, Islamabad.

18. Krueger, Anne (1998) "Why Trade Liberalization is good for Growth?" Economic Journal 1513-1522

19. Mamoon, D and S.M. Murshed (2006) "Trade Policy, Openness, Institutions", Pakistan Development Review 24(1)" 99-110

20. Mohsin, M.H. et al (2001) "Impact of Trade Reforms on Poverty" PIDE 16th Annual General Meeting: Islamabad

21. Panagariya, Arvind(2006) India and China: Trade and Foreign Investment, A paper read at Stanford Conference on Economic reforms

22. Ravallion, Martin (2001) "Growth, Inequality and Poverty: Looking Beyond Averages" World Development 29(11): 1803-15

23. Rodriguez, F. and D.Roduk (2000) "Trade Policy and Economic Growth" Macro economics Annual 2000, Ben Bernanke and K.Rogoff (eds) MIT Press for NBER

24. Sachs, J. and A. Warner (1995) "Economic Convergence and Economic Policies" Brookings Papers on Economic Activity 1-1-95.

25. Social Policy Development Centre (2006) "Trade Liberalization, Growth and Poverty" Karachi, SPDC.

26. Taneja, Nisha (2006) "India - Pakistan Trade" ICRIER Working Paper 186(New Delhi, ICRIER June)

27. Winters, A et al (2004) "Trade Liberalization and Poverty" The Evidence so far." J. Economic Literature 43(1) 72-115

28. World Bank (2004) "Trade Policies in South Asia: An Overview" (Washington D.C. , World Bank Sector Report 29949)

29. Yanikkaya, H (2003) "Trade Openness and Economic Growth" J. Dev. Economies 72(1): 57-89.

30. Yasmeen, B.et al (2006) "Trade Liberalization and Economic Development: Evidence from Pakistan" The Lahore Journal of Economics 11(1): 19-34