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India-Pakistan trade

[*Ishrat Husain*](http://thenews.com.pk/TodaysPrintWriterName.aspx?ID=9&URL=Ishrat%20Husain)Thursday, March 24, 2011

Economic theory and empirical evidence have clearly established the links between trade, productivity and economic growth. Countries that have large internal markets have also benefitted from integrating into the world economy and opening up their economies. World trade in 2009 amounted to $12 trillion. The size of Pakistan’s domestic market is only $180 billion. Even a 0.5 percent share in the global export market implies that our exports could rise to $60 billion. Imagine the jobs that will be created directly or indirectly as a result of expansion in the production of exportable items. On the other side, imports bring into the country the transfer of technology embedded in imported goods and services and raise the country’s production possibility frontier. Thus, it follows that increased trade is in the larger economic interest of the country.   
  
It is also becoming quite obvious that the balance of economic power is moving away from developed countries to developing countries. China has overtaken Germany to become the largest exporting country and surpassed Japan to become the second largest economy in the world. China and India are projected to be the two fastest growing economies of the world over the next several decades. Pakistan is blessed by its location being neighbour to both these large economies. Our national economic interests dictate that we should expand our trading relations with both these countries and penetrate their markets.   
  
The question then arises: Will expansion of trade with India bring benefits to Pakistan or would we be swamped by our big neighbour? A lot of myths and misperceptions on this point need to be explored. India-Pakistan trade is a win-win situation. India has a middle class of about 300 million people with rising purchasing power that matches that of South Eastern Europe while Pakistan’s middle class is approximately 30 million. A 10 percent penetration into the Indian middle class market would double the market size for Pakistani companies and businesses.   
  
All studies on India-Pakistan trade have so far demonstrated that the relaxation of constraints in the way of bilateral trade would benefit both the countries. State Bank of Pakistan study in 2005 estimated that the volume of trade could rise five times from the actual one billion dollars. An ICRIER study showed a much higher volume - about $10-11 billion (Pakistan 55 percent textiles; India 90 percent non-textiles). Net welfare gains are positive in every single scenario - conservative to optimistic.   
  
Trade will lead to some limited specialisation and trade in intermediate inputs for use in exports to high income countries. Granting MFN treatment to India would bring gains to Pakistan and an FTA would generate even larger benefits.   
  
At a highly disaggregated level it was found that there are 2,646 common items of Pakistan’s imports that India exports worth over $15 billion. For half of these items, the unit value of Pakistani imports is more than the unit value of Indian exports. Pakistan can import these items cheaply from India. At the same time 1,181 items worth $3.9 billion are common between India’s imports and Pakistan’s exports. About 70 percent of these common items have unit values less or equal to the Indian import unit value. This suggests that these exports from Pakistan can be supplied to India at a lower cost than what they are getting from other countries.   
  
It should also be kept in mind that bilateral trade balance with any particular country does not have to be positive. There would be no trade in that case. Pakistan would run a trade deficit with India just as it does with China and surpluses with others. India is a larger, more diversified economy and also produces goods that Pakistan exports. The determining factor is whether the cost of imports from India is less than comparable quality imports from other sources. In that case both our local industry and consumers would gain.   
  
If the empirical evidence is so strong why is trade between the two countries so low - less than one percent of Indian exports and less than five percent of Pakistani imports. The volume of bilateral trade has not exceeded two billion dollars (the total volume of Indian and Pakistani exports is around $200 billion).   
  
There are three main reasons that have impeded the growth of trading relations: (1) political relations between the two countries have remained discordant and contentious over a long period of time. A trust deficit does not allow stability which is a pre-requisite for any exchange of goods and services to take place, (2) both countries have, until recently, pursued import substitution policies that protected local industry behind protective barriers, (3) the commitment to regional economic integration in South Asia has remained quite weak. Even in face of bilateral political disputes it is possible to promote trade within a regional preferential trading area framework. This has not happened in South Asia.  
  
These constraints can be relaxed. Countries with adverse political relationships, without giving up their principled stand on disputes and differences, have engaged in cross border investment, trade and movement of people. Over time these activities have helped in fostering better understanding of each other’s view points. Confidence building measures and creation of stakeholders in the countries can eventually defuse the tension and soften the ground for peaceful resolution of disputes and disagreements.   
  
It is therefore not right to wait for resumption of economic relations until the bilateral political disputes are resolved. If economic engagement is fierce, it is most likely that the hawks in each country will be confronted by the new stakeholders who are benefitting from such engagement and without giving up their respective positions while carrying out the composite dialogue. Resumption of economic relations should be allowed without any pre-conditions and without the countries giving up their respective positions. Composite dialogue should carry on at the same time to resolve the disputes and disagreements.  
  
On the second constraint, it is heartening that both India and Pakistan have opened up their economies, abandoned the old Import Substitution policies and embarked upon a process of integration with the world economy. The reforms they have carried out, such as cutting tariff rates, elimination of QRs, regulating duties, para-tariffs which leave them in a much better position to pursue preferential liberalisation.  
  
To be continued  
  
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Pakistan and India signed SAFTA in January 2004 – which came into force in January 2006. SAFTA is aimed at reducing and eventually eliminating tariff barriers, facilitating cross-border movement of goods, promoting fair competition in the region and creating an effective framework for regional cooperation. But the agreement is still hindered by fairly restrictive sensitive lists, strict rules of origin and a slower time frame and scope.   
  
Regional Trade Agreements like SAFTA will have positive effect on growth, trade, technological diffusion and foreign investment. Trade within the region will unleash new technology, lower domestic prices, provide new technology and usher in economics of scale in production and distribution as the effective market size expands. Joint ventures in pharmaceuticals, chemicals, petrochemicals, automobiles, agro processing, technology transfer arrangements among IT firms, and joint gas pipeline projects are some of the possibilities that can take place within SAFTA if harmonisation takes place.   
  
India – a much bigger economy accounting for more than 80 percent of Gross Regional Product, imbued with self-confidence and aspirations to become an economic power – should demonstrate a greater degree of generosity instead of insisting upon reciprocity. A wider offer to its neighbouring countries in terms of opening up the markets and trade and removing barriers to mobility would be of ultimate benefit to India. It is advisable for India to establish asymmetric relationships with its neighbors and provide more concessions to them and expect less from them in return.   
  
Given the large and growing size of its effective market the economic losses to India would be miniscule while political good will and returns would be substantial over time. Pakistan, Bangladesh, Sri Lanka will be much better off economically if they are able to penetrate the buoyant Indian market. Friendly, peaceful and irritant-free neighbours would aid rather than hinder India in moving towards its long term goals. A region with the highest number of people living below the poverty line would surge ahead.   
  
Recommendations:   
  
What needs to be done in practical terms to open up bilateral and regional economic cooperation. While India and Pakistan should continue the dialogue to resolve the core political issues they should start by focusing on non-political constraints that will promote bilateral trade. Businessmen of the two countries will then take care of the opportunities that will present themselves.   
  
• Pakistan should grant MFN treatment to India while India should reduce its tariffs on agriculture commodities, textiles and other goods that are of potential value to Pakistan.  
  
• Both countries should reactivate SAFTA and agree on a phasing out of the sensitive list over next few years. A restrictive list would nullify all the potential gains of preferential trade access.  
  
• Technical barriers to Trade (TBT), Sanitary and Phyto Sanitary Measures (SPS) that are in fact, acting as powerful deterrents to exchange of goods should be rationalized and simplified. These are, in fact, non-tariff barriers that hinder the flow of goods.  
  
• Trade facilitation through expeditious border crossings, new border crossings, quick custom clearance, telecommunication, improved transport links, shipping protocols, easing visa restrictions for businessmen should be carried out immediately. Railway, air and road connections between the two countries should be increased.  
  
• Governor Reddy and I had signed an agreement for opening of branches by two Indian banks in Pakistan and two Pakistani banks in India in 2005. This agreement has not yet been implemented. Without banking services, opening of letters of credit, cross border transactions of funds, trade cannot take place.  
  
• Domestic tax, tariff and subsidy policies that distort incentives for production and trade should be substituted in both the countries by more neutral policies.  
  
• Institutions to manage and facilitate trade integration such as setting standards, quality control, technical regulations, material testing should be strengthened and made user friendly.  
  
• Harmonisation in legal regulations for investor protection, contract and IP Rights enforcement, labour relations, would promote relocation of industries within the region as the expanded market size and mobility of goods and services would result in economies of scale. Locations for inputs, components, raw materials with low transaction costs would confer comparative advantage to final finished goods.  
  
Let us recall that the 2006 composite dialogue had on its agenda resumption of Rail Service between Khokhrapar and Monabao, bus service between Srinagar and Muzaffarabad, religious visits to Lahore and Nankana Sahib, new shipping protocol, deregulation of air services and joint registration of Basmati rice.   
  
The above outlined measures, if implemented sincerely, can open a new vista for the two countries in the 21st Century. It is high time political leaderships of India and Pakistan demonstrate courage and conviction.  
  
  
  
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