6 IMPLICATIONS OF TRADE LIBERALIZATION WITH INDIA

Pakistan and India are the two most populous and largest economies in South Asia. The current status of trade is not reflective of any remarkable progress as total volume of trade between the two countries remained at a low level during the past five years ending FY04. The liberalization of bilateral trade between the two countries would not only lend impetus to the integration of both the economies but would also be seen as a good omen by the other nations as well. With political and economic stability, India and Pakistan can expect fresh foreign investment coming into these countries. Cheaper cost of production, skilled labor, educated middle class, female literacy, booming economy, vital US and European interest in the region can change the fate of many people of the sub-continent in a span of 5/10 years' time.

There is an enormous potential for increasing trade flows between India and Pakistan. As compared to the average trade flows of $415 million during FY 2000-01 to FY 2004-05, the estimates of trade potential range from $1.85 billion to $10.0 billion. However, part of such flows would certainly be the conversion of existing trade now routed through third countries into direct India-Pakistan trade, as well as the formalization of trade flows currently smuggled across the border.

Advantages of Trade Liberalization for Pakistan

Higher Economic Growth

Trade liberalization can lead to higher economic growth. Gains in total factor productivity achieved through the economies of scale and enhanced efficiency are likely to translate into higher growth of potential output. In addition, a liberalized trade regime is likely to attract FDI, as an economy with larger access to regional markets becomes more attractive to foreign investors. Higher FDI, in turn, may lead to increased technology transfer and total factor productivity. Moreover, trade liberalization can be seen as part of the broader process of regional integration, which may foster closer relations between India and Pakistan.

The potential advantages of trade liberalization for Pakistan appear to be large**.** Going well beyond the immediate creation of trade flows, the advantages of dismantling tariff- and non-tariff barriers include the potential for boosting productivity and economic growth, and can also extend to promoting regional cooperation in all areas. The lowering of trade barriers can create trade flows which will increase economic efficiency, in product groups currently being produced in Pakistan. Similarly, the lowering of trade barriers will create new export opportunities for Pakistani products in other SAFTA member countries. Consistent with other gravity models that assess the impact of free trade agreements (see Frankel 1997, for a general review), the study conducted by Eugenia Barroncelli confirms that the presence of system of regional preferences induces higher flows of imports among partner countries vis-à-vis non-members.

Regional cooperation is likely to have a positive and statistically significant effect on total Pakistan-India bilateral trade. At the aggregate level, by entering a preferential trade agreement such as SAFTA, the model estimates Pakistan and India could increase their bilateral trade by 79 percent.[66]

Access to Larger Markets

Pakistani producers would lose due to falling consumer prices, but gain due to access to larger markets and possible efficiency boosts. As a main disadvantage for producers, trade liberalization is expected to lower prices of imported products, and Pakistani firms competing with those imports are likely to face decreasing profit margins. By contrast, trade integration will allow producers to access a much wider market, allowing for greater efficiency in production by exploiting economies of scale in production, thereby boosting productivity. In addition, since freer trade provides entrepreneurs with an incentive to explore new export opportunities and to compete more fiercely with imports, trade liberalization can lead to efficiency gains through learning and innovation. Finally, like consumers, producers would also benefit from increased reliability of power supply that may materialize if trade in power is liberalized.

Benefits to Pakistani Consumers

Trade liberalization will unambiguously benefit Pakistani consumers, when product prices will fall and consumer choice will increase with reduced trade barriers. Importing from India rather than from more distant locations would imply lower transportation costs. These, as well as lower tariffs, would be largely passed on to consumer prices if there is sufficient competition among suppliers. In addition, in agriculture, price volatility could decline, as at times of unforeseen shortages in local production, access to Indian production could help smooth out price spikes. Pakistani consumers could also gain from liberalized trade in power, as the reliability of power supply could increase. In textiles, lower prices would be expected to have a beneficial income distribution effect, as lower income households spend a higher share of their income on textiles. For upper income groups, access to high-quality Indian silk products would imply an increase in consumption choices. In engineering goods, consumers may

[66] Barroncelli, in Naqvi and Schuler, 2006.

benefit from lower prices for cars, motorcycles and bicycles, as well as access to Indian products.

Welfare Gains from Trade in Wheat and Sugar

Food grain production, in general, and production of wheat, in particular, carries great significance in the agriculture sectors of Pakistan. Similarly, sugar industries have an important contribution to the GDP in both Pakistan and India. The partial equilibrium analysis to simulate welfare implications of trade between India and Pakistan under the three scenarios, i.e. FTA, SAFTA and MFN regimes, reveals that while there would be net gains from trade to both countries, the highest welfare gains would accrue to both countries under free trade agreement (FTA).[67] The study reveals that there is no clear comparative advantage to either India or Pakistan in wheat trade. Unlike Pakistan, India maintains huge subsidies to its farmers. If subsidies to Indian farmers are removed, their comparative edge will disappear in favor of wheat farmers in Pakistan. Trade under FTA would be beneficial to both countries mainly coming from savings in the form of subsidies (exports/imports subsidies). For 2004-05, Pakistan would save Pak Rs 1.6 billion in subsidies resulting in a total welfare gain of Rs 2.1 billion to its economy. The Indian Government would save Rs 10.7 billion in export subsidies. Therefore, as part of SAFTA negotiations, Pakistan should negotiate the phasing out of distortions in the agriculture sector.

In case of trade in sugar, the study simulate that if Pakistan had a sugar deficit in 2000-01 and sugar import from India were allowed, Pakistan would have net welfare gain which was highest under an FTA regime with India (Rs 2.42 billion), followed by SAFTA (Rs 2.3 billion), and finally by granting MFN status to India (Rs.766 million).

Generate Higher Customs Revenue

The Pakistani government would gain in terms of customs revenue. Increased trade flows that stem from the lifting of import prohibitions from India and diversion from informal to formal trade would generate additional customs revenue for Pakistan. By contrast, to the extent that existing tariffs are lowered, there would be corresponding losses in customs revenue. However, as the existing trade flows are much lower than the potential for such flows, the former effect would almost certainly dominate the latter. In addition, to the extent that trade integration increases the likelihood of the construction of a gas pipeline from Iran or Afghanistan through Pakistan to India, the government could then get profit from transit fees, estimated in the order of US $500–700 million.[68]

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[67] Burki, Khan and Hussain, in Naqvi and Schuler, 2006.

[68] Lama and Kemal, 2003; IMF Country Report Pakistan, December, 2004.

Regional Protection

Economic relations between countries are changing fast because globalization and WTO are making such changes compulsive. More and more developing countries are seeking to boost their economies through larger exports and regional trading blocs. There are too many examples in the modern world of economic cooperation and cultural exchanges between political rivals leading eventually to a political settlement. A classical example of economic cooperation and cultural exchanges overriding political disputes can be seen in the relationship between the Soviet Union and the US and the West as a whole. They traded with each other amply despite their cold war rhetoric. Later, the same pattern was witnessed between China and the US and other Western countries. In Asia, China and India, putting aside their major territorial disputes, are promoting economic and political cooperation and even having joint military exercises. Viewed against this background, initiation of a program of greater collective cooperation between the two large economies of the region could serve as an appropriate response to counter the adverse effects of emerging trading /economic blocks in the industrial world. It can make SAARC a vibrant organization thus making it more competitive for other regional blocs like ASEAN, NAFTA, and the EU to ponder upon the strength and prosperity of the region. This would also enable both countries to get better bargaining position vis-à-vis other countries. Within the protective walls of regional economies, both countries can achieve specialization in various sub sectors of industry. Moreover, the strengthening of bilateral/regional trade would also provide a cushion to the economies of both countries from the financial or stock market shocks.

Joint Ventures and Transfer of Technology

India had achieved remarkable development and growth in the span of just 12 years since the advent of economic reforms. There is no denying the fact that the technological base of India is quite advanced. Pakistan, on its own part, has also made a modest progress in agricultural and industrial fields. Both countries have made a remarkable progress in their perception management strategies for the outside world. At present, joint ventures between the two countries are non-existent, and so is direct investment. While India and Pakistan compete to sell their goods in the global market, there are many areas in which both the countries can complement each other's needs and hence produce cost-effective quality goods. Both the countries, besides, promotion in trade and industry could also look forward to industrial cooperation and sharing of technology and establishment of joint ventures in some potential sectors, i.e. information technology, drug pharmaceuticals, fish processing and dairy products, chemicals, agro chemicals (pesticides), automobiles and spare parts, etc. In addition, India and Pakistan can establish joint ventures to harness and transmit the region's hydropower resources. Cooperation in water management and hydropower projects can help in increasing irrigation benefits, decreasing risks of floods, and establishing an India-Pakistan electric grid system for intra-country transmission of electricity. The infrastructure and other facilities provided in the Export Processing Zones could be utilized to establish joint ventures, which in turn would augment the transfer of technology and manpower to each other. The industry of both the countries will benefit by exchanging expertise, knowledge and technical know-how.

Transit Trade

Pakistan holds potential as a feasible and viable transit route for the international trade of land-locked Central Asian Republics, Afghanistan and Chinese provinces bordering Pakistan. Realization of this potential could mark an impressive addition to our economic capacities. Pakistan as a transit state has to look far beyond just the presently perceived Indian comparative advantage. A bulk of what Pakistan trades in the future with India will emanate in Iran, Qatar and Central Asia. Granting of transit rights will open up huge markets for India in Central Asia and for Pakistan in the South Asian countries.

Enhanced Efficiency

Since trade liberalization with India entail tariff restructuring, it is likely to bring efficiency in the domestic industries as the reduction in protection to the domestic industry would force them to restructure in the face of greater competition. Promotion of investment by the Indians in Pakistan can add to such competition in the export oriented industries.

Social Benefits

Trade is an area that will have economic as well as social benefits for both countries and their people. There are about 373 million people in both India and Pakistan who are living below poverty line out of the total population of about 1.20 billion people in both countries. According to ADB’s annual report, the experience of five Asian countries - China, India, Thailand, Pakistan and Vietnam - reveals that poverty is a challenge that can be overcome if states pursue "sustained pro-poor" policies. India is a huge market second to China. Free trade will provide smaller economies like Pakistan access to new market and increased demand for their products which in turn will raise output and employment levels and contribute to their prosperity. Continued strong growth in the two large low-income countries will reduce global poverty, serve as an incentive to other developing countries and benefit the world economy as a whole.

Savings Foreign Exchange

Imports from India will cost less because of low freight costs and easy accessibility of the market which could save country's foreign exchange substantially. India has a well diversified exports structure and also produces internationally reputable products in sectors like chemicals, IT and consumer electronics and transport equipment. Consumers in Pakistan can benefit from a wide variety of items in such sectors.

Curb Smuggling

Unofficial trade between the two is substantially higher than the official trade, which is depriving the exchequer of huge revenues. Both countries failed to achieve any significant gains as the advantage is passed on to corrupt elements and Mafia, who thrive on smuggling, illegal border trade, transit through third countries, personal baggage in connivance with customs officials, etc. at both the ends. Legalized trade, therefore, will be favorable to Pakistan mainly because it will reduce smuggling and increase government revenue besides providing us vast market across the border.

Reduction in Defense Expenditure and Peace Dividend

Pakistan and India have a long history of armed conflict over the Kashmir issue. Super power rivalries, regional conflicts and internal instabilities in the developing countries including Pakistan provided a justification to increased spending on defense. India and Pakistan are heavily relying on external assistance to finance their defense expenditures. An adverse effect of the heavy expenditure in defense and debt service has been that a very small amount is left for other important sectors of the economy viz. education, medical health, etc. By diverting some part of savings from military spending to productive investment, the country could be able to raise its rate of growth substantially. More commerce between India and Pakistan will enhance the political and economic space to deal with differences. Healthy trade relations between the two nations would ultimately pave the way for the settlement of political dispute, which in turn, would facilitate a negotiated mutual reduction in military expenditures resulting in peace dividends for two impoverished countries. During 2004-05, Pakistan spent 3.1 percent to 3.5 percent of GDP, and India 1.5 to 1.7 percent of GDP, on defense. Eugenia Barroncelli finds that the trade gains from peace would have resulted in a 405 percent increase in bilateral trade between the two partners. The model predicts that, in the absence of war, trade would have been $591 million in 2000 against the recorded trade flows of $117 million in that year; a peace dividend of $474 million. Assuming the informal trade in 2000 was at about the same level as recently estimated at $535 million for 2005; total bilateral trade may have been around $652 million. The peace dividend computed on this higher base trade flow is estimated at $2.6 billion. Total potential trade in 2000 could therefore have amounted to $3.2 billion.[69]

Promotion of Tourism

Promotion of tourism is another area of mutual cooperation and benefit. Pakistan offers great untapped potential for development of tourism in its Northern and coastal areas. Besides, a lot of historical and religious places exist to attract the tourists. Tourism has been given the status of industry in Pakistan and offered fiscal and tariff incentives. This is an area where we can benefit from the experience of highly developed tourist industry in India and seek collaboration for developing tourism industry in Pakistan. But all these require liberal visa facilities for both businessmen and tourists. In this regard introduction of railway passengers booking between important cities of the two countries, extension of transit visa facilities and easing of policy in respect of reporting procedures on short visits and greater liberalization of travel facilities would not only facilitate people-to-people contact between the two countries but also generate additional foreign exchange earnings.

Cultural Cooperation

On public level, relations between Indians and Pakistanis are usually very cordial and friendly. Most recently there have been frequent visits of artists, delegation of trade bodies, social scientists, academics and information media personnel between the two countries who have been extended very warm welcome. Promotion of trade and economic activities would also enhance cultural and educational exchanges, which could help in reinforcing the fabric of our bilateral relations. Both the countries have a large number of common game events and frequent visits of their teams will greatly improve social and cultural relations.

Harmony in Political Relations

Improved trade relations with India are likely to enhance Indian interest in the region and may motivate India to agree for the gas pipeline through Pakistan. India, which is deficient in energy, has been reluctant in having the pipeline through Pakistan for various political reasons. It is likely to bring substantial improvement in political situation which in turn would bring more economic benefits to both India and Pakistan.

[69] Barroncelli, in Naqvi and Schuler, 2006.

Concerns and Threats

The benefits of trade with India must be weighted against the costs inherent in certain apprehensions about competition from India which has been feared in the past for a number of reasons. Some studies conducted so far, have identified three potential areas of Pakistan's economy, i.e. agriculture, textiles and engineering sector that would be affected following its trade liberalization with India.[70]

Despite liberalization, India's trade regime still remains more restricted than Pakistan in terms of both tariff and non-tariff barriers. Prohibitive non-tariff barriers in India have made Pakistan's exports to India unattractive. Though some trade barriers exist in Pakistan and MFN status has not been granted to India, however, Pakistan can consider granting the MFN status in case the trade barriers particularly the non-tariff barriers imposed by India are minimized.

A large part of the resistance in Pakistan comes from the country's business community who feel that the higher cost of production in a relatively smaller economy in comparison to India will make them vulnerable to tough competition. Though low transport cost from India will provide the Pakistani consumers cheaper products, however, it is also likely to reduce the natural protection of Pakistan's domestic producers. The decision to relax trading links with India should have to be in stages, only opening up sectors first where Pakistani businesses and industries do not feel threatened on a large scale.

There is a general apprehension in the business community in Pakistan that the opening up of trade will adversely affect our industries particularly the textiles, automobile and some other industries in which Pakistan is not so competitive in terms of prices. The decision to liberalize the trade will need to be made keeping in view the developmental stage in different industries. For example, in case of automobile industry, we may prefer to import automotive components and spare parts from India instead of importing complete assembled cars which are much cheaper in India compared to Pakistan.

[70] IMF, 2004; PILDAT Briefing Paper, the South Asia Free Trade Area (SAFTA): Advantages and Challenges for Pakistan, February 2004.