1 INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

Recent times have seen a renewed emphasis on improving upon the economic and commercial relations between Pakistan and India. In particular, the liberalization of trade between the two countries has become a growing issue at both regional and bilateral level meetings. The global trend of regional economic cooperation which has rapidly gained importance in the last few years has remained strong and persistent because globalization and the World Trade Order (WTO) are making such changes necessary. However, when it comes to South Asia, the situation is disappointing because intra-regional trade has remained stagnant at less than 2 percent of the total trade in the last twenty-five years. Similarly, bilateral trade between Pakistan and India, the two largest economies and trading nations in the region, is also not reflective of any remarkable progress given the history of acrimony between the two countries.

This study attempts to examine the issues concerning the move towards liberalizing trade with India and prospects for investment in Pakistan in an economic perspective. The book is structured as follows: Chapter 1 constitutes the introduction and executive summary; Chapter 2 reviews the structure of Pakistan's trade with India through various channels, along with a comparative analysis of product diversification and spread of exports in both countries. In addition, Pakistan's trade policy with India, tariff and non-tariff trade barriers in both countries and the issue of granting the Most Favored Nation (MFN) status are discussed. Chapter 2 also undertakes a detailed analysis of Pakistan's exports and imports in comparison with Indian imports and exports (based on the 8-digit level HS Code) with a view to assess a list of potential items for mutual trade. Chapter 3 elaborates Pakistan's foreign investment policy, potential areas of mutual cooperation between Pakistan and India through Multi-national Corporations (MNCs) and Indian based investors, as well as the role of Non-Resident Indians (NRIs) in Indian investment. In this regard, opportunities and threats in some important sectors which are likely to emerge by the opening up of trade between the two countries are covered in Chapter 4. These sectors include Textiles and Clothing, Iron & Steel, Chemicals & Pharmaceuticals, Automobile, Small & Medium-sized Enterprises and Information Technology. Chapter 5 examines in detail the aspect of trade liberalization between Pakistan and India in the regional perspective and the implications of the South Asian Free Trade Agreement (SAFTA) on Pakistan. Chapter 6 highlights the implications of liberalizing trade with India and the main findings and conclusion are discussed in Chapter 7.

Executive Summary

Trade Integration between Pakistan and India

Pakistan and India are the two most populous and largest economies of the South Asian Region. However, official bilateral trade remains negligible and neither country falls in the category of top ten trading partners of each other partly due to their history of being relatively closed economies. India's foreign trade openness remained low at 31 percent than 38 percent for Pakistan and the average for South Asia (65 percent) and ASEAN countries (144 percent) in 2003.

India's share in Pakistan's total exports remained less than one percent, whereas in total imports, it fluctuated within a narrow range of 1.36 to 2.66 percent during the last five years (FY01-05). Pakistan's share in India's total exports averaged 0.45 percent whereas in imports it constituted only 0.11 percent during FY 1999-00 to FY04. Compared to the actual trade worth $476 million in FY04, the potential of bilateral trade based on FY04 data has been worked out at $5.2 billion in the SBP study. This can be compared with other estimates of $1.85 billion in a World Bank study, using fixed effects gravity model of bilateral trade based on 2001 data, $6.5 billion in the Indian Council for Research on International Economic Relations (ICRIER) study of December 2004, using the augmented gravity model specification, and the informal estimates at around $10 to $15 billion quoted in the Karachi Chamber of Commerce & Industry (KCCI) report of March 2004.

The informal trade between Pakistan and India is estimated at $1.5 to $2 billion which is being carried out through exchange of goods at the Indo-Pakistan border, the misuse of the personal baggage scheme through "green channel" facilities and Afghanistan. Trade through third countries or circular trade is mainly conducted through agents operating in free ports like Dubai or Singapore and the Central Asian Republic (CAR) countries. The size of circular trade underlines the potential of flourishing bilateral trade between the two countries.

Pakistan's Trade Policy with India

Pakistan has adopted a conscious strategy to gradually open trade with India, particularly in sectors in which it is not so competitive. While Pakistan allows all kinds of exports to India, it had maintained a positive list of 687 items which were officially importable from India. In pursuance of the South Asian Preferential Trade Agreement (SAPTA) negotiations, the positive list of importable items was expanded by 81 items to a total of 768 items and further to 773 items in February 2006. On the other hand, India does not impose equivalent formal restrictions on exports to or imports from Pakistan, but other restrictions (e.g. on travel, remittances, banking, customs clearance) are generally believed to have a similar effect, especially as regards imports. In order to protect domestic industries in India, it also maintains a list of "Sensitive" consumer goods, imports of which have been regularly monitored by the Ministry of Commerce, India.

Since the establishment of SAPTA, Pakistan and India have moved gradually towards liberalizing trade with each other. The total number of items on which Pakistan has so far given concession to India has been extended to around 463 items while India extended concessions on 262 items. Under SAPTA, Pakistan and India will scale down tariff rates from 25 percent to 20 percent within a time frame of two years, w.e.f. January 2006.

Tariff and Non-tariff Trade Barriers

Low volumes of trade and low trade integration in India and Pakistan have their roots in their respective trade systems, as both have relatively restrictive trade regulations. India's trade restrictiveness measures 8 (on a scale from 1 to 10), while Pakistan's index stands at 6. Comparatively high trade restrictiveness is partly a regional feature, with the average of South Asian countries at 5.9, compared to an average of all Asian countries of 4.4. India's tariff peaks are concentrated in the agricultural, automobile, and textiles and garments sectors. India's average tariff stands higher at 22.2 percent against 14.9 percent for Pakistan and a developing country median of 11.2 percent.

India started its trade liberalization process in 1991-92 and from 2002-03 the general maximum customs duty was reduced from 35 percent to 20 percent (30 percent for agricultural products) in January 2004. The agricultural tariffs at an average of 40.1 percent remain substantially higher than non-agricultural tariffs (19.7 percent). The highest rate of basic customs duty in India is 70 percent whereas some agricultural products are subject to import duties as high as 80-150 percent.

In India, significant non-tariff barriers include: requirement of political or security clearance, sampling or customs inspection, requirement of technical or standard certification, labeling and marking rules, packaging rules specification, etc. Government-mandated import monopolies in the areas of agricultural and petroleum products are also in place. In addition, India maintains tariff rate quotas in the agricultural sector, and uses technical barriers to trade in the form of technical standards and regulations, administered by the Bureau of Indian Standards.

In Pakistan, trade liberalization started in 1980 and by 2002-03, the basic maximum tariff was reduced to 25 percent. Currently Pakistan operates with a relatively simple, four-rate structure, i.e. 25 percent, 20 percent, 10 percent and 5 percent. The average unweighted customs duty is 14.9 percent. Pakistan's trade liberalization has included the agricultural sector, where the unweighted average tariff (20.5 percent) is only moderately above the non-agricultural tariff average (13.8 percent). Pakistan's imports from India remain restricted to items covered on a positive list.

The Issue of MFN Status

MFN is one of the instruments in use by the WTO to make member countries' trade regimes competitive and non-discriminatory. India granted MFN status to Pakistan in 1996 but Pakistan has not yet reciprocated in the same manner. As a signatory to the WTO Agreement, Pakistan is bound to grant MFN status to all member countries including India without any discrimination. Instead of granting MFN status, Pakistan has gradually increased the number of items permissible for trade with India.

The KCCI has already recommended to the Government to grant MFN status to India because, in their view, it is unlikely that it will cause any damage to the Pakistani industry. Pakistani manufacturers, however, feel that liberalizing trade between the two countries, after granting MFN status to India, will mostly benefit India given that it possesses a substantial industrial and engineering base. Moreover, dumping of cheap Indian products is also likely which will pose problems for the regulators in Pakistan.

Potential Areas for Mutual Trade

Of the total value of Pakistan's exports in FY04, 32 percent represent those items which are also imported by India from the rest of the world, constituting one-third of the total Indian imports. About 1,181 items worth $3.9 billion are common between Pakistan's exports and India's imports during FY04, covering 45 percent of the total items exported by Pakistan**.** About 70.3 percent of the common items exported from Pakistan have unit values less or equal to the Indian imports unit values. There is a large scope for export of these items simply by producing the quality required in India. The potential of trade (exports plus imports) between the two countries estimated by the SBP amounts to $5.2 billion.

In FY04, there were 2,646 common items of Pakistan's imports worth over $7 billion (which account for 53 percent of the total items and 47 percent of the aggregate value). Under these items India also had exports worth over $15 billion (covering 24 percent of the total value of imports). Analysis revealed that for 48.7 percent of the items in FY04, the unit values for Pakistan's imports are more than the unit values of India's exports. Even after excluding the items which are currently permissible for imports from India, about 45 percent of the items still remain in the common list which could be imported from India at a lesser cost than the current cost of import from the rest of the world. Allowing import of such items from India (i.e. expanding the current list of positive items) will give Pakistan an average saving estimated between $400 million to $900 million.

Prospects of Investment for MNCs and Indian Investors in Pakistan

Pakistan's recent economic reforms offer unprecedented and conducive business opportunities to all MNCs including Indian-based investors. As 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. Pakistan has so far made bilateral investment agreements with 46 countries (except India) during the period from 1959 to 2004. At present, joint ventures between the two countries are non-existent. Foreign Direct Investment (FDI) flows to Pakistan originating from India are negligible, as is Pakistan's share in flows to India.

Potential sectors for mutual cooperation between India and Pakistan include: agricultural products, tires, auto spare parts, minerals, chemicals, pharmaceuticals, leather, textiles, telecommunications, gas pipeline, electricity generation using coal and wind energy in the Sindh province of Pakistan. India and Pakistan have mostly common MNCs operating in their respective countries. These can act as meaningful conduits for trade and investment if they source raw material from each other. In order to attract export-oriented FDI, Export Processing Zones (EPZs) have long been a popular policy tool in developing countries like Pakistan. For this purpose, creation of exclusive economic zones in Pakistan for Indian-based investors may be a good option to attract their investment.

Industry Specific Opportunities and Threats

Textiles and Clothing

The textile and apparel sector continues to be the driving force for economic growth in both India and Pakistan. This sector contributes 18.8 percent in India and 65.6 percent in Pakistan, of the total value of exports in FY04. The comparison of textile industries suggests that Indian textile industry is better placed than Pakistan in the post quota scenario. In both countries, the textile and apparel sectors exhibit different degrees of specialization. India is regarded as a major alternative source to China for apparel and made-up textile products in the post quota regime. Pakistan is termed as a supplier of limited range of products. However, it is considered a competitive supplier of cotton goods, particularly men's apparel, home textiles, and fabrics. Allowing for the differences in labor and capital productivity, on average, Pakistan is a higher cost location than China, India or Bangladesh.

Presently trade in textile and clothing between India and Pakistan is almost non-existent. The comparison of exports of both countries identifies 176 common items which have comparable unit values. Out of these 176 items, India has a price advantage, i.e. lower realized export unit value in 48 textile products while Pakistan has price advantage in 128 textile products. Since other factors like quality, production and design of products, etc. are also important , it is hard to conclude on the basis of just export unit value that granting of MFN status will result in a uni-directional flow of textile products, i.e. Indian products flooding the domestic market of textile products.

Although Pakistan ranks above India in both the textiles and clothing sectors, this advantage should be interpreted cautiously in terms of the "revealed" comparative advantage (RCA). The higher magnitude of RCA index in case of Pakistan shows the country's vulnerability of export earnings to sector specific events. Pakistan's economy is far less diversified as compared to the Indian economy and depends heavily on the textile industry. Unless efforts are made to rectify this situation, granting unrestricted access to Indian textiles in Pakistani domestic market may have serious repercussions for the whole economy.

Iron and Steel

India was the major source of raw material (iron ore) to this vital industry and accounted for 69.2 percent of the total imports of iron ore in FY04 followed by Australia (19.9 percent) and Iran (10.9 percent). Unlike Pakistan, India has a well-established steel industry and is a net exporter of steel and steel products. Indian steel industry produces a whole range of steel products. On the back of abundant raw materials, highly skilled technical manpower and competitive labor, India is the eighth largest crude steel producer and largest producer of sponge iron in the world.

Pakistan's iron & steel product imports from India were just a small fraction of its total imports. In FY04, Pakistan imported $662 million worth of iron & steel products (326 items) of which India supplied only 25 items worth $7.1 million. About 46 items are identified as potential imports that are cheaper to import from India on the basis of lower unit value of Indian exports compared to the import unit value of Pakistan's imports from the rest of the world.

Chemicals and Pharmaceuticals

Pakistan's chemical industry has by and large developed on a fragmented and ad hoc basis, motivated by a combination of the existence of a small local market and traditionally high tariffs. As a result, it suffers from the lack of economies of scale, national integration and consequent uncompetitiveness. Resultantly, the country is highly dependent on imported chemicals to cater to the needs of its agriculture as well as industrial sectors. During FY04, imports of chemicals stood at $2.8 billion, an increase of 29.5 percent over the last year.

Compared to Pakistan, the Indian chemical industry is well established and has shown impressive growth over the years contributing about 6.7 percent in the Indian GDP. In terms of volume, it is the twelfth largest in the world, and third largest in Asia. With a current turnover of about $30.8 billion, it accounts for 14 percent of the total manufacturing output in India.

The pharmaceutical industry in Pakistan plays an important role in the economic development of the country. Total local production/consumption of pharmaceuticals is presently estimated at $2.0 billion. There are about 316 pharmaceutical manufacturing companies including 30 multinationals (47 percent share), which are meeting around 80 percent of the country's requirement. Almost 95 percent of the basic raw materials used for manufacturing of medicines are imported from China, India, Japan, United Kingdom, Germany, Netherlands and others. Other production inputs, i.e. technology, labor, packaging materials, power and raw materials are easily available and the Government provides good incentives for importing raw materials and technology. Compared to the pharmaceutical industry of India, the size of Pakistani companies is relatively small and hence uncompetitive.

The Indian pharmaceutical industry has become a net exporter and is now putting up USA approved plants and is exporting to advance economies. In some pharmaceutical raw materials, the Indian companies are the only suppliers worldwide. The country ranks fourth worldwide accounting for 8 percent of world's production by volume and 1.5 percent by value. India is also among the top twenty pharmaceutical exporters and among the top five manufacturers of bulk drugs in the world.

During FY03 and FY04, Pakistan imported 4.3 percent and 6.8 percent of its total imports of chemicals and pharmaceutical products respectively from India. Out of total imports of $2.9 billion (1105 items) in FY04, India supplied 353 items worth $196.8 million. Out of the total imported chemicals and pharmaceutical products from India, 166 items had a lower unit value of imports compared to the unit value of the same items imported from elsewhere. These items have the potential for enhancing imports from India.

Automobiles

The automobile industry in Pakistan operates under franchise and technical cooperation agreements with leading world manufacturers and can be broadly categorized into various segments, i.e. cars and light commercial vehicles (LCVs), two and three wheelers, tractors, trucks and buses and vendor industry. The automotive industry contributed over Rs 30 billion to the government exchequer in the form of duties and taxes in FY03, with a contribution of Rs 17 billion from the top four manufacturers alone. From the late 80s to the early 90s, the demand for automobiles in Pakistan was on the rise, setting the stage for a decade of robust growth. The industry has achieved a phenomenal growth of 50.2 percent in FY04 and increased competition has led to the introduction of innovative products as well as a decline in financing costs.

Compared with Pakistan, India has a strong engineering base and has successfully created a sizable capacity for production of vehicles. It enjoys a clear edge over Pakistan in the automobile sector. Indian auto companies are highly cost competitive due to appropriate levels of automation and low cost automation and have achieved a high level of productivity by embracing Japanese concepts and best practices. India is already the second largest two wheeler manufacturer, second largest tractor manufacturer, and fifth largest commercial vehicle manufacturer in the world and has the fourth largest car market in Asia. The automobile industry in India is now gradually evolving to replicate those of developed countries.

Pakistan can import automotive components and spare parts from India at a lower price as presently these items are being imported from the Far East at higher prices. On the other hand, India is expected to benefit from free trade due to its low raw material, electric and labor costs.

Small and Medium Enterprises (SMEs)

The SME sector is an important sector of the economy of Pakistan. More than two million small and medium enterprises (SMEs) spread across the country contribute 30 percent to GDP and generate around 25 percent of the manufacturing sector's export earnings. The SMEs constitute 90 percent of business and are responsible for 80 percent of non-farm based employment. However, the competitiveness of the SMEs is marred by their structural weaknesses and to some extent insufficient institutional support from the government in spite of its significant contributions to the economy.

On the other hand, India has a strong industrial base and its small-scale sector has grown phenomenally during the last three decades. SMEs are considered to be one of the principal driving forces of economic development in India. Presently Small Scale Industries (SSI) account for 95 percent of all industrial units in the country and contribute 40 percent of the total output. About 7,500 products are manufactured in the small-scale sector with export share to the extent of 35 percent. Prudent policy measures have given thrust to the simplification of regulations and procedures, economic viability of SSI units, improving their competitive strength, export promotion, credit flow and development of integrated infrastructure for the sector.

India is one of the most protected economies and its industrial base is stronger than Pakistan. Most of the small and medium entrepreneurs are of the view that SMEs in Pakistan do not have the kind of strength that they need to compete in a free-trade environment. Some entrepreneurs view the prospect of liberalization of trade as a window of opportunity to improve production quality and efficiency through greater exposure to regional competition, especially with India, despite the challenges of free trade. There is an urgent need to address these issues in Pakistan, and to formulate a policy framework before entering into free trade with India.

Information Technology

In India, the IT industry has made tremendous progress and has emerged as one of the fastest growing sectors. A majority of the multinational companies operating in the area of information technology in India have either software development centers or research development centers. India's expertise in emerging technologies has actually helped the country to get new customers and the companies in Europe and Japan are directing their outsourcing to India.

In Pakistan, the IT industry is in its infancy but is growing at an enormous pace while struggling to catch up with the regional and global industry. However, most of the companies are small to medium-sized with a little representation of entities having full concentration in the export of software and IT enabled services. Pakistan has lagged dangerously behind other regional countries in exploiting IT as a catalyst for economic revival. This is one of the potential areas which could be exploited. India with its wider software industry can extend help to Pakistan to promote IT through the establishment of joint ventures.

Trade Liberalization under SAFTA

The SAARC member countries including Pakistan and India concluded a landmark treaty SAFTA on January 6, 2004 with a pledge to allow free trade among member countries by eliminating trade barriers and scale down their tariffs in two phases to 0-5 percent from January 1, 2006. The treaty allows free cross-border movement of goods within the region, with the provision for a list of sensitive items for member countries to safeguard national interests.

SAFTA is likely to contribute significantly to intra-regional trade along with a scope for enhanced trade between India and Pakistan—particularly in transportation equipment and engineering goods, including IT products. Complete elimination of tariffs under SAFTA may increase the intra-regional trade by 1.6 times the existing level. In the dynamic framework the gains from liberalization are substantially (at least 25 percent) higher than the static gains. The above projections need to be viewed against the cost of non-cooperation, which was estimated by an earlier RIS study to be about $511 million for Pakistan.

Advantages of Trade Liberalization for Pakistan

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 other nations. 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.

Trade liberalization will unambiguously benefit Pakistani consumers, since product prices fall and consumer choice increases with reduced trade barriers. Increased trade flow that stem from the lifting of import prohibitions from India would lead to additional customs revenue for Pakistan. Within the protective walls of regional economies, both countries can achieve specialization in various sub-sectors of the economy. Moreover, the strengthening of bilateral/regional trade would provide a cushion to the economies of both countries from the financial or stock markets' shocks.