5 TRADE LIBERALIZATION BETWEEN INDIA AND PAKISTAN: A REGIONAL PERSPECTIVE

Trade Liberalization under SAFTA

The seven SAARC member countries including Pakistan and India concluded a landmark treaty South Asian Free Trade Area (SAFTA)[60] on January 6, 2004 at Islamabad 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 that will come in force on January 1, 2006, and will be fully implemented by December 31, 2015.[61] SAFTA has replaced SAPTA, which was established in 1993 to liberalize trade among the SAARC countries. The SAFTA treaty, which was signed by India, Pakistan, Bangladesh, Nepal, Bhutan, Sri Lanka and Maldives, seeks to allow 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. The recent behavior of Pakistan's trade with SAARC countries is described in the following table.

Objectives

The objectives of the treaty to promote and enhance mutual trade and economic cooperation among members would be achieved by: a) eliminating barriers to trade, and facilitating the cross-border movement of goods; b) promoting conditions of fair competition and ensuring equitable benefits, taking into account their respective levels and pattern of economic development; c) creating effective mechanism for the implementation and application of the agreement, for its joint administration and the resolution of disputes; and d) establishing a framework for further regional cooperation to expand and enhance the mutual benefits.

SAFTA Accord

1. SAFTA treaty adopted a strategy for trade liberalization program that envisages sliding tariff reductions over a timeframe of 2 to 11 years, with the Least Developed

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[60] Text Agreement on SAFTA; 12th SAARC Summit (2004), Islamabad; www.saarc-sec.org/.
[61] Pakistan ratified SAFTA on 15 February 2006 which came into effect retrospectively from 1 January 2006. All other members have also ratified the treaty. The first phase of SAFTA tariff reductions along with the rules of origin will come into force from 1 July 2006. (Source: The Daily Business Recorder and the Daily Dawn 16 February 2006 and 25 March 2006).

Countries (LDCs) being allowed the concession of a slower pace of tariff reduction. The non-LDCs, i.e. Pakistan, India and Sri Lanka will scale down tariff rates to 20 percent within a timeframe of 2 years from January 2006, while the LDCs

2. (Bangladesh, Nepal, Maldives and Bhutan) will curtail their tariff rates to 30 percent.
3. The subsequent tariff reductions by non-LDCs from 20 percent or below to 0-5 percent shall be carried out within the second timeframe of five years, beginning from January 2009, except Sri Lanka which has been granted a six-year period for this purpose. For the LDCs, reduction from 30 percent or below to 0-5 percent shall be done within eight years, starting from the third year from the date of coming into force of the Agreement.
4. Both the LDCs and non-LDCs will be permitted to draw up a Sensitive List, which will be subject to a maximum ceiling to be mutually agreed among the contracting states with flexibility to LDCs to seek derogation in respect of the products of their export interest. The Sensitive List shall be reviewed after every four years or earlier by SAFTA Ministerial Council (SMC), established under Article 10, with a view to reducing the number of items in the List.

Pakistan's Trade With SAARC Countries

(million US$)

	2000-01		**2001-02**		**2002-03**		**2003-04**		**2004-05**	
Countries	**Exports**	**Imports**	**Exports**	**Imports**	**Exports**	**Imports**	**Exports**	**Imports**	**Exports**	**Imports**
Bangladesh	133.4	33.5	101.1	27.7	114.3	32.7	195	45.9	205.87	61.21
	(1.45)	*(0.31)*	*(1.11)*	*(0.27)*	*(1.02)*	*(0.27)*	*(1.58)*	*(29.00)*	*(1.43)*	*(0.30)*
Bhutan	0.2		0.2	0.4	0.1	0.7	0.4	0.2	0.11	0.51
	(..)	*(..)*	*(..)*	*(..)*	*(..)*	*(..)*	*(..)*	*(..)*	*(0.00)*	*(0.00)*
India	55.4	235.1	49.2	186.5	70.7	166.5	93.7	382.4	288.24	548.22
	(0.60)	*(2.19)*	*(0.54)*	*(1.80)*	*(0.63)*	*(1.36)*	*(0.76)*	*(2.45)*	*(2.00)*	*(2.66)*
Maldives	1.8	0.2	1.5	0.2	3.3	0.1	1.9	0.2	2.56	3.45
	(..)	*(..)*	*(..)*	*(..)*	*(..)*	*(..)*	*(..)*	*(..)*	*(0.02)*	*(0.02)*
Nepal	2.3	1	2.4	0.8	3.1	1.4	4.6	3.4	2.74	3.77
	(0.02)	*(0.01)*	*(0.03)*	*(0.01)*	*(0.03)*	*(0.01)*	*(0.03)*	*(0.02)*	*(0.02)*	*(0.02)*
Sri Lanka	75.3	35.4	72.1	28.5	76.1	38.3	97.8	48.4	155.86	44.91
	(0.82)	*(0.33)*	*(0.79)*	*(0.28)*	*(0.68)*	*(0.31)*	*(0.79)*	*(0.31)*	*(1.08)*	*(0.22)*
Total (SAARC)	**268.4**	**305.4**	**226.5**	**244.1**	**267.6**	**239.7**	**393.4**	**480.5**	**655.4**	**662.1**
	(2.92)	*(2.85)*	*(2.48)*	*(2.36)*	*(2.40)*	*(1.96)*	*(3.19)*	*(3.08)*	*(4.55)*	*(3.21)*
Pakistan (Total)	**9,201.6**	**10,728.9**	**9,134.6**	**10,339.5**	**11,160.2**	**12220.3**	**12,313.3**	**15,591.7**	**14,391.1**	**20,598.1**

Note: Figures in parenthesis represent country's percentage share in Pakistan's total trade.

(..) Negligible

Source: Federal Bureau of Statistics

5. The Contracting States shall notify the SAARC secretariat all non-tariff and para-tariff measures to their trade on an annual basis, which shall be reviewed by the committee of experts to examine their compatibility with relevant WTO provisions. The committee of experts shall recommend the elimination or implementation of the measure in the least trade restrictive manner in order to facilitate intra-SAARC trade. Member states shall eliminate all quantitative restrictions, except otherwise permitted under GATT, 1994, in respect of products included in the Trade Liberalization Program.

Additional Measures

In order to support and complement SAFTA for mutual benefit, Pakistan and India along with other SAARC members had also agreed to consider the following additional measures for the adoption of trade facilitation:

Table 1
Tariff Reductions Proposed Under SAFTA

Countries	Existing tariff rate	Proposed SAFTA reduction	Timeline
	First Phase		
India, Pakistan, Sri Lanka	> 20%	Reduce to 20%	2 years
	< 20%	Further annual reduction	2 years
Bangladesh, Bhutan, Maldives, Nepal	> 30%	Reduce to 30%	2 years
	< 30%	Further annual reduction	2 years
	Second Phase		
India, Pakistan, Sri Lanka	≤ 20%	Reduce to 0–5%	2 years
Bangladesh, Bhutan, Maldives, Nepal	≤ 30%	Reduce to 0–5%	3 years (primary products) 5 years (other products)

SOURCE: M. Asaduazzaman, Nazneen Ahmed, sharif M. Hossin, and Subrata Sarker. 2003. "South Asian Free Trade Area: An Analysis for Policy Options for Bangladesh," Dhaka, Bangladesh: Bangladesh Institute of Development Studies, page 8.

a) harmonization of standards, reciprocal recognition of tests and accreditation of testing laboratories and certification of products;
b) simplification and harmonization of customs clearance procedure;
c) harmonization of national customs classification based on HS coding system;
d) customs cooperation to resolve dispute at customs entry points;
e) simplification and harmonization of import licensing and registration procedures;
f) simplification of banking procedures for import financing;

g) transit facilities for efficient intra-SAARC trade, especially for the land-locked Contracting States;
h) removal of barriers to intra-SAARC investments;
i) macroeconomic consultations;
j) rules for fair competition and the promotion of venture capital;
k) development of communication systems and transport infrastructure;
l) making exceptions to their foreign exchange restrictions, if any, relating to payments for products under the SAFTA Scheme, as well as repatriation of such payments without prejudice to their rights under Article XVIII of the GATT and the relevant provisions of Articles of Treaty of the IMF; and m) simplification of procedures for business visas.

All matters related to any type of disputes regarding the interpretation and application of the provisions of the agreement or any instrument adopted within its framework concerning the rights and obligations of the members will be amicably settled among the parties concerned through a process initiated by a request for bilateral consultations. The SAFTA agreement also contains following safeguards against contingencies.

- Article 8 of the agreement provides exceptions to foreign exchange restrictions if any, relating to payments for products under SAFTA Scheme, as well as repatriation of such payments which will be governed by existing multilateral agreements signed by these countries as part of GATT and the Articles of the IMF. As such "the countries ratifying SAFTA will not be obliged to alter their exchange policies". Pakistan's financial sector is fairly well regulated, as such there seems to be a little chance for any adverse impact of SAFTA.
- Article 15 provides safeguard against any possible contingency arising from ratifying the agreement. Under this Article "any contracting state facing balance of payments difficulties may suspend provisionally the concessions agreed under this Agreement". This implies that in case of a BOP problem member country can remove tariff concessions extended to SAARC countries. "Such a provision is not present in the WTO."
- Article 11 provides special and more favorable treatment exclusively to a Least Developed Country (LDC). In case any LDC is losing a significant amount of customs revenue then "other member states are obliged to compensate for this loss".
- Article 8 of the agreement calls for simplification of banking procedure for import financing. The banking and financial system has to be made supportive and responsive to the demand of regional trade. If freeing of trade in goods leads to enhanced trade especially exports from Pakistan then additional capacity may have to be created and banks may be asked to finance this requirement.

Recent Developments under SAFTA

In November 2005, the Committee of Experts (CoE) met in Kathmandu to negotiate on some of the pending issues regarding the implementation of SAFTA. The main outcomes are described below:[62]

- Under the agreement reached on rules of origin, the products from non-LDCs will qualify for preferences in a 40 percent domestic value-added rule basis (30 percent for LDCs). Furthermore, regional accumulation will be accepted (50 percent of regional value in addition to 20 percent of domestic value added at the last stage of processing).
- Regarding the mechanism for Revenue Loss Compensation, it was established that such compensation will be paid in US dollars by the non-LDC countries to the LDCs in region based on an agreed formula that will be designed by the CoE .The mechanism will be in force for four years (five years in the case of Maldives).
- Each country proposed a list of “sensitive” products. The total number of tariff lines proposed by each country is as follows: Bangladesh, 1254 items for non-LDCs and 1249 items for LDCs; Bhutan, single list of 259 items; India, 884 items for non-LDCs and 763 items for LDCs; Nepal, 1350 items for non-LDCs and 1300 items for LDCs; Pakistan, single list of 1183 items and Sri Lanka, single list of 1574 items.

The lists of sensitive products remain under negotiation. In fact, some countries are in the process of submitting a new list for approval before July 2006. The entry into force of the agreement has also been postponed to July 2006.

Implications of SAFTA on Pakistan

Far-reaching impacts of the free trade agreement among the SAARC countries include:

- The South Asian free trade bloc will offer tremendous economic opportunities supported by a huge consumer market in view of the massive population in countries like Pakistan, India, and Bangladesh. The huge export potential of the region under the free trade facility could also attract foreign investment in the region at a massive scale because of the higher rates of returns in the region.
- The preferential trading arrangement in South Asia is likely to contribute significantly to intra-regional trade along with scope for enhanced trade between India and Pakistan — particularly in transportation equipment and engineering goods, including information technology (IT) products. Studies conducted in the framework of gravity model have estimated that complete

[62] Newfarmer, in Naqvi and Schuler.

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[63] study to be about $511 million for Pakistan.[64] Both studies conducted by Srinivasan and Canonero (1995) and Sengupta and Banik (1997) predict that the impact of a South Asian FTA on trade flows will be small for India but much larger on the smaller countries. Sengupta and Banik predict a 30 percent increase in official intra-SAARC trade and as much as 60 percent if illegal trade, which is currently out of official count, becomes a part of official trade. Bandara and Yu (2003) find that SAFTA leads to a 0.21 percent gain in the real income of India, 0.03 percent gain for Sri Lanka and 0.8 percent gain for the rest of the South Asia (Bangladesh loses 0.1 percent). Besides the issue of trade linkages, there are several possibilities for enhanced economic cooperation in the region, most notably in the energy sector. India, whose current power shortfall (estimated at 10 percent) is rapidly increasing in the face of burgeoning demand, could purchase power from Pakistan and natural gas from Bangladesh.

- Using a gravity model, the World Bank study[65] estimates the potential gains that can accrue to Pakistan and India by entering a preferential trade system such as SAFTA. In its basic form the gravity model assumes that trade between two countries is directly related to their size (their GDPs) and inversely related to the geographical distance between them. The study verifies that conflict has a negative impact on trade and indicates that the volume of trade between Pakistan and India is significantly lower than what would be expected on the basis of their GNPs, populations, distance, geographical peculiarities and cultural ties. On the basis of aggregate regression, the expected imports of Pakistan from India in 2002 would be $1.24 billion against the actual of $163 million, a gain of $1.08 billion in trade, or 1.8 percent of Pakistan's GNP in that year. Along the same vein, expected imports of India from Pakistan in the same year are equal to $1.38 billion against the actual $54 million, representing an increase of $1.3 billion, or 0.26 percent of India's GNPs in the same year. The gravity model shows that had Pakistan and India traded as two other countries of comparable GNPs, population, and sharing a multitude of cultural ties, with a border in common and comparable distance between them, they would have both increased their level of import demands.
- Proposed reduction in tariff and non-tariff barriers on a product-by-product basis would undoubtedly benefit consumers in the region who would gain from

[63]The Research and Information System for the Non-Aligned and other Developing Countries (RIS), India.
[64] South Asia Development and Cooperation Report 2004 (Page 49, Chapter 6); ibid 59 (see Box 2.2).
[65] Pakistan-India Trade Study: Economic Gains and the "Peace Dividend" from SAFTA by Eugenia Baroncelli. The World Bank. E-mail ; ebaroncelli@worldbank.org.

a cheaper and wider variety of imports. Over a longer term, regional trade liberalization could result in dynamic gains from increased foreign direct investment and economies of scale through access to a larger market.

- The free trade movement of goods under the treaty would pave the way for the establishment of South Asian Economic Union.
- The change of the social and political image, which so far features as a hostile region among the comity of the nations and signs of peace and stability would benefit the economies of South Asia. Besides reaping the dividends of the integrated South Asian region, chances are that these nations may be able to come up with better bargains jointly in international economic forums such as WTO. The reactivation of economic activities in Pakistan and India under SAARC would provide an effective forum to collectively deal with the protection policies of the developed countries.

In order to make trade liberalization with India under SAFTA arrangements to be successful a number of preparatory measures are required which are described below:

a) Trade facilitation through expeditious border crossings, quick custom clearance, efficient port facilities, and improved transport links should proceed simultaneously with the expansion of volume of cross border trade;
b) Domestic tax, tariff and subsidy policies that affect production and trade incentives should be harmonized to avoid recurrence of trade disputes and frequent use of anti-dumping laws. The recourse to a long negative list that restricts the volume of trade should be avoided at all costs;
c) Macroeconomic policies such as fiscal and monetary policies should be harmonized to achieve a stable, non-discriminating macroeconomic environment for all the countries in the region;
d) Supporting institutions to manage and facilitate integration, for example, setting standards, establishing regional development funds and for dispute resolution should be created;
e) Communication and transport infrastructure between the bordering countries should be improved and upgraded to facilitate increased trade and factor mobility;
f) Legal regulations for investor protection, intellectual property rights enforcement, anti-trust law, commercial law, labor relations, and financial institutions should be harmonized;
g) Financial markets should be widened and regulatory changes introduced to promote cross-border investment, listings, syndication, bond issues, etc.

South Asia has made substantial progress in the last decade to integrate in the World economy but given its slow start and initial handicaps there is a need for much rapid pace for liberalizing trade, attracting foreign direct investment, assimilating new technology, upgrading human skills and actively participating in regional and multilateral arrangements. Economic development and poverty reduction require ever expanding economic resources, which can only be generated through high economic growth. Openness is found to positively impact upon economic growth by making investment more productive and efficient and by nurturing incentives for new investment. South Asian countries facing a high degree of poverty will benefit enormously from openness, integration in the World economy and maximizing benefits of globalization.