OPINIONS

Trade between India and Pakistan: Potential Items and the MFN Status

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During the last several years, opening up of trade between India and Pakistan has become the most sought after question at many policy forums and among concerned groups. The issue has gained particular importance after India granted the Most Favored Nation (MFN) status to Pakistan, to comply with the principles of World Trade Organization (WTO) regime in 1995, and Pakistan's reluctance in reciprocating so far. It is believed that increased trade relationship can play a vital role in normalizing the political relationship between the two countries. This will, therefore, benefit millions of people living in both countries as the resources would be diverted from less desirable areas, such as defense spending, to poverty alleviation initiatives.

Given the likely impact of trade liberalization between the two countries, the unavailability of any established estimate of potential trade and the items likely to be traded is unfortunate. With a view to come up with some estimates based on some methodology, however simple it is, this note attempts to find the potential of trade between the two countries by identifying the potential items. It estimates the scope for exports and savings by substituting our imports from the rest of the world with those from India. It also identifies the potential items with their potential size. Further, the note gives an argumentative discussion on the granting of MFN status to India.

The results show that on the basis of existing pattern of Pakistan's trade with the rest of the world and price structures, the total trade potential (exports plus imports), between Pakistan and India could be around $ 5.2 billion. Though the overall market size available for Pakistan's exports may reach $ 5.1 billion, given the fact that additional exportable surplus might not be available in the short run,

the potential exports to India is estimated around $ 2.5 billion. The export items include fresh and dry fruits, sugar, raw cotton, gems, fish, marbles and onyx, power, and textiles.[1]

The size of potential imports from India is about $ 2.7 billion.[2] The potential import items include tea, spices, auto parts, consumer and light engineering goods, tires and transport equipment, entertainment, healthcare, information technology, and pharmaceuticals. Allowing import of these items, it is estimated, could result in savings for Pakistan of $ 400 million to $ 900 million.

Arguments against the granting of MFN status to India usually stem from the misconception of this principle, theoretical arguments such as 'infant industry', political considerations, and the presence of high non-tariff barriers in India. However, it is seldom analyzed that even in the presence of these 'obstacles', the gains from granting MFN status to India is considerable. In fact, the analysis in this note does suggest that Pakistan can not only increase its exports by capturing a big market, it stands to save substantially by substituting some of its imports from the rest of the world with India.

This note consists of three sections. Section 1 develops the background by reviewing the status of trade between the two countries. Section 2 estimates the potential trade items with India. Section 3 concludes with a discussion on Pakistan's granting of the MFN status to India.

1. Trade between India and Pakistan

Trade between India and Pakistan is as old as the two countries are, but the volume of trade between them is minuscule relative to the size of their economies. However, this has not always been the case. After 1947, Pakistan's exports and imports with India remained quite significant for several years, as high as 30 percent of exports and 10 percent of imports. Later on both of them declined to less than 5 percent (on average). In 1990s, the volume of trade began to improve again when the average exports ($ 85 million) doubled the average of the past two decades. During the same period the increase in imports was also manifolds.

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[1] Unless mentioned otherwise, all the data is from the Federal Bureau of Statistics, Pakistan and the Directorate General of Foreign Trade, Ministry of Commerce India (http://dgft.delhi.nic.in). All the figures in the note are in US dollars.
[2] The results appear to be quite reasonable but arguably one can debate its reliability as these are based on data for two years only. This is due to the fact that a longer time series of detailed data on Harmonized System Code (HSC) is not available.

With WTO becoming effective in 1995, it was expected that trade between the two countries would increase significantly as the two countries would be required to open their borders for trade, but this did not happen. Despite the fact that India gave the MFN status to Pakistan, exports to India could not witness a significant increase. In contrast, Pakistan has still not reciprocated the same status to India and allows only a select of items for import, but interestingly the volume of imports rose to more than double in the post 1995 period. Nevertheless, the share of imports from India is still low, as opposed to the recorded trade between India and Pakistan, trade through third country and illegal channels is quite significant and is estimated to be more than $ 2 billion.

Given the market size available in the two countries, the current volume of trade between India and Pakistan is not commensurate with the existing potential. The two broad reasons, generally quoted, for low volume of trade between the two countries are (i) the presence of non-tariff barriers in India; and (ii) the absence of MFN status to India. While the first reason is quoted exclusively by the Pakistani exporters the second reason is shared by traders on both sides of the border.[3]

As regards the trade barriers, both India and Pakistan have had a very restrictive trade regime. But, during the last two decades both the countries have liberalized their trade regimes significantly by reducing tariffs, multiplicity of tariff types and slabs, regulatory duties, and exemptions. Also, other barriers on trade such as import licensing, improper valuation methodology, tariff rate quotas have also been removed or reduced. Nevertheless, the Indian trade regime is still more restrictive than its counterpart in Pakistan. According to an IMF study, India's trade restrictiveness measures 8 (on a scale from 1 to 10), while Pakistan's index stands at 6 [IMF (2004)].

Pandey (2004) estimates that the average coverage ratio (which measures the percentage of imports subject to non-tariff barriers) for 1996-97 is 47 percent for the whole economy and 55 percent for the manufacturing industry. While the protection in case of consumer goods (65 percent) is quite high relative to the average rate for the whole economy, the protection for intermediate goods (43 percent) and the capital goods (34 percent) are also quite substantial.

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[3] The non-tariff barriers, generally quoted by exporters in Pakistan, include requirement of political/security clearance, sampling/customs inspection, requirement of technical/standard certification, labeling and marking rules, packaging rules specification, and etceteras. In addition, India maintains tariff rate quotas in the agricultural sector and the efficiency of customs operations also act as a de facto barrier to trade [For details, see draft report on 'Implications of liberalizing Trade and Investment with India', State Bank of Pakistan (available from the author on request)].

Anecdotal evidence suggests that the volume of informal trade between the two countries is around $ 2 billion. This suggests that if trade diverts from informal to formal channels it might increase the formal trade to that extent. The Karachi Chamber of Commerce and Industries estimates the potential of trade between the two countries in the range of $ 10 to $ 15 billion. Nabi and Nasim (2001) estimate the total volume of trade in the range of $ 700 – $ 1000 million. Their estimate is also based on various anecdotal evidences.

While removing the above mentioned hurdles is likely to improve the flow of trade between Pakistan and India, it appears pertinent to ask as to how much trade is likely to increase to make a significant contribution to the overall trade of the two countries. What is the potential of exports as well as imports and in which commodities? Do the two countries have something to offer to each other? How much they are likely to save by trading with each other? Answers to these questions would be interesting for policy makers, traders, manufacturers, and consumers alike.

2. Potential Sectors for Trade[4]

By comparing Pakistan's exports with India's imports, potential sectors can be identified. Similarly, potential items which could be imported from India can be judged by comparing India's exports and Pakistan's imports. This section contains the analysis of exports and imports of Pakistan and India at the 8-digit level HS code for the two fiscal years FY03 and FY04 by comparing the unit values (presuming it reflects the price content only) to identify the potential sectors/items.[5] Data has been obtained from the Federal Bureau of Statistics, Pakistan and the Directorate General of Foreign Trade, Ministry of Commerce India.[6] Since the data covers the full year trade, the difference in time periods of the fiscal years of Pakistan and India has been ignored. Further, the fact that the existing trade between the two countries is nominal given their overall trade with the rest of the world has also been ignored in the analysis of the data.

2.1. Potential Items for Export to India

A comparison of Pakistan's exports with Indian imports indicates various potential sectors that can be explored in case trade between the two countries is liberalized. Of the total value of Pakistan's exports in FY04, 32 percent represents those items

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[4] The results in this section have been discussed with respect to FY04 only. Nevertheless, FY03 numbers have also been given.
[5] See, Appendix for the methodology used for this analysis.
[6] As available on the website, http://dgft.delhi.nic.in.

Table 1. Frequency Distribution of Common Items between Pakistani Exports and Indian Imports (millions of dollars)

Export or Import Value		FY03				FY04			
		Pakistan		India		Pakistan		India	
		No. of items	Exports	No. of items	Imports	No. of items	Exports	No. of items	Imports
Less than or equal to:	0.1	511	12	185	7	704	17	272	10
	0.2	69	10	85	12	106	15	104	15
	0.3	37	9	56	14	57	14	50	12
	0.4	17	6	37	13	31	11	49	17
	0.5	17	8	30	13	23	10	43	20
	1	40	29	77	56	67	48	132	94
	5	63	146	195	481	98	219	288	722
Above:	5	42	1549	131	19272	95	3575	243	25402
Total Common Items:		796	1768	796	19868	1181	3909	1181	26291
Grand Total :		2391	11978	7900	61412	2646	12313	8887	78150

which are also imported by India from the rest of the world, constituting one third of the total Indian imports. There are about 1,181 '8-digit-level' items worth $ 3.9 billion which are common between Pakistan's exports and India's imports during FY04, covering 45 percent of the total number of items exported by Pakistan (Table 1).

Majority of the items (about 60 percent) have exports worth less than or equal to $ 0.1 million. These items pertain to major sectors like textiles and textile articles, prepared foodstuffs, spirits and vinegar, raw hide and skins, leather, fur skins, mineral products, plastics, rubber, vegetable products, machinery, mechanical appliances, and electrical equipment.[7] The textiles and textile articles remain the dominant sector with 20 percent share in the total number of common items and around 68 percent of the export value of common items.

Nevertheless, sectors other than the textiles cover items for which there is a wide scope for exports. The Indian imports under these non-textile items constitute over 98 percent of the total value of imports in common items with 45 percent of these items having individual imports worth more than or equal to $ 5 million. The bulk of these common items imported by India pertain to mineral oil and products (mineral fuel/oil/wax, and bituminous) but since Pakistan itself is a major importer of petroleum products, this sector does not offer much scope for exports.

The remaining sectors, however, still account for a significant proportion as Indian imports in these categories amounts to about $ 5 billion. The major sectors other

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[7] The detailed results are available from the author on request.

Table 2. Frequency Distribution of Ratio between Unit Values of Pakistani Exports and Indian Imports

Ratios		Common Items			
		All		> $ 1 million	
		FY03	FY04	FY03	FY04
Less than or equal to:	0.2	140	204	13	20
	0.4	146	179	24	27
	0.6	91	142	6	30
	0.8	63	87	9	11
	1	48	80	9	16
	1.2	45	59	5	12
	1.4	26	37	6	4
	1.6	15	35	2	8
	1.8	16	28	0	3
	2	11	15	3	2
Above:	2	67	118	6	20
Common Items with available Unit Values:		668	984	83	153
Total No. of Common Items:		796	1181	796	1181

than mineral oil and products include: machinery, mechanical appliances and electrical equipment; vehicles, aircrafts and parts; vegetable products; products of chemical or allied industries (including items like fertilizer); plastics and rubber; and textiles and textile articles.

In order to analyze the potential sectors on the basis of pricing, the average unit price of the Pakistani exports and Indian imports as an approximation of the actual prices are used. Since the unit values also reflect the quality of the products, as such two items with the same HS-code may still not be comparable as their unit values may be different due to the differences in quality. An analysis of the unit values of Pakistan exports and Indian imports reveals that 70.3 percent of the common items exported from Pakistan have unit values less or equal to the Indian imports unit values (Table 2). The share remains 68 percent even if items with export value more than one million dollars are considered; though the number of items decline drastically to just 104. Although the differential between the unit values might be due to the quality factor, still this shows that there is a large scope for the export of these items simply by producing the quality required in India.

As mentioned earlier, the overall market size for items with unit values less than that of India is around $ 5.1 billion. The actual export, however, would depend upon the availability of exportable surplus. In the short run, it is expected that trade might divert from other destinations to India for two reasons. First, due to

lower transportation costs, the profit margins may give an incentive to exporters to change the destination; second, traders may start exporting to make inroads in the Indian markets to diversify their markets and to take advantage of a socially identical consumer base. Based on FY 04 exports of 692 common items having unit values less than that of Indian imports, the maximum likely diversion of exports to India is estimated at $ 2.5 billion.

Of the common items with unit values of Pakistan's exports less than twice the unit value of Indian imports, the major categories include: nuclear reactor, boiler, machinery and parts; aircrafts, spacecrafts and parts; vehicles other than rail or tramway parts; plastics and articles thereof; optical, photographic, cinematographic items; fertilizers; wool, fine or coarse animal hair; miscellaneous chemical products; rubber and articles thereof; man-made filaments; ships, boats and floating structures; edible fruits and nuts, fresh/dry and edible vegetables roots tubers. Within these categories, however, the trend of import of some of the items (such as fertilizers, man-made filaments and edible vegetables roots tubers) in India is quite volatile and probably depends on the domestic supply situation. Currently, Pakistan's exports in these categories are also quite low.

2.2. Potential Items for Imports from India

While making assessment of the needs for Pakistan's imports by comparing items imported by Pakistan with those which are exported by India, it is observed that Indian exports cover almost 53 percent of Pakistan's total import items.

Table 3. Frequency Distribution of Items Common in Pakistani Imports and Indian Exports (millions of dollars)

Export or Import Value		FY03				FY04			
		Pakistan		India		Pakistan		India	
		No. of items	Imports	No. of items	Exports	No. of items	Imports	No. of items	Exports
Less than or equal to:	0.1	885	26	468	20	1094	34	475	20
	0.2	241	35	226	32	312	45	270	38
	0.3	132	32	126	31	196	48	156	38
	0.4	89	31	129	44	128	44	135	46
	0.5	53	23	79	35	97	44	119	53
	1	168	118	248	175	266	194	398	280
	5	224	476	386	867	383	829	673	1599
Above:	5	112	3312	242	5949	170	6061	420	13176
Total Common Items:		1904	4054	1904	7152	2646	7298	2646	15249
Grand Total:		4754	12220	9554	52719	4948	15592	10224	63842

In FY04, there were 2,646 common items of Pakistan's imports worth over $ 7 billion (47 percent of the aggregate value of imports). Under these items India also had exports worth over $ 15 billion (covering 24 percent of the total value of imports). Analysis reveals that 41 percent of the total common items have individual imports of less than or equal to $ 0.1 million only. Moreover, imports are concentrated to few items, that is 6.4 percent of the total common items with individual imports above $ 5 million contribute 83 percent of import value of these common items (Table 3).

Excluding mineral products, bulk of Pakistan's imports pertains to products such as chemical or allied industries; machinery and mechanical appliances; electrical equipment; vehicles, aircrafts; vegetable products; base metals and its articles; plastics; rubber; natural pearls, precious or semi precious; textiles and textiles articles; animal or vegetable fats and oils; wood pulp, waste and scrap, optical, photographic, and surgical instruments. Within these categories, India's exports are to the tune of $ 12.8 billion but excluding textiles and textiles articles (for which Pakistan is a major exporter) this comes to $ 8.5 billion. While comparing the unit values of Pakistan's imports and Indian exports, it is observed that for 48.7 percent of the items, the unit values for Pakistan's imports are more than the unit values of India's exports and import value of these items amounted to $ 2.7 billion in FY04 (Table 4).

Table 4. Frequency Distribution of Ratio between Unit Values of Pakistani Imports and Indian Exports

| | | Common Items | | | | Common Items not allowed to Import from India | | | |
| | | All | | > $ 1 million | | All | | > $ 1 million | |
Ratios		FY03	FY04	FY03	FY04	FY03	FY04	FY03	FY04
	0.2	152	210	8	31	138	194	7	29
	0.4	203	254	38	44	181	236	30	40
	0.6	186	263	33	55	163	242	27	47
	0.8	167	257	42	51	147	236	36	46
Less than or equal	1	161	231	45	68	145	208	40	59
to:	1.2	131	180	36	56	111	157	30	46
	1.4	97	134	15	31	81	116	12	27
	1.6	72	112	14	22	62	107	10	21
	1.8	56	92	10	22	51	84	10	21
	2	59	67	7	13	54	62	7	13
Above:	2	372	568	59	118	347	539	54	114
Total Common Items with available Unit Values:		1656	2368	307	511	1480	2181	263	463
Total No. of Common Items:		1904	2646	1904	2646				

These items pertain largely to sectors like 'nuclear reactor, boiler, machinery and parts; organic chemicals; electrical machinery and parts; optical, photographic, cinematograph, and surgical instruments; inorganic chemical compounds; plastics and articles thereof; articles of paper pulp/paper-board; articles of iron or steel; miscellaneous chemical products; rubber and articles thereof; copper and articles thereof. Similarly, 51.3 percent of items with individual imports of over $ 1 million have unit values greater than that of Indian exports unit values.

Note that after excluding the items that are currently permissible for imports from India, about 45 percent of the items remain in the list of common items. These items could be imported from India at a cost lesser than the current cost of import from the rest of the world. Based on the average unit values of Indian exports in the FY03 and FY04, it is estimated that allowing import of such items from India (that is, expanding the current list of positive items) the average saving for Pakistan could range between $ 400 million to $ 900 million.

3. Should Pakistan give MFN Status to India?

MFN is one of the fundamental principles of the multilateral trading system and is at the heart of many of its agreements. Since the WTOs inception, it was believed that the foremost requirement from its member countries would be the implementation of this principle and this would be the major booster to the whole process of free trade. As such no comprehensive evidence can be found as to how many countries have completely complied with this article, but there are countries, such as USA, China, India, and Pakistan, which have not completely implemented this clause.[8]

As mentioned earlier, soon after the enactment of the WTO agreement, India gave MFN status to Pakistan, but the same status was not reciprocated by Pakistan.

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[8] USA has been using the granting of MFN as a tool to achieve various objectives with respect to various countries, such as China, Cuba, Iran, and Libya, for years [see, Cato Handbook for Congress Unilateral Sanctions at: www.cato.org]. Cebi and Ludema (2001) show that over time the cost (relative to the benefits) of granting an unconditional MFN for developed countries to all countries increases with respect to less developed (or smaller) countries. The unconditional MFN increases the trade gains and reduces opposition to liberalize trade in smaller countries. This explains why large countries who were the strong supporter of unconditional MFN clause in GATT retreated and began circumventing the MFN clause exploiting other clauses of the agreement. Nevertheless, the utilitarian approach helps to reach the conclusion that trade sanctions, embargoes, or the denying of MFN status is ineffective in changing the behavior of countries considered inappropriate for international community. McGee (1998) concludes that using the utilitarian approach to assess the negative effects of trade sanctions is insufficient and a better approach would be to find out if there has been any violation of property, contract, or association rights.

Over the last several years there is now growing pressure for such reciprocity both from internal and external stakeholders. The business community and, in particular, the traders in Pakistan have been advocating for a complete opening up of the borders for trade for quite some time and with the current wave of dialogue and official visits between the two countries, their insistence has gained further momentum. Pakistan, however, has so far been very cautious about this issue. Exporters on the Indian side have been persuading their government to put pressure on Pakistan for reciprocating the MFN status but India has so far kept a soft tone in its demand for MFN status.

The opposition to MFN status for India is perhaps quite often based on the misconception of its definition. It is believed that giving MFN status is tantamount to giving some special status to India that would result in imports with duties either zero or less than what is levied at imports from other countries. This is, nonetheless, not the case and MFN status only suggests that for trade purposes a WTO member country would not be discriminated with other member countries.[9]

Generally, the argument against MFN status is given by the stakeholders related to industrial sector and is of 'infant industry'. It is asserted that the opening up of Pakistani market for all Indian products would hurt the domestic manufacturing sector. The arguments reflect that our industry is uncompetitive and inefficient relative to the Indian industry. It is expected that the Pakistani markets will glut with cheap Indian products and the domestic producers will not be able to compete due to lower prices. Specifically, the domestic auto and the electronics industry may face tough competition as the Indian industry is relatively well established and efficient. For the textiles sector, it is argued that since the Indian textiles industry is more into the domestic supply as compared to an export oriented Pakistani textile sector, the low cost textiles of India would wipe out the Pakistani textile production meant for the domestic consumer.

Granting MFN to India is also opposed on the grounds that Pakistan will be a net looser in terms of the overall trade balance with India, since despite the MFN status given by India, Pakistan has not been able to make inroads in the Indian market and this is due to the presence of high non-tariff barriers.

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[9] Therefore, if a country reduces tariff on imports from a particular country or a group of countries, the MFN rule requires the same treatment be given to all other WTO member countries. This, however, does not suggest that countries cannot enter into regional trading arrangements. In fact, GATT Article 24 allows such arrangements provided certain strict criteria are met [See, "Understanding the WTO: Cross-Cutting and New Issues - Regionalism: Friends or Rivals?" (http://www.wto.org/english/thewto_e/whatis_e/tif_e/bey1_e.htm)]. In USA the term MFN was replaced with Normal Trade Relations to remove the impression of any privileged treatment.

'Strategic considerations' are also used to advocate denial of MFN to India. It is argued that since political relations between the two countries are not stable and in the wake of existing conflicts these are unlikely to become stable, dependence on an 'enemy state' should not be increased. Trade means more flow of human traffic between the two countries making it difficult to check infiltration of 'persona non grata'. Also, in the absence of a long lasting solution of the political disputes the trade ties would remain vulnerable and are likely to be broken with a slightest degree of strain in relations. In such situations, it is difficult to establish business relations involving long term or continued commitments. In India, such apprehensions regarding the gas pipeline crossing Pakistan have also been shown.

Protecting the domestic economy from Indian products 'infiltration' appears to be based on assumption that all Indian goods are more competitive than the domestically produced goods. This is, nevertheless, unlikely and only those items, as also suggested from the analysis in the preceding section, are likely to make inroads that: (i) will substitute the items being already imported from other countries; (ii) are currently being smuggled or coming through third country; (iii) remain cheaper than the domestic goods after the application of tariffs. While the first two kinds of imports are unlikely to affect the domestic market since these are already available, importing other items would depend upon the cost competitiveness and the tariff barriers.

Opening the borders does not suggest an unrestricted flow of Indian products. All the Indian imports will remain subject to the tariffs already in place. For the third kind of imports, it can be argued that if the Indian goods remain cheaper than their domestic counterparts even after paying the import duties, then why not allow them? Though the ultimate conclusion could only be based on gains in general welfare, there is no doubt that the consumers will be the net gainer in this situation. Other major beneficiary is the government for the revenues raised through such trade.

The substitution of our imports with cheaper Indian products should be more than welcome since this may benefit in two ways: first, the low cost of imports and secondly, lesser time involved. Trade with India is likely to bring another advantage in terms of enlarged road transportation services. Today, our domestic shipping services are either not available or are not competitive. Given the already available structure of road transportation, trade through road vehicles is likely to promote such services and foreign exchange receipts to the country. Many products of multinationals are cheaper in India than Pakistan; they may 'adjust' their productions resulting in lower prices.

The analysis of the comparison of Indian and Pakistani trade composition in this note provides us a clue about the potential of trade and identifies the potential items. It does suggest that Pakistan can benefit not only by accessing a big market for its exports it can save significantly by substituting its expensive imports from the rest of the world with those from India. Indeed, in this likely scenario, granting MFN status to India should not be a worry for Pakistani producers.

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Appendix: Methodology

The unit value of exports/imports can be obtained simply by dividing the value of exports/imports by its quantum as:

Exports   **Imports**

$$x_i^{\mathrm{P}} = p_i^{\mathrm{P}x} q_i^{\mathrm{P}x}$$ $$m_i^{\mathrm{P}} = p_i^{\mathrm{P}m} q_i^{\mathrm{P}m}$$

$$p_i^{\mathrm{P}x} = x_i^{\mathrm{P}} / q_i^{\mathrm{P}x}$$ $$p_i^{\mathrm{P}m} = m_i^{\mathrm{P}} / q_i^{\mathrm{P}m}$$

$$m_i^{\mathrm{I}m} = p_i^{\mathrm{I}m} q_i^{\mathrm{I}m}$$ $$x_i^{\mathrm{I}} = p_i^{\mathrm{I}x} q_i^{\mathrm{I}x}$$

$$p_i^{\mathrm{I}m} = m_i^{\mathrm{P}} / q_i^{\mathrm{I}m}$$ $$p_i^{\mathrm{I}x} = x_i^{\mathrm{P}} / q_i^{\mathrm{I}x}$$

Where,

x: value of exports	m: value of imports
p: unit value	q: quantity
P: Pakistan	I: India
i: 8-digit level HS Code	

Therefore, a commodity is *exportable* if $p_i^{Px} / p_i^{Im} \leq 1$ and the scope for export earnings, E, would be $E = \sum_i m_i^I$ for all exportable items.

Similarly, a commodity is *importable* if $p_i^{Pm} / p_i^{Ix} \geq 1$ and total savings to Pakistan, S, if it imports the same commodity from India would be $S = \sum_i (p_i^{Pm} - p_i^{Ix})q_i^{Pm}$ for all 'importable' commodities.