

Chapter 22

India–Pakistan Economic Co-operation: Implications for Regional Integration in South Asia

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22.1 Introduction

One of the most significant recent developments in India–Pakistan bilateral economic co-operation is the revival of trade talks in 2011. Since then, the two countries have built closer economic relations with a shared vision of enhancing peace and stability in the South Asia region. There have been several initiatives taken by both countries to strengthen bilateral relations, of which Pakistan's decision to offer most favoured nation (MFN) status to India is remarkable.

After partition in 1947, India accounted for about 70 per cent of Pakistan's official trade. However, discordant political relations brought a halt to the bilateral official trade between the two countries. Between 1965 and 1973, bilateral trade dropped to zero. In 1971, India and Pakistan signed a first trade agreement, which did not last long. In 1989 Pakistan introduced a first positive list of tradeable items (for four products originally), and it kept increasing the number of items almost every year. Soon after establishment of the World Trade Organization (WTO) in 1995, India granted MFN status to Pakistan. From end of 1990s until the mid-2000s, political issues affected bilateral economic relations. When the leaders of the two countries felt the need for stronger bilateral economic relations, they came forward with measures to enhance economic exchanges. The Musharraf–Singh Composite Dialogue in 2004 is an example where 'trade' alone was the subject of four treaties between the two countries. Later in 2004, Pakistan announced a positive list of 757 trade items, and rail and air routes were re-opened in the same year. Pakistan announced another positive list of 1,075 items in 2006, and more trade incentives were introduced, such as for cross-border truck movement, among others. Bilateral trade declined sharply in the aftermath of the 2008 global financial crisis, and Pakistan had to announce another positive list of 1,934 items in 2009 with the aim of bringing back momentum to the growth in bilateral trade.¹ As the region recovers from the global financial crisis, India and Pakistan have agreed to deepen their bilateral relations. Pakistan decided to extend MFN status to India in 2012 and replaced the restricted positive list with a negative list in February 2012. India reciprocated by allowing Foreign Direct Investment (FDI) from Pakistan. There have been many such initiatives initiated by both the countries; have agreed to simplify customs procedures, facilitate the process of goods certification, and liberalise the issuing of visas. Undoubtedly, the environment for bilateral trade has greatly improved.

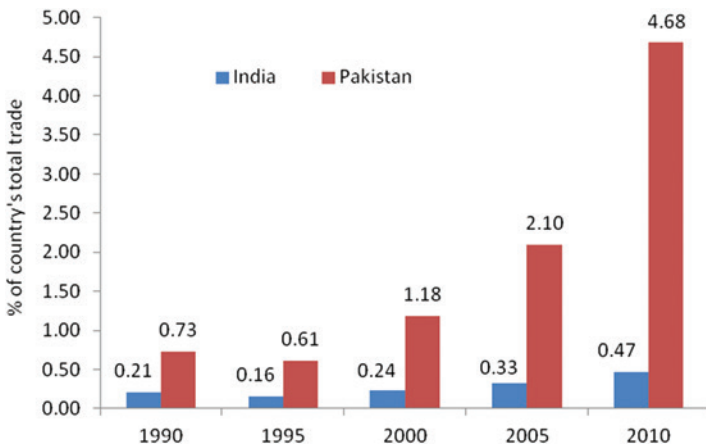
Against this backdrop, this chapter presents a comprehensive overview of the trade relations between India and Pakistan, analyses the modalities of co-operation, and assesses the potential economic benefits for both countries and the South Asia region. It examines the trade potential between India and Pakistan and maps the major trade barriers affecting both bilateral and regional trade, and also makes an attempt to quantify the gains for India and Pakistan and the South Asia region from the MFN scenario.

22.2 Bilateral trade: Trends and bottlenecks

South Asia remains one of the least-integrated regions in the world. Pakistan and India account for almost 92 per cent of South Asia’s gross domestic product (GDP), 85 per cent of South Asia’s population and 80 per cent of South Asia’s surface area, whereas only 20 per cent of the regional trade is India–Pakistan trade.² South Asia’s two largest economies barely trade with each other (Figure 22.1). Despite the fact that trade between the two countries has increased over the years, India’s trade with Pakistan has remained negligible. By 2010, trade with Pakistan accounted for less than half a per cent of India’s total trade, whereas Pakistan’s trade with India was 4.7 per cent of her total trade.

The bilateral trade between the two neighbours witnessed an upward trend in the second half of the 2000s, owing much to the India–Pakistan Composite Dialogue in 2004. India’s trade with Pakistan trebled in 2010 and reached an all time record of US\$2.56 billion (Table 22.1). India’s exports to Pakistan increased much faster than imports, thereby making India’s trade surplus with Pakistan increase from less than US\$100 million at the beginning of 2000 to US\$1.94 billion in 2010 (Table 22.1). Therefore, the increasing trade between India and Pakistan has also been accompanied by a sharp rise in the bilateral trade deficit in Pakistan.³ Nevertheless, compared with their economic strength, trade between India and Pakistan is negligible and much below its potential.

Figure 22.1 Bilateral trade as a percentage of each country’s total trade



Source: Calculated based on IMF Direction of Trade Statistics (DOTS)

Table 22.1 India's trade with Pakistan

	Exports	Imports	Total trade	Trade balance
	(US\$ million)			
1990	43.49	44.86	88.35	-1.37
1995	70.4	37.37	107.77	33.03
2000	163.33	65.05	228.38	98.28
2005	647.19	158.42	805.61	488.77
2010	2,252.89	310.44	2,563.33	1,942.45
Compound annual growth rate (CAGR) (%)				
1990–99	9.22	9.88	9.56	
2000–09	27.45	17.32	25.18	

Source: UN Comtrade database

An analysis by sector reveals that the composition of exports from India to Pakistan was primarily limited to about 14 commodities defined by the HS four-digit level in 2010–11, which on average accounted for around 78 per cent of the total exports. These commodities include sugar, raw cotton, synthetic fabrics, tea, petroleum products and chemicals. The shares of both raw cotton and woven fabrics in India's exports to Pakistan increased from almost zero in 2000 to more than 13 per cent in 2010, whereas the share of oil-cake and other solid residues declined from about 16 per cent to 3 per cent during the same period. Official major imports from Pakistan to India have been limited to 18 commodities, namely fruits and vegetables, wool and wool products, petroleum products, chemicals, lead, and, more recently, cement. These products together form about 88 per cent of India's total imports from Pakistan. In 2010, the sectors with large shares of the exports from Pakistan to India were fruits (19%), followed by petroleum products (12%) and cement (11%). In short, the trade volume between India and Pakistan has never expanded in the way it would have in a normal trade environment. Why? First and foremost are political disturbances. Bilateral trade and commerce were held hostage to the resolution of political disputes. Second is protectionism. For years, domestic industry in Pakistan has feared it would be swamped by imports from India. Third are restrictive trade policies in both countries, which are embedded in a variety of trade barriers targeted at each other's markets.

Pakistan places 1,209 items on the negative tradeable item list, which was supposed to be phased out by end of 2012, but this did not happen. The remaining 6,800 can now be imported from India, while the previous positive list had only 2,000 items. The South Asian Free Trade Area (SAFTA), which both India and Pakistan have signed up to, will gradually phase out all tariffs on traded goods, with zero tariffs by 2016.

India and Pakistan have 3,323 km of land border that demarcates the Indian states of Punjab, Rajasthan and Gujarat and the Pakistani provinces of Punjab and Sindh. In addition to the Attari–Wagah land border, which is the major road and rail crossing between India and Pakistan, three more land routes, namely, Khokrapar–Munabao, Muzaffrabad–Srinagar and Poonch–Rawalakot, have been used for bilateral trade. Three land customs stations handle the overland trade between the two countries.

India and Pakistan also have one direct sea route (Mumbai–Karachi) and three air routes (Delhi–Lahore, Delhi–Karachi and Mumbai–Karachi). Needless to say, restrictions imposed by the two countries on trade across the border have opened many indirect trade routes through neighbouring countries, some of which, Mumbai–Dubai–Karachi and Mumbai–Dubai–Bandar Abbas–Afghanistan–Pakistan act, as major trade axes between the two countries

Bilateral barriers to trade are very complex in nature and appear to be ‘thick’ at the land border. This results in a large informal trade, because of restrictive trade policies and transport bottlenecks, which varies in value from US\$500 million to about US\$1 billion (Khan et al. 2007). At present, a great deal of trade goes via Dubai, a trade process which is inefficient and fraught with illegalities, effectively functioning as behind-the-border barriers to trade.

The composition of informal trade between the two countries shows that a range of products are avoiding official tariff and non-tariff barriers through a third country, reflecting the potential to expand official trade. The South Asian Association for Regional Cooperation (SAARC) Chamber of Commerce and Industry (SCCI) and several other business groups in Pakistan have listed a variety of goods and services traded informally or through a third country, which could offer considerable potential for trade between the two countries (SCCI 2011). Indian products that arrive in Pakistan through this process include tyres, auto components, pharmaceuticals, engineering products, betel leaf, chemicals and some textiles. These industries in India will, therefore, benefit immediately from the changing environment. Moreover, consumers in Pakistan will benefit from reduced prices for these products. As far as Pakistan’s exports to India are concerned, cement, fruit and vegetables, cotton, some specialised textiles, and sports items – also currently arriving via Dubai – are expected to experience a rapid increase. And these are only the existing sectors; there are possibilities for emergence of trade in new products between the two countries in the new environment. It should, however, be mentioned that India and Pakistan perform poorly compared with their global peers in terms of improvement in trade logistics. Non-price barriers, such as costs of documentation and transportation, surpass the price barriers to trade in South Asia.⁴ Trade becomes uncompetitive when channeled through Dubai due to the increased transportation costs and time taken, since the normal/MFN trade at the land border between India and Pakistan is still not permitted.⁵ While both countries have adopted a negative list of tradeable items, Pakistan still maintains a positive list for imports from India at the Attari–Wagah land border. Incidentally, both the lists are inconsistent with the General Agreement on Tariffs and Trade (GATT) principles.

It should also be mentioned that tariffs between India and Pakistan have come down much faster than NTBs. Despite the fall in average tariffs, the trade restrictiveness of both India and Pakistan has been heavily influenced by the large volume of NTBs.⁶

Some notable anti-trade measures are as follows:

- Only a limited number of items are allowed to be transported via rail/road; there are specific timings for the opening of these routes and, in most cases, there

are no proper warehousing/storage facilities available. The quality of the road network is low with few regional road linkages, while rail networks between ports and markets are often missing, putting unnecessary burdens on already inadequate road networks. Unavailability of railway wagons and locomotives at the border, fixed times of loading and unloading of goods and inter-changing goods trains between the two countries add to the high transaction time and cost of trade.

- The imposition and application of standards in India is often perceived as a non-tariff barrier by Pakistan. More importantly, information flow for trade-related matters between the two countries is particularly weak, thereby generating enormous problems for exporters and importers.
- India and Pakistan still follow restrictive visa regimes. Granting city-specific visas, visas for a limited number of cities, limits on the number of entries and for limited periods of stay, requirements to report to police on arrival and before departure, requirements to exit from the port of entry, lack of criteria for rejection of visas, granting mode-specific visas, disregarding the requested date of entry, and delays in granting visas are some of the restrictions known to us.
- There is a mismatch between the Harmonized System (HS) classifications of goods. The Indian HS eight-digit classification is sometimes used for the Pakistani HS six-digit classification of items on the positive list, giving customs officials room to allow entry based on discretion.
- Most bilateral payments are made through the Asian Clearing Union and businessmen and women in both countries have complained about the inefficiency of this procedure. Since banks are not allowed freely to open branches across the border, this leads to significant delays, especially when letters of credit need to be confirmed, which can take up to a month.
- Mechanisms for redress of grievances do not exist, which prevents some mutually beneficial exchanges from taking place.

Both India and Pakistan have announced several NTBs under SAFTA and later under the bilateral trade negotiations. As mentioned in Taneja (2012), some of these NTMs did not offer any barriers, as they were compatible with WTO rules; some NTMs were also applicable to domestic manufacturers in India but were perceived as NTMs by Pakistan (e.g. inter-state taxes); and in some cases corrective action had been taken but they were still notified as NTMs (e.g. for jute bags). On the other hand, some NTMs imposed by India were found to be trade restrictive. For example, some of the technical barriers to trade (TBT) and sanitary and phytosanitary measures (SPS) measures in India involved cumbersome procedures. Also, the lack of transparency in the regulations is a problem (e.g. regulations related to woollen products and other textiles and jute products). The measure related to labelling requirements for processed foods qualifies as a barrier because it violates the principle of national treatment.⁷ Lack of information about regulatory regimes (e.g. pest risk assessments) is another NTM. Absence of systems for recognition of standards for products (e.g. textiles for the domestic market) is also a NTM faced

by traders between India and Pakistan. To facilitate bilateral trade, these are the immediate challenges that need to be addressed through appropriate policy measures.

Another barrier is the use of dual lists for bilateral trade by both India and Pakistan, which is inconsistent with General Agreement on Tariffs and Trade (GATT) principles. Pakistan has 1,209 items on the negative list for trade with India. Contrary to popular belief, these items are not allowed to be traded through land routes. For trade through land routes (mainly Attari–Wagah), Pakistan maintains a positive list of 137 items, most of which belong to commodity groups such as vegetables, cotton, and iron and steel. This clearly suggests goods should move by ocean and/or air routes despite there being land border crossings between the two countries. With the Integrated Check Post (ICP) in Attari, handling goods across the land border may not always be cost effective but is certainly faster than ocean routes. Once the infrastructure at the land border has been improved, India and Pakistan should not impose any restriction on movement of goods across the land border.

Finally, India and Pakistan compare poorly with their global peers in terms of logistics. Trade procedures are lengthy and flow of goods is constrained by the poor condition of infrastructure, congestion, high costs and lengthy delays.⁸ These problems are particularly severe at India–Pakistan border crossings, many of which pose significant barriers to trade.

22.3 Trade complementarity between India and Pakistan

To what extent are India and Pakistan competitors in the world market? Do they show any complementarities in trade? Answering these questions gives an idea of the prospects for trade between them. At first, the export similarity index (ESI) for the two economies at a disaggregated level is constructed.⁹ The results in Table 22.2 suggest the export profiles of these two economies are not very similar. In large part this reflects the major shift by India into exports in the high-skilled and technology-intensive categories, a move that is yet to be matched by Pakistan (Table 22.3). A quarter of India's global exports are contributed by manufacturers having medium to high skill and technology intensity, whereas almost two-thirds of Pakistan's global exports come from labour-intensive and resource-based manufactures. Trade complementarity between the two countries may be seen in this perspective.

One can construct a trade complementarity index (TCI) to measure the degree to which the export pattern of one country matches the import pattern of another.¹⁰

Table 22.2 Export similarity index (%)

Trade classification	Trade partner	2005	2010
HS six-digit (at H2)	India–Pakistan	21.027	22.496
HS six-digit (at H3)	India–Pakistan		23.158

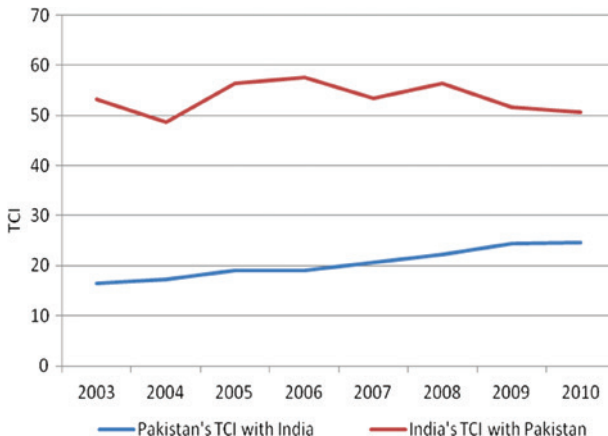
Source: Calculated based on UN Comtrade database

Table 22.3 Structural change in merchandise trade: Share in the country's exports

	Pakistan			
	1995	2000	2005	2010
Labour-intensive and resource-based manufactures	79.18	78.74	73.15	62.03
Manufactures with low skill and technology intensity	0.41	0.66	1.39	1.84
Manufactures with medium skill and technology intensity	0.53	0.98	1.79	2.39
Manufactures with high skill and technology intensity	2.08	3.17	4.80	5.18
	India			
	1995	2000	2005	2010
Labour-intensive and resource-based manufactures	32.90	32.74	21.45	15.09
Manufactures with low skill and technology intensity	6.16	6.77	9.29	9.88
Manufactures with medium skill and technology intensity	6.59	6.67	9.68	9.90
Manufactures with high skill and technology intensity	9.97	11.87	12.90	13.84

Source: Calculated based on UNCTAD Stat database

TCI trends in Figure 22.2 indicate that both countries have witnessed a rise in trade complementarity between 2003 and 2010. However, as noted in Lopez-Calix (2012), major gains would come from diversifying exports since a 'Complementarity Index' as low as 24 per cent between Pakistan's exports and India's imports shows

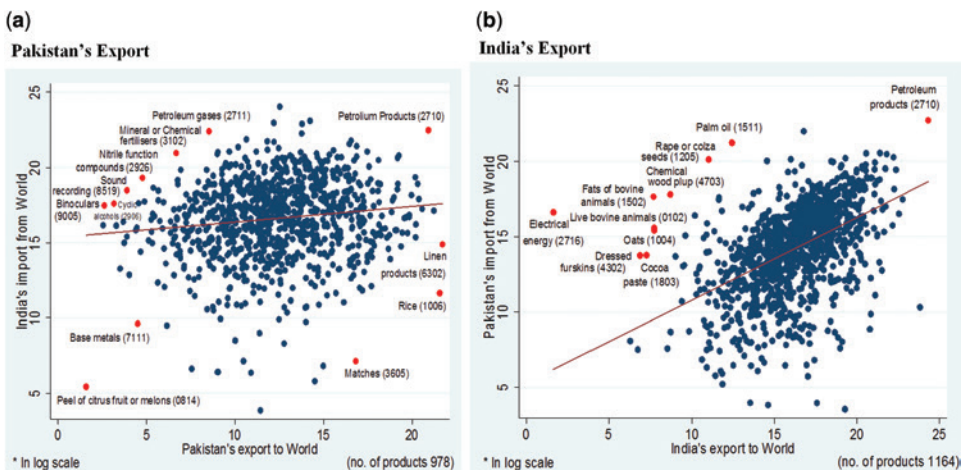
Figure 22.2 Trends in complementarity between India and Pakistan

Source: Calculated based on UN Comtrade database

clearly that the opportunities for Pakistan are not large at the ‘intensive margin’ (to export more of the same to new Indian markets).¹¹ Hence, developing exports at the ‘extensive margin’ (diversifying the exports basket to India) is fundamental to tapping larger benefits from accessing this large and growing neighbouring market. In short, it can be said that an increase in trade competitiveness of India and Pakistan has been accompanied by a rise in trade complementarities. However, almost 90 per cent of the goods on the Pakistan’s negative list belong to manufacturing items for which India has gained competitiveness (e.g. automobiles, iron and steel, etc.). Therefore, Pakistan would lose welfare gains by trading with India if the negative list continues in operation. Improving trade complementarities would thus hold promise for encouraging intra-industry trade across borders. Apparently, the potential for intra-industry trade between the two countries is not limited to a few products (Figure 22.3).

Raihan and De (2014) provide the number of the common set of traded goods between India and Pakistan and compute the intra-industry trade (IIT) scores for these products. Over 32 per cent of total traded products are found to have scored IIT scores greater 0.50 in the case of India; for Pakistan the comparable figure is 15 per cent. The IIT index scores also indicate that there is large potential for about 30 products, with varying capacity. The range of such potential varies from textiles and clothing, iron and steel, electrical machinery and equipment, to mechanical appliances, etc. This indicates potential to integrate their production structures in many sectors and improve their global competitiveness. This can lead to regional and/or global value chains, if supported by improved logistics and lower NTBs. In order to realise the potential, both countries have to undertake further trade liberalisation, such as reducing tariffs and removing NTBs, and also take effective action to reduce trade costs by improving trade facilitation both ‘at-the-border’ and ‘behind-the-border’.

Figure 22.3 Potential trade sectors



Source: Authors

22.4 Pakistan's granting most favoured nation status to India and its impact on bilateral and regional trade

How much would be the bilateral gains from the two countries trading on the basis of the MFN principle? Do other South Asian countries benefit from India–Pakistan MFN trade? To what extent would MFN trade between India and Pakistan increase regional trade in South Asia? These are the questions we often face with changes in the trade environment between India and Pakistan. To answer these questions, we use the help of a computable general equilibrium (CGE) modelling exercise, the details of which are provided in Raihan and De (2014).

First, we identified 561 products for Pakistan at the HS six-digit level from the World Bank's World Integrated Trade Solution (WITS) database, where the unit costs of imports if they were sourced from India would be lower than the unit costs of imports if they were sourced from other countries. The percentage differences in these unit import costs were then calculated. The percentage differences in unit prices for these 561 products at the HS six-digit code were then aggregated into Global Trade Analysis Project (GTAP) sectors matching the concordance and weights for each product.

Since Pakistan would only enjoy a fall in unit import prices for these products if the import source were India, in the GTAP model a scenario ('MFN' scenario) is considered, where there would be a fall in import prices for Pakistan while importing from India. This simulation is done by shocking on the transaction cost of the import from India to Pakistan. In brief, the MFN scenario incorporates a reduction in import prices for Pakistan because of the increased potential to source imports from India at cheaper prices. In addition, it is assumed that there would be some 'peace dividends' for all the South Asian countries because of the improved trade relations between India and Pakistan. In the GTAP framework, such a 'peace dividend' is assumed to lower transaction costs in bilateral trade among the South Asian countries by 0.5 per cent.

The results of the MFN scenario are presented in Table 22.4. The simulation indicates that the welfare effects of MFN will be positive for both India and Pakistan. The results

Table 22.4 Welfare effects of MFN: equivalent variation in US\$ million at 2007 prices

Country	Welfare effects of MFN
Bangladesh	21.08
India	160.71
Nepal	18.01
Pakistan	99.21
Sri Lanka	34.92
Rest of South Asia	15.72
China	-10.52
USA	-18.39
EU25	-29.55
Rest of the World	-66.71

Source: GTAP simulation

also suggest some positive welfare effects on other South Asian countries out of the ‘peace dividends’ generated by improved economic co-operation between India and Pakistan. There will, however, be some negative welfare effects for countries outside of South Asia, since Pakistan, after giving MFN status to India, would change the source of some of its imports from other countries to India.

According to the MFN scenario, Pakistan’s imports from India would rise by 32 per cent. Also, there would be some marginal rise in imports from Bangladesh, Nepal and rest of South Asia. However, imports from China, the USA, EU25 and the rest of the world would decline by some margin.¹² This suggests that a rise in imports from India would lead to a fall in imports from other major sources. Pakistan’s total imports would, however, increase by only 0.28 per cent. This apparently indicates that the MFN scenario on its own would not have a major impact on Pakistan’s total imports. A number of sectors in India would benefit in terms of increases in exports to Pakistan due to MFN status. Such rises in exports from India would happen because of India’s unit cost advantage compared with Pakistan’s other trading partners. Under this scenario, the change in exports from India to Pakistan would vary from meat (348%) to vegetables, fruits and nuts (0.2%). Furthermore, India’s exports to Pakistan would rise for chemical, rubber and plastics, food processing, mineral fuels (petroleum, coal products), metals, machinery and equipment, textiles, leather products, dairy products, fishing, etc.

The impact of the MFN scenario on Pakistan’s total exports would also be minimal. Pakistan’s total exports might rise by only 0.17 per cent and the exports to India in particular might rise by 0.4 per cent. MFN status for India would thus have negligible impact on Pakistan’s sectoral exports to India. There would, however, be some rise in the exports of plant-based fibres, animal products and metals from Pakistan to India. Pakistan would experience some rise in exports to Bangladesh, Nepal, Sri Lanka, the rest of South Asia and China. At the same time, Pakistan would experience some marginal fall in exports to its major export destinations, such as the USA and EU25. This suggests that the MFN scenario would lead Pakistan to re-orient some of its exports to the South Asia region.

The above analysis points to the possibility that, though the MFN scenario would generate some welfare and export gains for both India and Pakistan, such gains would appear to be small. This is because MFN alone would not be enough; and to reap larger benefits extended economic co-operation between India and Pakistan might be needed. In order to explore such possibilities we look at several other scenarios in the GTAP framework. These scenarios include a bilateral free trade agreement (FTA) between India and Pakistan, a bilateral FTA plus increased bilateral trade facilitation, a SAFTA scenario (where all South Asian countries reduce their bilateral tariffs on the goods trade to zero) and a SAFTA scenario plus regional trade facilitation scenario. All these scenarios incorporate the MFN scenario.

Table 22.5 presents the welfare effects of different scenarios. Under a bilateral FTA scenario, both India and Pakistan gain, and the gain for Pakistan would be larger than that for India. Other countries would, however, experience some welfare losses

Table 22.5 Comparison of welfare effects: Equivalent variation in US\$ million at 2007 prices)

Country	MFN	MFN plus India–Pakistan FTA	MFN plus India–Pakistan FTA with bilateral trade facilitation	MFN plus SAFTA	MFN plus SAFTA with regional trade facilitation
Bangladesh	21.08	−2.58	−14.59	−111.77	1,479.56
India	160.71	376.43	2,288.46	1,810.73	5,452.03
Nepal	18.01	−0.65	−6.85	485.03	1,654.21
Pakistan	99.21	443.96	1,964.11	1,121.67	2,618.38
Sri Lanka	34.92	−4.28	−15.56	71.88	2,173.12
Rest of South Asia	15.72	−20.27	−41.22	298.21	1,265.02
China	−10.52	−4.81	−128.04	−216.19	−760.12
USA	−18.39	−62.13	−223.79	−270.47	−985.54
EU25	−29.55	−38.32	−262.74	−348.32	−1,394.91
Rest of the world	−66.71	−185.81	−861.13	−681.72	−3,020.78

Source: GTAP simulations

due to exclusion from the FTA. The gains from the bilateral FTA would be much larger for both countries when associated with enhanced bilateral trade facilitation.¹³ Under this scenario, however, the size of the welfare gain for India would be larger than that for Pakistan. It should be mentioned here that deeper bilateral economic co-operation between India and Pakistan may give rise to some concerns about the prospect of deepening economic co-operation among other countries of South Asia. Therefore, effective implementation of the SAFTA would be more desirable for the South Asian countries. Thus, a scenario of SAFTA was also run and the simulation results suggest larger welfare gains for both India and Pakistan. In terms of gains in both allocative efficiency and of trade, a full SAFTA would generate much larger welfare gains for India and Pakistan than those under a simple bilateral FTA between the two countries. There would be welfare loss for Bangladesh due to the possibility of a larger trade-diversion than trade-creation effect Raihan (2012). However, when the SAFTA scenario is run with a regional trade facilitation scenario, welfare gains for all South Asian countries would increase dramatically, and Bangladesh's welfare loss would be more than compensated by the resulting large welfare gain.¹⁴ Under this scenario, the welfare gains for India and Pakistan would be much higher than those under any other scenarios.

The scenarios with enhanced trade facilitation would result in much larger rises in Pakistan's overall imports and exports. Under the bilateral FTA scenario with trade facilitation, Pakistan's total imports would rise by 7.35 per cent which would be 4.95 percentage points higher than under the bilateral FTA scenario. Similarly, the rise in total exports would be 5.4 percentage points higher under the former scenario than under the latter scenario. Similar observations can also be made for the SAFTA scenarios. The rises in imports and exports would be the highest under the scenario of SAFTA with enhanced regional trade facilitation. It should also be mentioned that

the MFN scenario on its own would result in the least increases in imports and exports for Pakistan. Although the magnitudes are lower, similar results are observed as far as the impacts of different scenarios on India's imports and exports are concerned.

To conclude, Pakistan granting MFN status to India would generate larger benefits if supported by improved connectivity and trade facilitation.¹⁵ The net economic impacts of SAFTA along with trade facilitation are beneficial to both Pakistan and India, and eventually would lead to stronger economic growth of the entire South Asian region. With Pakistan granting MFN status to India, the full implementation of SAFTA is, therefore, not beyond reach. Both countries should go beyond MFN and embrace a second generation FTA that would open the door to other regional co-operation initiatives. At the same time, investment from India could provide a major boost to Pakistan's export industry, which in turn would reduce its trade gaps with India and other countries in the world.

22.5 Role of foreign direct investment in narrowing Pakistan's trade gap with India

Despite the huge inflow of FDI towards developing countries, particularly in China and India, the inflow of FDI in Pakistan has not been impressive. During the 2000s, Pakistan accounted for 0.16 per cent of world FDI, increasing marginally over the next two decades, but always remaining lower than the South Asia average (Table 22.6). India, on the other hand, successfully increased its share in global FDI inflows to over 1 per cent in the 2000s from a meagre 0.11 per cent in the 1980s. The size of FDI inflows to Pakistan was not significant until the beginning of the 2000s, when the FDI inflow increased sharply (Table 22.7). However, the 1980s was a good decade for Pakistan in which it outperformed neighbouring India in attracting FDI. On average, 149 per cent of India's total FDI inflow went to Pakistan, but this reduced in later periods (Figure 22.4). In 2009, FDI inflow contributed to about 1.78 per cent of GDP in Pakistan and 1.54 per cent in India, but remained consistently lower than

Table 22.6 FDI inflows from 1980–2009

	1980–89		1990–99		2000–09	
	Inward FDI	Share in world FDI inflow	Inward FDI	Share in world FDI inflow	Inward FDI	Share in world FDI inflow
	(% of GDP)	(%)	(% of GDP)	(%)	(% of GDP)	(%)
China	0.63	1.83	3.91	6.24	3.09	6.26
India	0.02	0.11	0.39	0.35	1.54	1.13
Pakistan	0.33	0.12	0.88	0.15	1.78	0.16
South Asia	0.08	0.29	0.45	0.55	1.52	1.37
World	0.67	100	1.48	100	2.85	100

Note: FDI inflows counts net inflows, and its share in world FDI inflow.

Source: Calculated based on UNCTAD Stat database

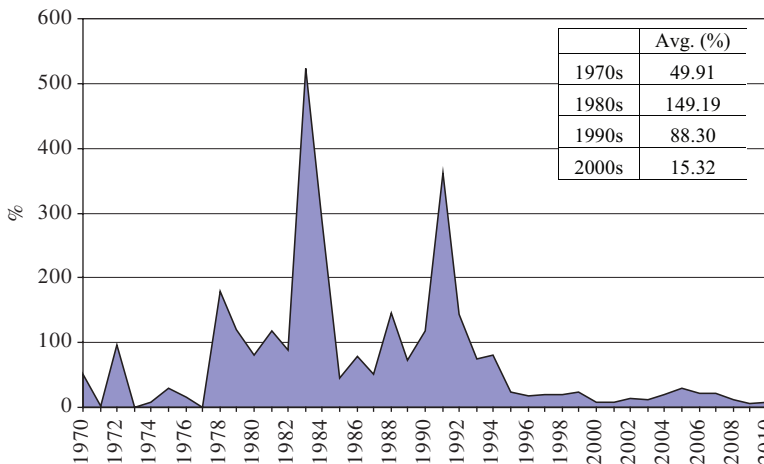
Table 22.7 FDI inflows and outflows (US\$ billion)

	Inward FDI		Outward FDI	
	India	Pakistan	India	Pakistan
2000	3.588	0.309	0.514	0.011
2001	5.478	0.383	1.397	0.031
2002	5.630	0.823	1.678	0.028
2003	4.321	0.534	1.876	0.019
2004	5.778	1.118	2.175	0.056
2005	7.622	2.201	2.985	0.045
2006	20.328	4.273	14.285	0.109
2007	25.350	5.590	17.234	0.098
2008	42.546	5.438	19.397	0.049
2009	35.649	2.338	15.929	0.071
2010	24.640	2.016	14.626	0.046

Source: Calculated based on UNCTAD Stat database

the Chinese and world averages (Table 22.6). On the positive side, India and Pakistan have witnessed sharp rises in FDI inflow since 2000. Table 22.7 shows that FDI inflow to India increased from US\$3.59 billion in 2000 to US\$24.64 billion with a peak of US\$42.55 billion in 2008, whereas a little over US\$2 billion FDI had gone to Pakistan in 2010, increased from less than US\$500 million in 2000. However, FDI to both the countries has shown a declining trend since 2008.

The inflow of FDI into Pakistan is small and concentrated in only a few sectors, mostly in communications, financial services and power (Table 22.8). Broadly, manufacturing industries, mining and quarrying, and the financial sector are the major sectors dominating FDI inflow into Pakistan. On the other hand, a large number of sectors have been attracting FDI in India. The sectoral compositions

Figure 22.4 Pakistan's FDI inflow as a percentage of India's FDI inflow

Source: Calculated based on UNCTAD Stat database

Table 22.8 Top 10 sectors attracting FDI during 2000–10 (US\$ million)

Pakistan		India	
Sectors	Volume	Sectors	Volume
Communication (IT and telecommunications)	7,375.80	Telecommunications	12,546.09
Financial business	4,929.30	Computer software and hardware	10,997.13
Others	4,666.90	Housing and real estate	10,932.53
Oil and gas	4,452.30	Construction activities	10,239.18
Trade	976.80	Drugs and pharmaceuticals	9,196.54
Power	918.40	Power	7,136.46
Construction	709.00	Automobile industry	6,601.12
Transport	626.00	Metallurgical industries	5,761.36
Chemical	588.50	Hotel and tourism	3,195.70
Textiles	350.10	Petroleum and natural gas	3,334.83

Sources: Department of Industrial Policy and Promotion (DIPP), Government of India and State Bank of Pakistan, various years

of FDI in Pakistan and India have also changed over time.¹⁶ Although FDI inflow to India and Pakistan shows wide variations in levels, both have some similarities. First, the communications sector occupies the top position in both the countries. While Pakistan attracted US\$7.36 billion FDI in the communications sector during 2000–10, about US\$12.55 billion went to India in the telecommunications sector in the same period. Power, oil and gas, and construction are other common sectors receiving FDI in India and Pakistan. The services, automobile, metallurgical, drugs and pharmaceuticals, and computer software and hardware sectors in India have also attracted modest FDI in the last decade. Incidentally, these are India's prime export sectors. Mauritius and the USA have been the largest direct investors in India and Pakistan, respectively. The USA, UAE, Switzerland, Japan and Germany are major common investors in both the countries.

South Asian economies have great potential to attract FDI. However, except for India, all other countries actually attract very low amounts of FDI. A number of policy and regulatory measures have been taken to improve the investment climate and attract foreign investment in most of the South Asian countries. For example, restrictions on capital inflows and outflows have been gradually lifted across the South Asian countries. In spite of the liberalisation of their formerly inward-looking FDI regimes and the tempering or removing of obstacles to foreign investors, the performance of most of the South Asian countries, barring perhaps India, in attracting FDI has been lackluster, volatile and unpredictable. Many believe that major barriers to investment in South Asia are widespread corruption, poor governance, and weak political and institutional structures, which are creating gaps between policies and their implementation in these economies.

In recent years, emerging market economies such as the BRICS countries are increasingly becoming a source of foreign investment for rest of the world. It is not only a sign of their increasing participation in the global economy but also

of their increasing competence. More importantly, a growing impetus for change is today coming from developing countries and economies in transition, where a number of enterprises are increasingly undertaking outward expansion through FDI. Companies are expanding their business operations by investing overseas with a view to acquiring a regional and global reach. For example, India has emerged as one of the key investors in the world. Outward FDI from India increased from half a billion US\$ in 2000 to US\$14.63 billion in 2010 with a peak of US\$19.40 billion in 2009, with most of the outflow being in the form of guarantees to offshore investment companies. Indian firms have continued to invest aggressively in foreign countries to explore new markets and also increase their global footprint, while taking advantage of the attractive valuations of assets overseas. However, not one Indian firm has any commercial presence in Pakistan. There is no denying that Indian FDI is important for Pakistan for many reasons, and one reason would certainly be to narrow Pakistan's trade gap with India.¹⁷

(a) Barriers to and constraints on bilateral FDI

While India and Pakistan have succeeded in attracting FDI from the rest of the world, there is hardly any investment between the two neighbours. Pakistan has long complained about the Indian government's policy that bars Pakistani industry from making investments in India. India did not allow FDI from Pakistan until recently.¹⁸ There has been demand from Pakistan to allow investments in India but the proposal did not find many takers within the government due mainly to security concerns. On the other hand, Pakistan does not place any major restrictions on Indian investments. However, Indian companies have not made any investments in Pakistan. In the cases of services trade and FDI, prior government approval has to be obtained, and it is clear that such approvals have been granted very sparingly by both countries.

At the time of writing, there are no joint ventures between India and Pakistan. Institutional mechanisms for bilateral investment guarantees are yet to be established. There is considerable lack of information and awareness in India about Pakistan's trade regime, commercial policies, and business and regulatory procedures. Indian companies have shown interest in floating joint ventures in Pakistan and have asked the two governments to set up an institutional mechanism that would guarantee protection of each other's investments. Companies from Pakistan are also showing interest in investment in India. As several companies are showing interest in investing in each other's countries, it is imperative to understand the nature of such investment and provide timely facilitation.

(b) Measures to strengthen bilateral FDI

There is a complementary (joint) impact of institutions and openness on FDI.¹⁹ Several empirical studies support the view that institutional quality is an important determinant of FDI and believe a healthy institutional environment (i.e. efficient bureaucracy, low corruption, better law and order conditions and secure property rights) is important to enhance FDI in developing economies.²⁰ When rising protectionism is slowing down

openness amid a global financial crisis, strengthening institutions and governance would perhaps help the South Asian countries increase FDI inflow.

Improving the investment environment and political relations are the most important measures for bilateral FDI between India and Pakistan. Physical and technological infrastructures also need to be developed, most importantly at the border check-posts. The poor state of infrastructure acts as a serious bottleneck not only for exports but also for foreign investment.²¹ Improving labour market conditions and administrative capabilities are also important to induce higher levels of foreign investment. Easier travel rules for business people should be enacted. There should be a pro active policy of promoting investment through joint ventures in both countries, market access for banks in each other's market, etc. At the same time, institutions to deal with investment-related grievances along with transparent rules and regulations should be set up. Improving the border trade infrastructure and mutual recognition agreements (MRAs) to facilitate movement of goods are also very important. In September 2012, India and Pakistan took steps to ease visa restrictions and increase travel between the two countries. Both countries have agreed to allow one-year multiple entry visas for business visitors and entry and exit through different cities. The central banks – the State Bank of Pakistan and Reserve Bank of India – had finalised a deal to open up banking outlets in each other's country which would reduce the transaction cost of trade and facilitate FDI.²² These steps are perceived as fruitful ways and means to boost business sentiments and bilateral relations.

(c) Industries to benefit from enhanced FDI

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. According to the SCCI, investment possibilities in Pakistan exist in sectors such as food processing, chemicals and pharmaceuticals, automobile components, and information technology. Previously, a number of potential sectors for mutual co-operation between India and Pakistan were identified, including agricultural products, the textile machinery industry, the automobile industry, the petrochemical industry, minerals, chemicals, pharmaceuticals, leather, telecommunications, etc.

India and Pakistan could also establish joint ventures to harness and transmit the region's hydropower resources. With higher energy demands, there is potential for co-operation between India and Pakistan in electricity generation using coal or wind energy. There is potential for tapping wind energy in the Sindh province of Pakistan, which could make use of wind power in co-operation with India. Co-operation in water management and power projects might help in increasing irrigation benefits, decreasing risks of floods, and establishing an India–Pakistan electricity grid system for intra-country transmission of electricity. Both countries require large volumes of natural gas imports to meet their future domestic needs. A single, joint natural gas pipeline extending overland from Pakistan to India would be economically more viable for both countries than constructing their pipelines independently.

(d) Recent progress in FDI

Both governments plan to restart investment flows, and have made notable progress in reinstating a favorable climate. With political and economic stability, India and Pakistan can expect fresh foreign investment coming into them. An atmosphere of co-operation and amicability is apparent between India and Pakistan, and both countries are trying to improve their bilateral trade relations, which would improve the security climate for investment. As a part of the broader process of regional integration, an economy with larger access to regional markets becomes more attractive to foreign investors. Greater inflow of FDI, in turn, may lead to increased technology transfers and productivity. These steps would greatly expand the scope of integration, with potentially large efficiency gains for both sides.

The Indian government has amended the Foreign Exchange Management Act (FEMA), which has paved the way for investment from Pakistan. Subsequently, FEMA rules have also been amended. Investment from Pakistan is now allowed except in the defence, space and atomic energy sectors. However, proposals for investment in India by companies from Pakistan must be routed only through the Foreign Investment Promotion Board (FIPB) and not through other channels. It is expected that FDI from Pakistan to India will be slow since companies may wait and watch overall political progress before making any commercial decisions. However, this is not to deny that compared with the past, current progress in FDI has been very healthy.

India and Pakistan have agreed to develop mechanisms to address trade and investment issues. The 5th Round of Commerce Secretary Level Talks held on 27–28 April 2011 discussed trade promotion options. The discussion progressed further at the 6th and 7th Rounds of Commerce Secretary Level Talks, held on 14–16 November 2011 and 20–21 September 2012, respectively. The concerned authorities, trade bodies and associations have suggested that the Pakistani government should consciously relax conditions on Indian investment. It was also clarified that there would be no harm to indigenous industry if an industry was established by Pakistani and Indian companies, each party having a 50 per cent share. The opening of investment would not result in a deluge of money flowing both ways across the border. Nonetheless, closer economic co-operation will lead to positive political gains.

22.6 Ways to facilitate bilateral trade and policy options: Some recommendations

Normal trade between India and Pakistan will place peace on a fast track. This is not to deny that there were disruptions in the past, but they have become shorter-lived. Some recent studies show that trade between the two countries may touch US\$12 billion by 2015, if trade and investment barriers are removed.²³ To achieve this, we have to strengthen the peace process and continue interactions. 'Peace dividends' is yet another effort to nudge the two countries into keeping the economy high on the agenda. Undoubtedly, normal relations between the two countries offer huge peace dividends. They offer great opportunities for a new era of integration.

While the foregoing is good, both governments must be much more ambitious. Pakistan needs to focus on improving customs and scrapping the remaining negative list of trade

items. But India, which stands to gain disproportionately from burgeoning trade, must take bigger responsibilities. Stable relations with Pakistan are a prize in itself for India. Immense hurdles remain, not least the quest for peace in Afghanistan, but the longer-term dream is of land trade through Pakistan to Central Asia, with its oil and gas, and even to European markets. Given all that, India should dare to be generous, removing NTBs, cutting duties on Pakistani imports and making it easier to invest in India. Important steps at the border today will bring great rewards in the future.

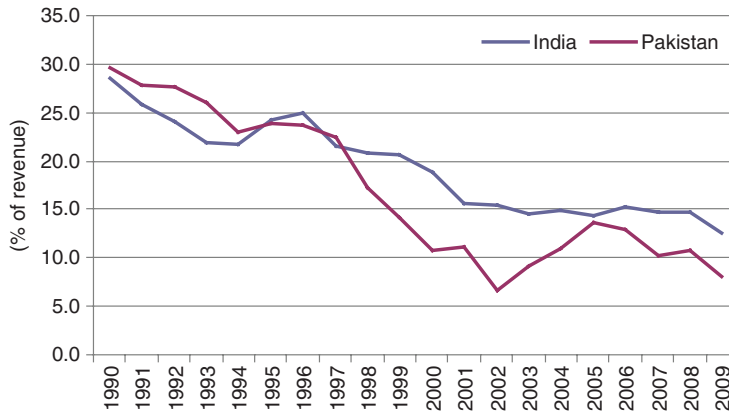
A battery of recent studies indicate that India and Pakistan should further liberalise trade by cutting lists of sensitive products and removing NTMs, along with improvements in trade facilitation, and in transit of goods and services.²⁴ So far, by replacing the positive lists with negative lists of trade items, India and Pakistan have come relatively closer to reinstating a non-discriminatory trade regime. With MFN status, Pakistan will provide equal treatment to India in terms of tariffs and trade regulations to that it offers to other WTO members. This will obviously encourage formal trade to grow, and informal and third country trade is expected to disappear gradually. At the same time, MFN treatment does not necessarily mean that the trade regime becomes preferential, open or accessible. As trade flows between India and Pakistan increase, there would be a greater demand for transparency, faster movement of goods and services across borders and increased market access. New solutions need to be worked out to ease NTBs. A step forward in this direction could mark the beginning of greater trade and economic co-operation between the two countries through the MFN regime. A lot more needs to be accomplished before free trade would give each country a stake in the other's success.

What makes a MFN work is the trade facilitation that surrounds it. The results of the general equilibrium simulations indicate Pakistan's granting MFN to India would generate larger benefits if supported by improved connectivity and trade facilitation. In other words, gains to Pakistan would be limited in the absence of improved connectivity and trade facilitation. The net economic impacts of SAFTA along with trade facilitation are beneficial to both Pakistan and India, and eventually would lead to stronger economic growth of the region. With Pakistan's granting MFN to India, the full implementation of SAFTA is, therefore, inevitable.

In general, three policy options are recommended. First, further deepening of trade liberalisation (e.g. removal of NTBs, cleaning the sensitive lists, duty-free, quota-free (DFQF) access to products where marginal return from trade is very high, removal of quantitative restrictions). Second, supporting trade facilitation to complement trade liberalisation (e.g. removing the delay in payment between exporter and importer by introducing internet banking, allowing more banks to operate). Third, making the FDI flow move freely between the two nations (e.g. building the institutional mechanism for bilateral investment guarantees).

Option 1. Tariff rationalisation and removal of NTBs

Both countries' trade liberalisation initiatives since the 1990s have been deep as well as broad. Government's dependence on import duties has declined in both India and Pakistan (Figure 22.5). Given that import tariffs introduce a bias against exporting, the large reductions in tariffs have played a role in improving export competitiveness

Figure 22.5 Taxes on international trade

Source: Calculated based on World Bank Doing Business database

in India and Pakistan. Thus, customs duties are still the principal instrument of trade policy, particularly in the context of India and Pakistan trade.

Average tariffs between India and Pakistan have come down much faster than NTBs. But both countries feature large variations between – and within – statutory tariffs (Lopez-Calix 2012). For example, India's distribution is skewed more to lower tariffs. Although the average tariff has come down to 10–15 per cent in both countries, high tariffs still persist for some major products. For example, Pakistan's import tariff of 35 per cent on Indian exports of granite (contributing about 55 per cent of Pakistan's total granite imports from the world) or 20 per cent on condensers for steam or other vapour power units (contributing about 100 per cent of Pakistan's condenser imports from the world) have been penalising the growth of bilateral trade. On the other hand, India's import tariffs of 24 per cent on Pakistani exports of dates (edible fruits and nuts) appears to be on the high side. India imported about US\$35 million of dates from Pakistan in 2009. India's tariffs are also relatively high on imports of textiles and agricultural products from Pakistan. India imposes both an *ad valorem* rate and a specific duty, whichever is higher, on the import of textiles and clothing and agricultural goods. Generally, the specific duties appear to be higher in India and, in some cases, exceed 100 per cent, especially on value-added textiles. Compared with the specific duty, *ad valorem* rates are much lower. Quick gains could be obtained by reducing Indian tariffs on Pakistani cotton yarn, fruits and vegetables and removing NTBs. Similarly, freeing imports of newsprint from India would help Pakistan to manage its huge shortfall in demand for newsprint. Therefore, pruning the sensitive lists and normalisation of import tariffs may enhance bilateral trade.

In addition to rationalising import duties, quantitative restrictions, regulatory duties and other para-tariffs, several other measures that have restricted trade in the past should be eliminated. Despite the fall in average tariffs, trade restrictiveness of both India and Pakistan has been heavily triggered by the large number of NTBs. In promoting trade between India and Pakistan, the major stumbling block is the

presence of such NTBs.²⁵ Deeper co-operation between India and Pakistan can potentially result in significant reductions of these barriers.

Trade liberalisation has long been seen as an important element of sound economic policy, and trade facilitation is a necessary step to achieve it. Trading more efficiently between India and Pakistan would probably increase average incomes, providing more resources with which to tackle poverty.

Option 2. Trade facilitation and improvement in connectivity

Trade facilitation is aimed at ensuring the movement and clearance of goods across borders within the shortest time at the minimum cost.²⁶ Thus, the two elements which form the crux of the issue are time and cost. Trade facilitation would mean addressing these issues and attempting ways and means to minimise the cost and time taken for movement of import and export cargo.

Trade facilitation in South Asia is unimpressive when we consider behind-the-border issues. India and Pakistan compare poorly with their global peers in improving logistics. South Asian countries suffer from excessive direct costs and excessive time taken to cross borders and from inefficiency in cross-border transactions, which ultimately affect trade negatively. Trade in the region is also constrained by the poor condition of infrastructure, congestion, high costs and lengthy delays. These problems are particularly acute at the India–Pakistan border crossings, many of which pose significant barriers to trade. Among the major causes of high trade transaction costs is the number of cumbersome and complex cross-border trading practices, which also increase the possibility of corruption. Goods carried by road are largely subject to transshipment and manual checking at the border, which creates serious impediments to regional and multilateral trade. The problem is further compounded by lack of harmonisation of technical standards.

The GTAP simulations show that improved trade facilitation (e.g. removal of behind-the-border barriers) would increase the volume of trade between India and Pakistan, by reducing the transaction costs of trade, making exports more competitive and imports less expensive. However, in reality, the South Asian countries are far behind their global peers in trade facilitation. India has an edge over Pakistan in all dimensions of the World Bank's Logistics Performance Index.²⁷ While larger economies such as India have successfully reduced the time taken to export, exporting a consignment in Pakistan still takes about 21 days. On the positive side, Pakistan beats India and the other South Asian countries with lowest cost of exports in the region. In terms of export time, preparation of documents takes most of the time needed for exports in South Asia, except for Maldives and Nepal where the time needed for customs and ports, and inland transit, respectively, outweigh document preparation time (World Bank Doing Business Database). Therefore, reduction of transaction time through simplification of documentation and paperless trade should be the priority.²⁸ Pakistan has the advantage of the lowest costs of trading across the border in South Asia. However, other South Asian countries have relatively higher costs of exporting and importing. Therefore, significant reductions in transaction costs in South Asia will be critical to the effectiveness of bilateral trade co-operation. To

reduce trade-related transaction costs, governments must collaborate on a trade facilitation agenda that encompasses procedures, regulations and processes that impose costs on cross-border commercial transactions (e.g. customs, standards, movement of people, etc.).²⁹

India and Pakistan do not have much cross-border infrastructure between them and, therefore, circumvent this by transporting much of their bilateral trade through unofficial routes. Thus, development of cross-border infrastructure, especially transportation linkages and energy pipelines, should be given the utmost priority, since completion of this will contribute to bilateral as well as regional integration by reducing transportation costs and facilitating trade and services. With MFN status in trade, India and Pakistan should consider a strategy that will not only eliminate the barriers to cross-border infrastructure development but will also encourage investment flows in the region. Given that most cross-border projects are associated with several risks, India and Pakistan have to play a larger role in creating an enabling environment for the private sector to invest in regional infrastructure projects.

Improved transit in South Asia is long overdue. SAFTA may give Afghanistan increased access to South Asian market. Similarly, the MFN agreement offers the potential for India and Pakistan to improve their connectivity with South West Asia, Central Asia and beyond. If goods are permitted to transit freely in South Asia, the whole region will benefit. Better trade relations with Pakistan can provide transit access for Indian goods to Afghanistan and Central Asia, on the one hand, and to Iran and Turkey, on the other. Pakistan has a bilateral transit agreement with Afghanistan, which was renewed in 2010. In addition, Pakistan is an integral part of the trade and transit arrangement in the Economic Cooperation Organization (ECO), which has helped Pakistan to run container trains between Islamabad and Turkey via Tehran. In November 2006, Pakistan signed an FTA with China, and in November 2008, fast-track clearance for cross-border transit between China, Pakistan, Kazakhstan and Kyrgyzstan commenced after 13 years of negotiations. Transit between Pakistan and Afghanistan will facilitate the market for goods and energy trade (power and gas pipelines) between India and the energy rich Central Asia, South West Asia and the Gulf. The advent of MFN status may perhaps help complete the implementation of the Turkmenistan–Afghanistan–Pakistan–India (TAPI) gas pipeline, as a new environment of trust and co-operation prevails. At the same time, subregional transit between Afghanistan, India and Pakistan would help build regional transit, thereby moving towards a Customs Union in 2015 and an Economic Union in 2020 in South Asia. In addition, India and Pakistan should work to harmonise trade and tariff policies, customs procedures, exchange of customs information, and establish linkages between trade associations in the trade transport and transit areas and prepare a trade guide and website giving information on trade, transport, transit and customs facilitation institutions and activities.

Option 3. Allowing FDI to narrow the trade gap

The GTAP simulations indicate the winning sectors in terms of rise in exports from India to Pakistan, such as chemical, rubber and plastics, food processing, mineral fuels (petroleum, coal products), metals, machinery and equipment,

textiles, leather products, sugar, etc. SAFTA with enhanced trade facilitation will help firms in India and Pakistan exploit economies of scale through access to an enlarged market. Indian FDI (and also from other countries) would help Pakistan to narrow the trade deficit with India. In view of the larger market size, Pakistan's MFN status for India would attract Indian FDI in Pakistan in these sectors, thereby facilitating intra-industry trade between the two countries.³⁰ For example, the export of petroleum products from India to Pakistan is one aspect of trade relations which will benefit from the new arrangement.³¹ Undoubtedly, there would be a huge expansion in the number of new opportunities for trade and commercial enterprise in the region.

FDI becomes relevant as economic engagement between the two countries deepens. A greater degree of bilateral investment could strengthen bilateral exports between India and Pakistan. Exports in sectors such as agricultural produce, chemicals, textiles and auto components could be enhanced through bilateral investment.

Can a Pakistani enterprise invest in India? Yes.³² Pakistan was the only country from which investment was barred until 1 August 2012. Indian investors have shown willingness to invest US\$20–50 billion in Pakistan's mining, petroleum, energy, power and infrastructure projects.³³ The Indian private sector has also shown eagerness to export electricity and petroleum products to Pakistan.³⁴ After enhancement of trade ties, opportunities will further increase for big projects like the gas pipeline project between Turkmenistan, Afghanistan, Pakistan and India.

India has amended the FEMA to allow FDI from Pakistan and made an appropriate change in the Consolidated FDI Policy. Subsequently, FEMA rules were also amended, the overall FDI policy would also apply to Pakistan and proposals for investment in India by companies from Pakistan would be routed through the Foreign Investment Promotion Board (FIPB).

Pakistan has lifted restrictions on investment but no Indian has been able to invest in the country. India is a large market and Pakistanis have great opportunities to set up manufacturing bases, besides exporting their products. Therefore, there is an urgent need for both governments to set up an institutional mechanism that would guarantee protection to each other's investments. As of yet, Pakistan and India do not have a bilateral investment protection agreement (BIPA). Both countries should sign a BIPA at the earliest opportunity. This would enable financial institutions to protect investments by extending insurance cover at the market rate.

There should be a proactive policy to promote investment through joint ventures in both countries, access for banks in each other's markets, etc. There is ample scope for joint ventures across borders. Linking the capital and financial markets of both countries would give a boost to economic activities. An integrated network of multi-commodity markets in the South Asian Association for Regional Cooperation (SAARC) countries would help in providing the maximum benefit from the region's potential.³⁵ The Karachi Stock Exchange (KSE) and Bombay Stock Exchange (BSE) are about to sign a memorandum of understanding, which would enable the KSE to be listed at the BSE.³⁶

Improving border trade infrastructure and mutual recognition agreements to facilitate movement of goods and services is also important. Facilitating visas for increased business travel is needed. Business travellers, medical patients and students from both countries should be exempted from any sort of visa restrictions. On-arrival visas at selected air and land ports should be extended to patients, investors and selected services professionals. Improved frequency of transport services (i.e. bus, rail, air) would provide increased flexibility for businessmen and the population as a whole. These steps are perceived as fruitful ways and means to boost business attitudes and bilateral relations. Finally, besides withdrawing bans on investment in both countries, a change in the mindset on both sides of border is a key to bridging the trust deficit and building a lasting partnership.

22.7 Concluding remarks

Trade is a key component of international co-operation and sustainable development. While the world has changed in fundamental ways since the global financial crisis erupted in 2008, and faces challenges both old and new, furthering South–South co-operation remains vital. Merchandise exports from developed economies have turned ominously downward. On the other hand, trade flows of developing economies have mostly remained strong. Thus, it appears that the trade slowdown is mostly confined to developed economies, especially in Europe. This suggests that South–South trade may be one of the best ways to avoid a more serious trade slump. Countries in the South will continue to have higher trade in the southern region. India and Pakistan from South Asia, and China from East Asia, for example, have the added responsibility to drive this.

India and Pakistan have come a long way in rebuilding their economic and political relations. A liberalised India–Pakistan trade regime would strengthen the economic relationship and regional integration. We need to undertake projects on priority basis, not only to rebuild bilateral relations (starting with MFN status) but also to strengthen South Asian regional co-operation.

Notes

- 1 Interestingly, the cumulative list of tradeable items in Pakistan's positive list saw a modest rise from 600 in 2000 to 4,376 in 2009.
- 2 Data refer to the year 2010, sourced from WDI Online Database of the World Bank.
- 3 The widening trade balance is in favour of India, but it should not be a major concern. A bilateral trade deficit has to be seen in the light of a country's total trade balance.
- 4 See De (2011), for a general discussion on the cost of trade in South Asia.
- 5 More because of Pakistan's trade with India, since Pakistan has a positive list of 137 items that can be imported from India through the Attari–Wagah land border.
- 6 India still has significant NTBs. For example, the NTB frequency/trade coverage ratio is as high as 51 per cent in India. In the literature we find NTBs that have protectionist intent such as quotas, tariff-rate quotas, licensing regimes, price bands and NTMs. NTMs are policy measures, other than ordinary customs tariffs, that can potentially have an economic effect on international trade in goods, changing the quantities traded, or prices, or both. Some of these measures may constitute NTBs.
- 7 The measure requires imported processed food items to have a shelf life of at least 60 per cent of its original shelf life at the time of import. There is no such stipulation for domestic goods.

- 8 See, for example, Roy and Banerjee (2010).
- 9 ESI can be calculated based on following formula:

$$\sum_i \min \left(\frac{\sum_w x_{isw}}{\sum_w X_{sw}}, \frac{\sum_w x_{idw}}{\sum_w X_{dw}} \right) \times 100,$$

where *d* and *s* are the countries of interest, *w* is the set of all countries in the world, *i* is the set of industries, *x* is the commodity export flow and *X* is the total export flow. In words, the smaller of the sectoral export shares (as a percentage) in each product category are taken and added together.

- 10 TCI can be calculated based on following formula:

$$\left[1 - \left(\sum_i \left| \frac{\sum_w m_{iwd}}{\sum_w M_{wd}} - \frac{\sum_w x_{isw}}{\sum_w X_{sw}} \right| \right) \div 2 \right] \times 100,$$

where *d* is the importing country of interest, *s* is the exporting country of interest, *w* is the set of all countries in the world, *i* is the set of industries, *x* is the commodity export flow, *X* is the total export flow, *m* the commodity import flow and *M* the total import flow.

- 11 Hummels–Klenow (Products) intensive margin refers to the share of Country A's exports in world exports of only those goods that Country A exports, whereas Hummels–Klenow (Products) extensive margin refers to the share of world exports only in goods that Country A exports in total world exports of all goods. Pakistan's intensive margin (products) is found to be only 0.17 per cent in 2010 at HS four-digit (at H3) trade classification, whereas the same for India is 1.57 per cent (calculated based on WITS).
- 12 Here, EU25 means the 25 member countries of the EU.
- 13 Under the bilateral trade facilitation scenario, the transaction costs in the bilateral trade between India and Pakistan are reduced by 25 per cent. In this regard, the 'ams' – import-augmenting 'technical change' in the Armington nest in the GTAP model (which can be used to lower the effective price of imported products) – is shocked.
- 14 Under the regional trade facilitation scenario, the transaction costs in the regional trade among the South Asian countries are reduced by 25 per cent. In this regard, the 'ams' – import-augmenting 'technical change' in the Armington nest in the GTAP model (which can be used to lower the effective price of imported products) – is shocked.
- 15 In an another study, Hertel and Mirza (2009) observed that trade facilitation plays an important role in determining patterns of global trade flows, where the relative effect on bilateral trade of improving an exporter's border logistics is larger than that of improving an importer's trade facilitation. The study also revealed that proportionate increases in intra-South Asia trade are larger in all countries for textiles and clothing, automobiles and their parts, and other manufacturing goods.
- 16 In India, foreign investments are currently permitted through financial collaborations, through private equity or preferential allotments and in joint ventures. FDI is not permitted in the arms, nuclear, railway, coal or mining industries.
- 17 See a joint press conference (on 15 February 2012) with his Pakistan counterpart, by Indian Commerce, Industry and Textiles Minister Anand Sharma. (Sharma is the first Indian commerce minister to visit Pakistan since independence. He arrived through the Attari–Wagah border, accompanied by a 150-strong business delegation.) Sharma told reporters 'The question of investment becomes relevant as economic engagement between the two countries deepens. The concerns expressed (by Pakistan) on investment have been seriously taken on board and would take an appropriate and correct view soon.'
- 18 There used to be a negative list of countries under the Foreign Exchange Management Act (FEMA) in India. The government removed Sri Lanka in 2006, Bangladesh in 2007 and Pakistan in 2012 from the list.
- 19 See , for example, Dollar and Kraay (2003).

- 20 However, many studies have failed to establish significant relationships between institutions and FDI. The literature revealing evidence of significant associations between institutions' quality and FDI remains mixed. See, for example, Lim (2001), Blonigen (2005).
- 21 Refer to, for example, Amjad et al. (2012), which evaluated Pakistani exporters' perceptions of the problems they face in exploiting their full competitive potential in the international market. Using firm-level survey data, they found that a shortage of skilled labour, the energy crisis, institutional rigidities, market imperfections, and weaknesses in physical infrastructure have been the key impediments to achieving export competitiveness.
- 22 From India, the Bank of India and the State Bank of India and from Pakistan, the National Bank of Pakistan and the United Bank are likely to open branches in Pakistan and India, respectively.
- 23 See, for example, De et al. (2012).
- 24 Gains for South Asian intraregional trade accruing from improvements in regulatory and logistical issues are huge. See Taneja (2012), Kochhar (2012), Lopez-Calix (2012), Khan (2011), De et al. (2012), Pasha and Imran (2012), etc.
- 25 This has been well recognised at the ministerial level. Refer to the Joint Declaration of 7th Ministerial Meeting, 20–21 September 2012.
- 26 The broader definition of trade facilitation goes beyond what has been noted in the WTO. In the literature, trade facilitation has been identified as the means of moving trade across borders and is not restricted to a country's customs authority.
- 27 This refers to the year 2010. Source: World Bank Logistics Performance Index (LPI).
- 28 To support the trade flows between the two countries, India's Integrated Check Post (ICP) at the Attari border, inaugurated on 13 April 2012, is a step forward. The setting up of the ICP is significant as it will naturally boost bilateral trade between the two countries. Built at a cost of nearly INR15 billion and spread over about 130 acres, the ICP has passenger and cargo terminals, security and scanning equipment, and passenger amenities, in addition to waiting areas, restaurants, restrooms, duty-free shops, banks and other financial services. The ICP can handle about 600 trucks at a time. As a consequence of this enhanced infrastructure, trade, previously conducted only between 8 am and 4 pm can now be conducted for 12 hours – between 7 am and 7 pm. Thus, more trucks can drive to India and cross over to Pakistan each day. However, the physical infrastructure facilities at the Wagah border-control facilities must be expanded. Specifically, sophisticated X-ray machines through which trucks can pass quickly should be a top priority, warehousing is needed at Attari, and several new train stations need to be built.
- 29 Seeking to give a big push to opening up of borders for trade and commerce, both the countries have set up several Joint Working Groups (JWGs), such as the JWG on electricity, petroleum and banking, the JWG for visas, the JWG for border trade on the Munabao–Khokharapar route, the JWG for trade in petroleum, the JWG for electricity trade, etc.
- 30 In an article, one of India's largest business chambers commented: 'Intra-industry trade should increase as the MFN agreement takes effect, and a large number of multinational corporations will likely set up their plants to serve both markets' (Kumar 2012).
- 31 Lakshmi Mittal, an Indian steel tycoon, is currently constructing a new oil refinery in the border city of Bhatinda in India's Punjab state in association with India's Hindustan Petroleum Corporation. It will eventually have the capacity to supply large amounts of petroleum products to northern Pakistan. India's Essar Oil has entered into an agreement with Pakistan's Maple Leaf, a major cement manufacturer, to supply petcoke.
- 32 But India did not allow FDI from Pakistan until recently. The Indian FDI Policy used to state: 'A non-resident entity (other than a citizen of Pakistan or an entity incorporated in Pakistan) can invest in India, subject to the FDI Policy. A citizen of Bangladesh or an entity incorporated in Bangladesh can invest only under the Government route.' Refer to Chapter 3, General Conditions of FDI, Consolidated FDI Policy (effective from 12 April 2012), Department of Industrial Policy and Promotion (DIPP), Government of India.
- 33 According to Pakistan–India Business Council (PIBC) Chairman, Noor Muhammad Kasuri.
- 34 There is a proposal to export surplus diesel from Bhatinda refinery in India to Pakistan through a 200km pipeline.
- 35 Refer to Mr Joseph Massey, Managing Director of the Multi Commodity Exchange, Mumbai.
- 36 Refer to Mr Muneer Kamal, Chairman, Karachi Stock Exchange (KSE), Karachi.

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