CHAOPHRAYA ESSAYS

India-Pakistan Trade: Economic Sense and Other Sensibilities

ABOUT THE SERIES

The 'Chaophraya Essays' is a series of essays on bilateral challenges to the normalization of India-Pakistan relations. The series is a culmination of ideas and thoughts exchanged at the Chaophraya Dialogue task force and side meetings since 2014, when participants at the dialogue discussed sharing the wealth of information, ideas and solutions that have been generated through the Chaophraya Dialogue over the years.

Each essay has been contributed by one of Pakistan's leading voices on policy who have regularly participated in the long running Chaophraya Dialogue, a joint India-Pakistan Track II initiative undertaken by the Islamabad-based Jinnah Institute (JI) and Melbourne-based Australia India Institute (AII).

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JINNAH INSTITUTE

INDIA-PAKISTAN TRADE: ECONOMIC SENSE AND OTHER SENSIBILITIES

By Asad Sayeed

INTRODUCTION

Efforts to encourage India and Pakistan towards becoming normal trading partners have been only marginally successful. Pakistan granting India Most Favored Nation (MFN) status, or Non-Discriminatory Market Access (NDMA) as it has been recently re-phrased to avoid literalist pitfalls will be a meaningful first move towards this normalisation. The trade ball thus squarely lies in Pakistan's court. Apart from the all-too familiar pitfall of geopolitics that stalls the process, skeptics who question the economic viability of normalising trade relations with India also present a major barrier to open trading ties. Much of this skepticism flies in the face of the fact that in 2011, an unprecedented consensus was established in the public eye when the Pakistan Business Council – an amalgam of the country's most prominent industries – as well as five major political parties with 90 per cent representation in Parliament at the time, endorsed the idea of trade normalisation with India.

This paper seeks to visit the issue of whether trading with India makes economic sense for Pakistan. In Section I, the paper starts with basic principles, couched in intra-regional trade theory, to demonstrate the case for trading with neighbors. With the help of recent data, the paper shows that it is because of the lack of trade between Pakistan and India that the South Asian region remains the least integrated trading region in the world. In Section II, the paper outlines the areas and sectors where trading with India will provide a boost to the Pakistani economy. This is further illustrated by a brief case study of the revival of Pakistan's film industry as a result of resumption of trade with India. Section III then addresses three prevailing myths in Pakistan about the negative impact of trading with India. Finally, based on the economic case for trade normalisation, this paper , argues that it is important to de-link the issue of trade normalisation from other matters that lie at the heart of conflict and animosity between these two perennially quarrelsome neighbors.

INTRA-REGIONAL TRADE THEORY

Literature on intra-regional trade demonstrates three specific features that are beneficial for neighboring countries. First, in industries and products where transport costs are an important component of aggregate product cost, geographical proximity reduces costs for both neighbors if they trade in that commodity with each other. Known as the 'gravity' model in the literature, this is considered one of the main benefits of intra-regional trade. Batra (2004) has estimated trade flows using this model for India with 145 countries and shows that the potential for India's trade with Pakistan is the highest in the SAARC region. Second, similarity in tastes across neighboring countries means markets for culture specific products expand if the neighbors trade with each other. Third, countries that are geographically proximate to each other also tend to have similar natural resource endowments and capital-labor ratios. These factors create opportunities for intra-industry trade. Intra-industry trade involves the prospects of trade that "exist within the same product (horizontal) or in a products value chain (vertical) spread across countries" (Hussain and Khan, 2014). This essentially means that Pakistan may import cotton from India but exports refined cotton cloth or dresses to India. All these distinct advantages that regional trade bestows upon trading partners serves to deepen the aggregate share of trade in GNP by converting non-tradeables into tradeables. This particular facet serves to enhance growth in two ways. First, when production takes place for a larger market, economies of scale reduce costs. Second, as production takes place for international markets by transforming non-tradeables into tradeables, product quality and cost efficiency is expected to improve also.

The literature, however, points out a downside of regional trade also. According to Bhagwati, Greenway and Panagariya (1998), regional trade can be restrictive for developing countries as it diverts exports

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from developed countries to developing countries. Known in economic parlance as 'trade diversion,' this hypothesis is based on the premise that the real gains from trade to developing countries occur with developed countries as they are able to maximize their comparative advantage given the difference in factor endowments between the two sets of countries. Also, demand for higher quality standards and competition with other developing countries for developed country markets enhances efficiency in factor use and improves competitiveness. Since most developing countries neighbor other developing countries, concentration on trading with similarly endowed countries will divert trade away from the developed world and thus reduce gains from trade.

There is sufficient evidence to demonstrate the minimal impact of the 'trade diversion' hypothesis for developing countries. First, as argued earlier, regional trade enhances the share of tradeables in GNP rather than diverting exports from global markets. Second, as Coulibally (2008) illustrates for Sub-Saharan Africa, imports of intermediate goods and machinery from neighboring countries enhance exports globally. As such, rather than diversion, regional and global trade can be complimentary to each other.

REGIONAL TRADE LAG IN SOUTH ASIA

South Asia does worse in terms of regional trade compared to virtually any other region in the world. As Figure 1 shows, except for Central Asia, that predominantly exports energy,, all other regions have a significant share of their aggregate trade within their regions. As we see in Figure 1, the European Union is the most integrated , with close to two thirds of trade taking place within the region. East Asia, North America, Southeast Asia, Latin America and even Africa are reasonably well integrated. South Asia's regional trade, however, is a meagre 5.31 per cent of its total trade.

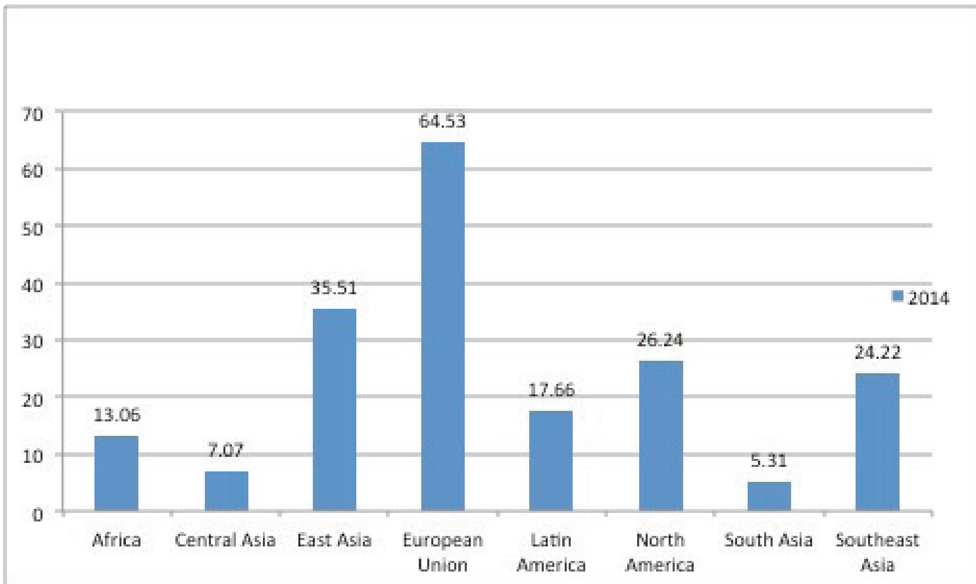

Figure 1: Intra-regional trade as a share of total trade of the region (%)
Source: Asia Regional Integration Center, Asian Development Bank

Lack of trade integration in South Asia, in turn, is mainly because of low levels of trade between India and Pakistan. Figure 2 shows each South Asian country's trade within the region as a share of its aggregate trade globally. The smaller and less developed economies in the region – Nepal, Afghanistan and Bhutan – have the largest trade share in the region. More than anything, this goes to show their lack of integration with the global economy. The two relatively developed economies of Sri Lanka and Bangladesh, with robust export-GDP ratios also have double digit regional trade shares. Given the level of global trade that both India and Pakistan engage in, their share of regional trade is expected to be close to that of Bangladesh or Sri Lanka rather than Nepal. In other words, if the two countries did not restrict trade with each other, their share of trade in the region could be roughly double of prevailing levels and pull up intra-regional trade in South Asia significantly.

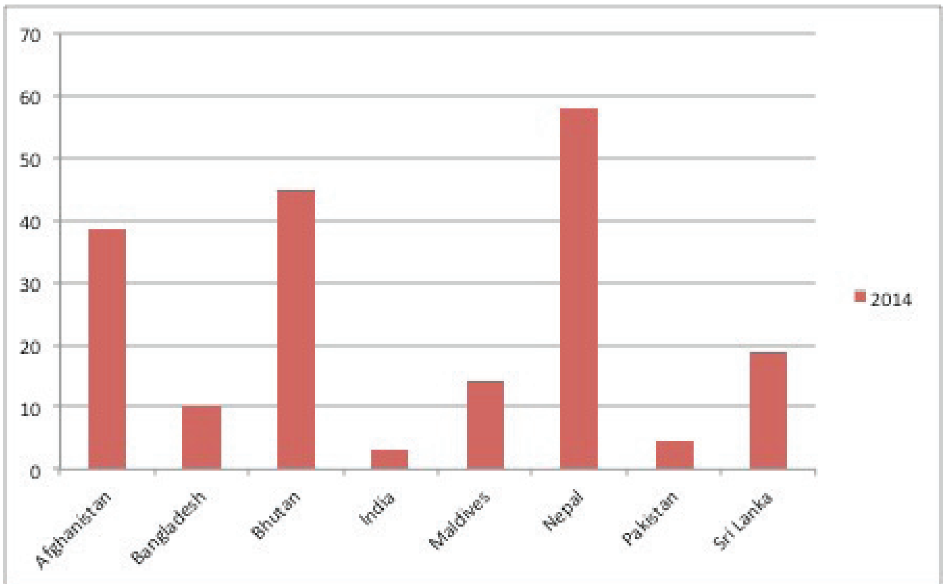

Figure 2: Individual Country Trade within South Asia as a Share of its Total Trade (%) (2014)
Source: Asia Regional Integration Center, Asian Development Bank (ADB)
Note: As ADB did not report data for Bhutan, data has been taken from the Ministry of Finance, Government of Bhutan and is for the year 2013.

POTENTIAL FOR TRADE EXPANSION

There are several studies that have estimated potential trade levels as well as specific products where trade potential is high in either country. The Trade Development Authority of Pakistan (TDAP, 2012) estimates that Pakistan's aggregate trade with India can increase at least four-fold and that Pakistan's exports to India have the potential to increase by a multiple of ten from the levels they were in 2012. The Pakistan Business Council (PBC, 2015) has determined a list of items that can be exported to and imported from Pakistan to India. The methodology adopted for this purpose was to compare growth in Pakistan's exports globally with growth in India's global imports. If India imports those items where Pakistan is globally competitive but does not import those goods from Pakistan, then that product is seen to have high potential for export from Pakistan to India. The same methodology is applied for Indian exports to Pakistan. The high potential item categories identified are as follows:

Pakistani Exports to India

1. Textile and footwear (Cotton trousers and shorts, bedspreads, t-shirts, leather shoes etc.)
2. Agricultural Products (Ethyl alcohol, sesamum seeds, fish, dates etc.)
3. Plastics (Polystyrene nes, plastics waste and scrap, household and toilet articles etc.)
4. Machinery (Fans, gas turbines, aircraft engines, air conditioning machines etc.)
5. Pharmaceutical products (Medicaments nes, hormones, dressings, antibiotics etc.)

Indian Exports to Pakistan

1. Agricultural Products (Black tea, soya bean oil, durum wheat, milk powder, grapes etc.)
2. Machinery (Plant and lab equipment, parts for diesel engines, taps, valves, compressors etc.)
3. Vehicles other than railway (Automobile and motorcycle engines, diesel-powered trucks etc.)
4. Auto Sector (parts and machinery for engines, air conditioning units)
5. Iron and Steel
6. Organic Chemicals

From the list above, we can see that there is significant potential for intra-industry trade. For instance, Pakistan's automobile industry currently imports 57 per cent of its auto-related raw material from Japan (SBP, 2014). India's auto sector is internationally competitive and presents opportunities to trade in parts and implements that are imported from elsewhere. It would be cheaper to import from India given lower production and transportation costs. Similarly, Hussain and Khan (2012) interviewed key stakeholders and identified opportunities for intra-industry trade in agriculture. Pakistan can focus more on inputs and India can specialize in processing and value addition. For instance, Pakistan can supply fruit pulp and juice concentrate, which can be utilized by the 'expanding' juicing industry in India.

It must, however, be noted that both India and Pakistan place around 30 per cent of the high potential products on their sensitive and negative lists respectively, although PBC (2015) notes that India "offers deeper protection to items within Pakistan's major export potential sectors than does Pakistan to items within India's major export potential sectors". Even if we assume that this remains unchanged after normalisation of trade with India (the worst case scenario for Pakistan), there is still significant potential for trade as the remaining 70 per cent items are being exported to and imported from elsewhere. Trading in these items would, thus, reduce costs for both countries.

PREVALENT MYTHS IN PAKISTAN ABOUT TRADING WITH INDIA

Myth 1: India Will Persistently Run a Trade Surplus with Pakistan

An important concern voiced by media and civil society in Pakistan is that if Pakistan and India trade normally, India will tend to dominate the trade profile and Pakistan will run a large trade deficit bilaterally. Given the size and structure of Pakistan and India's economies, Pakistan running a bilateral trade deficit viz. India will be true, at least in the medium run. However, gains from trade have to be seen in the aggregate and multilaterally rather than the narrow prism on which this argument is premised. The main reason for expecting India to run a bilateral trade surplus with Pakistan is founded on its relatively developed capital and intermediate goods industry. There is demand for Indian industrial machinery and equipment as well as industrial raw materials by Pakistan's industry. While demand for Indian machinery is across a large spectrum of Pakistani industry, ranging from textiles to paper products and pharmaceuticals, Indian raw materials for the pharmaceutical and plastics industries have high demand in Pakistan. Since Pakistani industries have been importing machines and raw materials from developed countries already, imports from India will only divert trade from a developed country to a developing country source, for reasons of lower product and transport costs. Thus a higher bilateral trade deficit will translate into a lower aggregate trade deficit for the country.[1] Moreover, as discussed earlier, increase in intra-regional trade should be seen as complimentary to a country's global trade prospects if it's cost of raw materials, intermediate products and machinery decline.

Myth 2: Trading with India will De-Industrialise Pakistan

Related to the notion of non-advantageous trade with a bigger and more industrialised neighbour is the fear that runs amongst some protagonists that opening up trade with India will result in a deluge of Indian goods in Pakistan and will further disincentivise Pakistan's already fragile industrial structure. This fear essentially emanates from the fact that India not only has a more diversified manufacturing sector but also because it caters to a larger domestic market, it can reap the benefits of economies of scale and its products will be available at a lower cost in Pakistan

This argument is flawed for several reasons. Most obviously, the fear of deindustrialisation because of trading with India is a non-starter given that Pakistan has signed up to the WTO. Signing up to WTO has meant that Pakistan has already committed to reducing protection for its industries and to provide a level playing field to other members of the WTO (Sayeed, 2011). Moreover the reduction of tariffs from a high of 125 per cent in 1991 to the average of 25 per cent presently means that there is a bipartisan policy consensus on an open trade regime in Pakistan. As such, if Pakistan's industry has not been destroyed by

1 See Sherani (2014) and Pasha et.al (2012) for further elaboration on this theme.

2 In fact, a prominent Pakistani industrialist said that "Pakistan has not suffered as much at the hands of animosity with India as it has for its friendship with Pakistan." Quoted in Sayeed(2011).

trading with developed industrialised countries in the OECD and with its other neighbour China, then trading with a developing country such as India is not going to significantly hurt local industry.[2]

Moreover, Nabi and Nasim (2001) show that there are a number of industries where rather than one country dominating the direction of trade, intra-industry trade will dominate the trade profile. While this may require some reallocation in relative specialisation in these industries, it will certainly not destroy those specific industries in Pakistan. Having said this, there may be certain firms within industries or certain sectors that may have to shut down, simply because they are either inefficient or because they are alive only because they are subsidised by the State. Examples in this regard are parts of the steel, auto, pharmaceutical, the yarn component of the textile industry and the cotton ginning sector (Siddiqa, 2014).

Myth 3: Pakistan's Agriculture Will Suffer in Trading with India

The agriculture sector is vital to both Pakistan and India by virtue of the employment it generates and its contribution to GDP. In Pakistan, 45 per cent of the total labour force is employed in agriculture while this sector's contribution to GDP is 21 per cent. In India, 58 per cent of the labour force was in this sector, which contributes 15 per cent to GDP (Hussain, 2014). Given the importance of agriculture to both countries, therefore, it stands to reason that there is greater sensitivity in protecting the interests of the sector.

While there is relatively greater acceptance of trading with India amongst the industrial and trading communities within Pakistan, there is much trepidation within the agriculturists' lobby. The main reason cited for this anxiety is difference in policies with regard to agriculture in the two countries. India, for reasons of food security, protects its agriculture sector through input subsidies and price supports, as well as tariff and non-tariff barriers. On the other hand, Pakistan has phased out its agricultural subsidies over the last two decades and has withdrawn price support for most crops. As a result, the perception in Pakistan is that if trade is liberalised, India will flood Pakistan's markets with cheaper products (as subsidies reduce production costs), which in turn would hurt local producers. Conversely, Pakistani exports to India cannot compete because of the barriers to market access.

As of 2011, total trade between the two countries in agricultural commodities was in the range of USD 550 million. Of this, Pakistan's exports were a mere USD 50 million and imports from India were more than USD 500 million (Hussain and Khan, 2014). Pakistan primarily exports dried dates to India, worth USD 47.2 million, while export of onions, shallots, shrimps and apricots are on the rise, although there volume is still small (Ibid). Pakistan's imports from India consist of cotton, worth USD 291 million, tomatoes, with a value of USD 76.2 million, and dried vegetables, worth USD 46 million, along with other goods such as tea and fruit seeds (Ibid).

Several studies have analysed relative competitiveness in agriculture for India and Pakistan. A study conducted by the Trade Development Authority of Pakistan uses existing trade data to estimate the Revealed Comparative Analysis (RCA) index for Pakistan's exports to India (TDAP, 2012). It finds that several agricultural products can compete with India's products, such as citrus fruits and juices, mangoes and ethyl alcohol (a byproduct of the sugar industry). In addition, there is considerable opportunity to increase exports in dried dates.

Likewise, Hussain and Khan (2012), through key stakeholder interviews, identify strong potential to export citrus fruits, mangoes, apricots, olives, fish and fish products to India. They note that only 5 per cent of India's total import demand of fruits and vegetables is currently fulfilled by Pakistan, which has a competitive advantage in these products.

Another study by the International Trade Centre uses the trade similarity index to assess trade possibilities of Pakistan with India (TRTA II, 2013). This study finds trade similarity for the agriculture sector to be 45 per cent, with considerable room for exports to India in fresh and dry fruits, dates and wool, while Pakistan can import tea, garlic, ginger and vegetables during seasonal shortages. However, as Hussain and Khan (2014) note, this also means that minimal trade will take place in Pakistan's major crops, which include wheat, rice, cotton and other grains. This is an important implication, as it suggests that Pakistan's major crops will not be affected by trade normalization with India. Thus, it is vital that these concerns are assuaged amongst the agricultural lobby in Pakistan.

While trade normalisation is not expected to impact Pakistan's major crops (TRTA II, 2013), nevertheless, there is some merit to the concern that cheaper imports will hurt minor crops in Pakistan. Hussain and Khan (2014) provide evidence that producers of perishable fruits and vegetables, such as tomatoes, capsicum and ginger, have been affected by cheaper Indian imports.

However, it is important to note that if India's imports were to see an upsurge after trade normalisation, then Pakistan can protect its agriculture sector under the WTO and SAFTA trade agreements. Additionally, Pakistan can also protect key agricultural items by placing them on the SAFTA sensitive list. At a bilateral level also, Pakistan can protect these producers by placing stricter requirements on arsenic content in the fruits and vegetables being imported (Hussain and Khan, 2014).

The other concern of the agriculture sector in Pakistan is of restricted market access in India for Pakistani products. This claim holds some merit, as India does protect its producers through subsidies, as well as tariff and non-tariff barriers. According to the World Bank (2009), India's Trade Restrictiveness Index for agriculture was 69.5 per cent in 2009, compared to 5.8 per cent for Pakistan in the same year. If this were not the case, Pakistani exports to India should have increased in this sector given that India has granted Pakistan MFN status.

Thus, as the literature highlights, Pakistani concerns on market access must be addressed when negotiating with India on trade normalisation, with an emphasis on agricultural products in which Pakistan has significant potential to export (TRTA II, 2013; Hussain, 2014; Hussain and Khan, 2014). Subsidies are a domestic issue for India, and these are unlikely to be reduced. Hence, Pakistan should negotiate with India to reduce specific tariffs and non-tariff barriers which prevent Pakistani exports from competing in India.

CONCLUSION

If trading with India is beneficial in the aggregate for Pakistan's economy, as argued in this essay, then how can constantly recurring hurdles be overcome? One way to do so is to de-link the trade (and eventually investment) debate from geopolitical concerns and other irritants that plague the bilateral relationship. In other words, trade normalisation should not be seen as instrumental to outcomes sought either by the doves or the hawks. At the core of their arguments, both doves and hawks believe that once trade ties are normalised, new interests will be created on either side of border that will dilute the existing status quo. Doves see this as positive because it will be a stepping-stone to develop deeper cultural and social bonds that were severed after Partition. Hawks, on the other hand, fear that trade normalisation will dilute Pakistan's pending geopolitical claims viz. India. In an era of access to social and cultural mores of either society, there is no reason to believe that trade will necessarily reduce prejudices and biases ingrained over three generations since Partition (or even earlier). In other words, trade will not necessarily make Indians and Pakistanis love each other more than they already do. Similarly, to the extent that territorial or other geopolitical conflicts are legitimate, there is no reason that Pakistan should withdraw from those claims. China and Taiwan trade with each other and without prejudice to their territorial claims. Moreover, since the two countries have gone nuclear, the possibility of a militant resolution to disputes has reduced anyway and the way forward can only be sought through sustained dialogue. In other words, trade will not necessarily make the two countries hate each other less either.

BOX: TRADE WITH INDIA AND THE RESURRECTION OF PAKISTANI CINEMA

In 2017, the cinema industry in Pakistan is doing better business than at any point in the last 30 years. This exciting revival of cinema in Pakistan serves as a case in point of the manner in which allowing the import of an Indian product that has cultural and linguistic affinity with most Pakistanis has led to reversal in the fortunes of that sector.

The Pakistani cinema industry was in a steady decline for the last three decades. In the early 1980s, there were over 100 feature films being produced annually and were exhibited in over 1200 cinemas all over Pakistan (Zaidi, 2015). By 2006, the number of cinemas had fallen into the double-digits and in 2003, not a single Urdu film was released in the country (Paracha, 2015). Why did this decline in film production and viewership in cinemas take place?

In the aftermath of the 1965 Indo-Pakistan war, Indian cinema was banned in Pakistan. This meant that the local film industry was provided protection from competition and the consumer was forced to watch local films or heavily censored Hollywood flicks. This status quo was altered by technological developments in the 1970s with the advent of the VCR. Subsequent technological advancements in the shape of satellite television, DVD, and more recently the internet, the consumer was able to informally and illegally access Hollywood and Bollywood films in the comfort of their homes instead of going to the cinema. This led to the vicious cycle of decreased demand for cinema houses, which in turn led to a steady decline in films being produced in the country (Zaidi, 2015).

Faced with this grim situation, Gazdar (1997) argued that Pakistan must open up to Indian films because Pakistani cinema was suffering from the “informal or pirated imports of Indian movies,” which had taken away a majority of local viewers. The theory was that formally importing Bollywood films would result in the revival of cinema houses, which would then lead to an increase in the number of cinemas. In turn, this would incentivise investment in local productions because now there was demand from a cinema-going audience as well as the infrastructure needed to earn profits.

Indian films were legally allowed to be shown in Pakistani cinemas in 2007. This resulted in consumers being able to “watch on the big screen what they were watching anyway at home” (Zaidi, 2015). The resulting increase in the number of cinemas in Pakistan provided the impetus for local film production. It is projected that there will be 200 operating screens by 2017, significantly greater than the current number of 70 (Ibid). According to Paracha (2015), local production restarted with Khuda Ke Liye in 2007 and since then the number of Urdu films being released each year has been greater than the year before.

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