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India-Pakistan Trade: Creating Constituencies for Peace

Bilateral trade between India and Pakistan is extraordinarily low—less than 1 percent of their global trade. Their volatile political relationship has overwhelmed attempts to encourage trade between the two countries, and has also impacted economic integration in the South Asian region as a whole. There are both political and economic obstacles to expanding trade between the two countries. Greater economic co-operation could, however, provide mutual economic benefits, such as lower prices for consumers, much-needed revenue for the governments, and cost-effective gas import to India via Pakistan. Perhaps most importantly, it could generate new linkages between the two business communities, thereby nurturing constituencies for peace in the region.

Brief history: In 2000-2001, India exported only $186 million worth of goods to Pakistan, out of $44 billion in total exports. Pakistan's exports totaled $8.8 billion, but only $65 million went to India. The two countries have not always had such anemic trade. Before partition and immediately after independence, India was Pakistan's most important trading partner. In 1948-49, 56 percent of Pakistan's total exports were directed to the Indian market, and 32 percent of its imports came from India. Lahore and Amritsar were important economic hubs, as trade flourished with a free flow of goods and services. However, by the early 1950s trade between the countries reduced to a trickle, and despite some ups and downs has not revived since.

Political obstacles to trade: The biggest barriers to trade are political. Because of India's market size and central location, 80 percent of intra-regional trade in South Asia is to or from India. All India's neighbors share a concern about being overwhelmed by Indian goods. Decades of mutual political hostility and suspicion compound the challenges in trying to build strong trade relations between India and Pakistan. Both sides tend to see progress on issues like trade as a favor to the other country rather a benefit to one's own country. Pakistan, moreover, is reluctant to move too fast toward normalization of trade and other relations with India lest the issue of Kashmir get sidetracked.

Economic barriers: In the decades following partition, both India and Pakistan adopted inward-looking economic policies that discouraged imports of consumer goods or of anything that could be made locally. The practical impact was to skew trade in favor of developed countries.

Partly as a result, there is considerable overlap in both countries' exports. Textiles are the best known example. From the economic viewpoint, this means that expanded trade will create rather than divert trade, and will therefore improve efficiency. However, this also makes trade politically controversial: cheaper imports compete with local production whose producers are well connected and whose facilities generate local jobs.

Pakistan does not extend normal GATT/WTO rights or the Most Favored Nation (MFN) principle to India, but maintains a "positive list" of 600 goods that may be legally imported from India. India in principle granted MFN treatment to Pakistan in 1995-1996 and has no list of permitted or forbidden products, but the meager imports from Pakistan suggest that India has found ways of imposing a de facto ban on most imports from Pakistan. Informal trade between the two countries is much larger, estimated at $1 to 2 billion annually, involving such goods as chemicals, medicines, videotapes, cosmetics, and viscose fiber. These goods find their way either through third markets, such as Dubai and Singapore, or through smuggling.

The big benefit: energy: The greatest economic benefit of trade relations between India and Pakistan would occur in the sphere of energy cooperation. India is one of the most rapidly growing energy markets in the world and will be able to absorb new sources of supply as they materialize in the region. Pakistan's potential role in fulfilling this need is not as a supplier but as a potential transit route for energy from Iran and Central Asia. This would require construction of one or more new pipelines, a major capital investment that makes sense only if the political stability and economic feasibility of the project can be counted on.

The economics look very promising. A project proposal submitted by Iran this past January to both countries estimated that Pakistan would gain between $600 to $800 million per year in transit fees. It would also be able to use the pipelines to fulfill its own energy needs. India would benefit from diversified sources of pipeline gas and lower dependence on more expensive liquid natural gas (LNG). Even with LNG prices dropping, industry sources believe that there would be a significant cost advantage, especially to a pipeline from Iran.

The big drawback, which has thus far prevented any serious discussion of a pipeline project, is India's reluctance to make itself dependent on Pakistan for a strategically important commodity. If India and Pakistan were interested in moving ahead, however, it should be possible to structure and agreement so as to include a third party and make special provision for political risk. Energy cooperation between India and Pakistan would have a stabilizing effect on the region as a whole.

Making trade liberalization practical: SAARC, the South Asian Association for Regional Corporation, could provide a useful framework for discussions on non-energy trade. The SAARC member countries have already agreed to establish a South Asia Preferential Trade Agreement (SAPTA), with a view toward eventually moving toward a free trade agreement (SAFTA). The SAPTA agreement does not prescribe which goods are to be subject to tariff reductions for member countries; implementation has been through bilateral agreements. India has signed agreements with Bangladesh and Sri Lanka. These agreements initially covered primarily goods that were not traded to any significant extent, but have gradually been expanded to include a more meaningful product list.

The political sensitivity of India-Pakistan trade makes it especially important to sequence liberalization so as to minimize its political fallout. Pakistan might start by extending normal, or MFN, treatment to a much expanded list of eligible Indian products. The choice of products, and the choice of products for any reciprocal step from India, should be based on worldwide export competitiveness. Trade liberalization, in other words, should be treated as an opportunity to expand the market for each country's "stars," and it should avoid, at least in the early stages, giving the other country treatment that is more favorable than that received by exporters from outside the region.

Besides trade liberalization, it would be useful to expand professional ties between professional counterparts in the Indian and Pakistani ministries that deal with general economic problems. Environmental problems, health, and water management are only three examples of critical economic problems that can more easily be tackled in a regional context. The SAARC countries lag behind the rest of the world in developing regional mechanisms for dealing with them. Here too, SAARC could be a useful forum for expanding India-Pakistan ties that are worthwhile in their own right.

Who stands to gain? The economic benefits of goods trade are more diffuse than for energy. One estimate of the impact of complete free trade within the South Asian region puts the total at $14 billion. In the short term, a more realistic benchmark is the $1 to $2 billion that now moves through other channels. India-Pakistan trade will be doing well if it can exceed these levels. Legalizing trade that now moves through third markets would cut transport costs and transit time for goods, resulting in lower prices for the consumers. Bringing smuggling into official channels would provide a much needed revenue stream to both governments. Because Pakistan would probably still import more than India, its government finances would benefit more from this change.

Expanded trade is likely to be in India's favor in dollar terms. Because the current level is so low, trade liberalization is unlikely to have much macroeconomic impact in either country. The impact on Pakistan is likely to be greater in relative terms, but the political sensitivity will also be higher. Some of Pakistan's traditional exports of small manufacturers (such as sporting equipment and surgical instruments) may be well placed to take advantage of a new market opening up. One potential area of mutual advantage is information technology. There is considerable interest in Pakistan in moving into IT. A fledgling Pakistani industry is unlikely to provide serious competition to the enormous Indian industry, but there could be some mutually beneficial business-to-business links that could be cultivated if the political context became more favorable to mutual trade. Since this industry does not depend on the movement of goods, it may have an easier time moving ahead than some other industries.

Beyond these trade-specific benefits, increased trade between the two countries could strengthen the outward orientation of both countries' market policies. Here too, Pakistan, with the smaller economy and the more fragile external links, would especially stand to gain. Trade opening is one of the things that investors in both markets are looking for; again, Pakistan's more difficult economic circumstances mean that it would stand to gain the most. Arguably, however, the greatest dividend of India-Pakistan trade would lie in growing business on both sides of the border, thereby giving people a stake in the other country.

Looking ahead: getting past the political barriers: It is easy to list the benefits of expanded India-Pakistan economic relations, but much more difficult to develop a road map for getting there. Ultimately, trade is unlikely to be the lead issue in this complex relationship. Both sides are accustomed their current economic isolation from one another. Once the two countries' leaders decide to start a political dialogue, however, expanding trade could become a useful adjunct to the political process, instead of being hamstrung by it.

Meanwhile, the United States can use its well-established economic relations with both countries to improve the chances of success. A stable and economically progressive Pakistan is of vital long-term strategic interest to the United States, both in the context of its war on terror and in the larger context of a stable South Asia. Similarly, economic ties are a key ingredient in the expanding Indo-U.S. relationship. The kinds of market opening that the United States has been trying to encourage in both countries will also improve the chances of success when they are ready to liberalize trade with one another.

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