ISAS Brief

No. 78 – Date: 31 July 2008

469A Bukit Timah Road
#07-01, Tower Block, Singapore 259770
Tel: 6516 6179 / 6516 4239
Fax: 6776 7505 / 6314 5447
Email: isasijie@nus.edu.sg
Website: www.isas.nus.edu.sg

Pakistan's New Trade Policy Initiatives: Implications for India and Pakistan

Iftikhar A. Lodhi[+]

In a significant policy shift, Pakistan has opened its doors to Indian investments and imports. As a result, India could become Pakistan's second largest trading partner after China at the end of this fiscal year.[1] The landmark directional change could have long-term political implications for the two nuclear rivals and the South Asian region.

The new trade policy, announced by the Pakistan Peoples Party (PPP)-led coalition government on 18 July 2008, sets a US$22 billion export target, up from the achieved target of US$19.2 billion last year, reflecting a 13 percent growth. However, the government has sidestepped the question of soaring trade deficit that reached US$20.7 billion last year.[2] Nevertheless, it did emphasise increasing exports and diversifying export products as well as markets.[3]

The Pakistan government, recognising structural problems in export growth, plans to increase the country's competitiveness by removing bureaucratic bottlenecks, increasing market intelligence, establishing a Trade Dispute Settlement Organization and special economic zones, improving infrastructure and building capacity, instead of providing subsidies. It will also provide tax and duty exemptions on all inputs for exports, including machinery under the Duty and Tax Remission Export (DTRE) scheme. On the diplomatic front, it has also decided to participate in re-negotiations on the South Asian Free Trade Agreement and the Regional Agreement on Trade in Services among the South Asian Association for Regional Cooperation countries.

[+] Mr Iftikhar Lodhi is a Research Associate at the Institute of South Asian Studies, an autonomous research institute within the National University of Singapore. He can be reached at isasial@nus.edu.sg.

[1] Pakistan's fiscal year is from July to June.

[2] The policy does not give any import projections, citing the uncertainty in the international and domestic market. The total imports in the last fiscal year were US$9.4 billion higher than the targets, giving rise to a trade deficit of US$20.7 billion. Almost 70 percent of this increase was due to high oil and food prices and a shortfall in cotton crop.

[3] This would be done by incentivising leather, sports, surgical, pharmaceutical, jewelry and processed food products, and by reaching new markets of Latin America, Africa and Eastern Europe. Presently, the textile group (bed wear and apparel) constitutes two-third of total exports, with half of the total exports destined to only seven countries (the United States, Germany, Japan, the United Kingdom, Hong Kong, United Arab Emirates and Saudi Arabia).

India-Specific Measures

The new trade policy of the Pakistan government allows Indian investors to establish compressed natural gas (CNG) bus manufacturing units in the country. It also allows imports of 10 CNG buses as test consignments from each manufacturer committed to investing in Pakistan. Islamabad has also enlarged the positive list of items by including another 136 commodities. Now, a total of 1,938 items can be imported from India. These include mining and agriculture machinery, stainless steel, cotton yarn, books and petroleum products, among other raw materials and capital goods. More significantly, virtually any product, whether it is on the positive list or not, can be imported from India under the DTRE scheme.

Although Pakistan has a more liberal trade and investment policy vis-à-vis India, both countries systematically restrict cross border investments and trade through tariff and non-tariff barriers. Economic relations between the two south Asian neighbours have been mired by political conflict, particularly the territorial dispute over Kashmir. While India has accorded Pakistan the Most Favored Nation (MFN) status, maintaining a negative list of items, Pakistan has declined to extend the MFN status to India, maintaining a positive list of items. However, there now seems a directional shift in Islamabad. Pakistan's Commerce Minister, Ahmed Mukhtar, while talking to press reporters after announcing the new trade policy, hinted at according India MFN status, provided "India removes tariff and non-tariff trade barriers inhibiting Pakistani exports to India".

Economic and Political Implications

Official trade between the two countries has increased manifolds in the recent past, reaching US$2 billion in 2008, while estimates suggest a three-time higher unofficial trade. However, the trade balance remains substantially in favour of India which has trade surplus of about US$1 billion. With the new policy of allowing entry to Indian imports, the trade volume between the two countries is expected to double. Nevertheless, Pakistani exports to India are less likely to increase unless India lowers trade barriers. Pakistan's trade deficit with India is, therefore, expected to double.

The "India-centric" trade policy stirred a storm in Pakistan. While the conservatives accused the PPP of giving in to India, more serious criticism came from policy experts and business lobbyists who seem to be wary of the "Indian tilt" in the new policy. Their criticism stems for their concern over the growing trade imbalance and the threat to Pakistan's domestic industry. The fact is that Pakistan has a trade imbalance with all its major trading partners, not just India. Furthermore, if the domestic industry is threatened by cheap Indian imports, it would also be the case with cheap Chinese imports that have flooded Pakistan's market. Why should India be viewed and treated differently? The answer lies in politics rather than economics. Rather than resisting Indian imports, perhaps Pakistan should look towards enhancing the competitiveness of its domestic production (and exports) while constantly ensuring its comparative advantage.

Despite the fact that India stands to gain more, the new trade policy undoubtedly holds promise for Pakistan as well. Most capital and intermediary goods that Pakistan imports from other countries are relatively cheaper to acquire from India. In addition, the transport cost is much lower. Pakistan stands to save about 15 to 30 percent in cost by importing from India, according to a study published by the State Bank of Pakistan two years ago. This would help

Pakistani manufacturers cut down the cost of production and enhance the competitiveness of their exports. A case in point is India's flourishing petroleum products industry, which has a potential to become Asia's largest refining industry. Pakistan would be better off by tapping into the Indian petroleum industry and saving payments on its soaring petroleum import bill. The price differential will also certainly offset some of the feared trade imbalance.

Cold Shoulder from India

However, New Delhi, overwhelmed by political and security concerns, has failed to appreciate these major steps by the new democratic government in Islamabad. India's Foreign Secretary, Shivshankar Menon, avoided any comments when asked about Islamabad's initiatives during a press briefing at the end of the first day of the fifth round of Pakistan-India Composite Dialogue held in New Delhi on 21 July 2008. The lack of any response from the Indian side seems to convey the message to Islamabad that, unless India's security concerns are taken seriously, it would not be impressed by the economic opportunities available.

According to the Indian Foreign Secretary, the dialogue was happening at a "difficult time" and "several events have vitiated the atmosphere between India and Pakistan". He was referring to the suicide attack on the Indian embassy in Kabul on 7 July 2008 and the recent uprising in Indian-administered Kashmir. India has accused Islamabad of "incitement to violence" in Indian Kashmir and the Inter Services Intelligence (ISI) agency of Pakistan for the attacks in Kabul. Unlike the National Security Advisor, M. K. Narayanan, the Indian Foreign Secretary avoided directly accusing the ISI but he echoed a similar view by referring to "elements in Pakistan" for being responsible for the violence. Another reason for the lukewarm response from India could be that Prime Minister Manmohan Singh's United Progressive Alliance government was pre-occupied with the more pressing issue of its own political survival, after having to go for a trust vote following the withdrawal of its Left partners over the United States-India nuclear deal issue.

Opportunities Ahead?

In a relevant development, Islamabad has reportedly invited at least three Indian companies (Tata, Reliance and Essar) to a meeting of potential investors in the power sector to discuss the development of the Thar Coal Power Project. Pakistan has been planning to use its enormous 175 billion tons of coal reserves in *Thar* (the Sindh province) for power generation.

There is no denying that an integrated economy will have a trust dividend, currently lacking so much in Islamabad and New Delhi. If political will and economic rationale prevail, there are enormous possibilities for the two countries. For example, Pakistan, by successfully wooing Indian investors in the *Thar* power project or some other projects of strategic importance, could win sympathies of the influential lobbyists in India. Perhaps an effective way to create interest groups in both countries is to engage in private-sector joint ventures. Also, some of the projects (and groups) may reduce tensions between the two countries over Afghanistan by catering to the Afghanistan and Central Asian markets. Similarly, public sector joint ventures will definitely carry the integration process a step forward. A case in point is the Iran-Pakistan-India gas pipeline and a potential India-Pakistan petroleum pipeline.

Thus far, the elite in Pakistan and India have long kept their people and economy hostage to their own aspirations and prejudices. There are no breakthroughs and shortcut solutions to the decade-old problems. However, maintaining the tempo of the dialogue, slow and steady economic cooperation, and a gradual increase in people-to-people contact certainly point to a bright and prosperous future for the region.

oooOOOooo