



## The political economy of trade relations between India-Pakistan

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### HIGHLIGHTS:

1. Examination of trade potential and barriers between India and Pakistan from a political economy perspective.
2. The effect of trade complementarity, distance, rivalry and government strength on cross-border trade flows.
3. Identification of four key issues - market access, trade liberalization, energy cooperation, and regional stability
4. As impetus for greater trade expansion between India and Pakistan.
5. Importance of a triadic cooperative framework - bilateral, regional, and international - to achieve the goal of trade expansion.
6. Expansion of bilateral trade reduces severity of conflicts between neighbors and the costs of hostility-driven trade disruption.

### Article History

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### ABSTRACT

A growing number of scholarly studies in and outside South Asia suggest the linkage between trade, economic development and peace between India and Pakistan. Despite many tangible political and economic gains of expanded India-Pakistan trade, the level of trade between India and Pakistan has remained anemic over the past six decades. Why hasn't trade grown between India and Pakistan? What are the prospects of trade expansion between these two countries? Drawing on the growing political economy literature, we have identified four facilitating conditions to explain the growth of trade flows between a given pair of countries: distance, trade complementarity, rivalry, and government strength. In this article, we examine the dynamics and implications of these four conditions for trade relations between India and Pakistan. Following this analysis, we identify several key issues - trade liberalization, market access, energy cooperation, and regional stability - that can provide impetus needed to drive these two countries toward greater trade expansion.

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## 1.0 Introduction

The level of trade flows between India and Pakistan is one of the most widely debated issues within the academic and policy arena in and outside South Asia. A number of studies have found that an expansion of trade would reduce political tension and the threat of conflict, while also enhancing economic development in these two neighboring countries (Chowdhry, 2012; De, Raihan, and Ghani, 2013; Gopalan, Malik, and Reinert, 2013; Khan, 2010; Mamoon and Murshed, 2010; Taneja, 2013). Scholars, while divided on specifics, generally embrace the linkage between trade, economic development and peace. Economically, expanding trade can raise incomes, reduce poverty, lower unemployment, expand foreign investment, improve production technologies and reduce cost of production, lower

consumer prices and increase variety of products available to consumers. Over time, the channels from trade to higher growth seem to be increased savings and investment, enhanced technology transfer, and improved macroeconomic policy and governance (Wacziarg, 2001). Politically, trade expansion has the potential to decrease rivalry, reduce severity of conflicts, and increase partnership, promoting regional peace and stability (Anderton and Carter, 2001; Barbieri and Levy, 1999; Morrow, 1999). Such stability itself could foster further regional development by expanding trade, investment, and other beneficial interactions within a region.

Despite these tangible political and economic gains of trade, the level of trade between India and Pakistan has remained anemic over the past six decades. Why hasn't trade grown between India and Pakistan? What are the prospects of trade expansion between these two countries? The answer to these questions requires an examination of a broader question on the growth of trade: i.e., under what conditions cross-border trade expansion occurs between two neighbors? It is widely recognized that trade flows between India and Pakistan are largely determined by political factors. Thus, a political economy approach that studies the interaction of political and economic factors – specifically, the influence of political processes on economic policies and the influence of economic factors on policy-making process— seem to provide a useful analytical framework to explain the trade flow dynamics between India and Pakistan. Based on the two influential models of international trade - Heckscher-Ohlin model and Ricardo-Viner Model-- researchers have generated an extensive body of work on political economy approaches to trade policy that can help us develop greater clarity about forces promoting and impeding trade flows between two countries (Grossman and Helpman, 1994; Hiscox, 2002; Mayda and Rodrik, 2005; O'Rourke and Sinnott, 2002; Rogowski, 1989). This body of literature is also useful in identifying key issues that can be drivers of trade growth between India and Pakistan.

To explain the trade flows between India and Pakistan, this study has derived two sets of conditions from the extant literature: factors that are primarily political and those that are primarily economic. In the political science literature, researchers note that bilateral trade tends to be higher among countries that are allies than among countries that are rivals (Gowa, 1994; Mansfield and Bronson, 1997; Grieco, 1997; Diehl and Goertz, 2001). Studies also find that political leaders with strong governments engage more in cross-border trade cooperation than political leaders with weak governments (Huelshoff, 1994; Solingen, 1996; Milner, 1997). The economics literature focuses on the existence of significant trade complementarity (Michaely, 1996; Schiff, 2001) and 'distance' as determinants of potential trade between a given pair of countries (Chaney, 2008; Disdier and Head, 2008; Frankel and Romer, 1999). Actual trade volumes depend on both potential trade and barriers to trade, including explicit barriers such as tariffs and quotas, the quality and quantity of trade-related infrastructure (Bougheas et al. 1999; Francois and Manchin, 2013), and the strength of complementary cross-border flows such as FDI, tourism, migration, etc. (Greenway and Kneller, 2007; White, 2010). Given these conditions, we examine several key questions in the following discussion: (1) what is the potential for trade between India and Pakistan? (2) what economic factors limit actual trade? (3) how has rivalry between India and Pakistan affected their trade relations? and (4) how has the relative strength of governments in India and Pakistan affected their trade policy preferences?

The paper is organized as follows. The next section discusses the research methodology used in this study. Section three examines the potential for expanding bilateral trade and some key economic barriers that have adverse impacts on trade expansion between India and Pakistan. In the fourth section, we discuss the nature of rivalry between India and Pakistan to explain the dynamics of their trade relations since independence. The fifth section evaluates the effect of the strength of governments in India and Pakistan and their interactive dynamics with civil society on their trade policy outcomes. The sixth section explores several key issues that can provide the impetus needed to drive these two countries toward greater trade expansion. The final section concludes by suggesting that expanded trade cooperation between India and Pakistan is not only mutually beneficial but also necessary for regional stability and development.

## 2.0 Data and research methodology

Data for this study are collected primarily through secondary sources. Secondary data on India-Pakistan trade has been collected from various data bases that include the IMF Direction of Trade statistics, World Bank Development Indicators, UN Comtrade, WTO Trade profiles, and a wide range of published papers and government data. The data have been used to evaluate trade trends and trade potential between India and Pakistan. In addition, several statistical methods, including regression analysis and Trade Complementarity Index (TCI) computation, are employed to measure trade relations between India and Pakistan.

For our regression analysis, we have followed the model initially developed by Syrquin and Chenery (1989). This analysis is conducted for 127 countries. The primary objective of this analysis is to determine the factors that contribute to low trade shares of GDP and relative trade openness of India and Pakistan. Specifically, we used this model to see if the relatively low trade shares of GDP of the two countries were a result of easily identifiable socio-economic or political characteristics. The model we are using here is quite simple, as it implicitly assumes that other

factors beyond the dependent variables are the same for India and Pakistan as for the other 127 countries in our sample.

We used the Penn World Tables version 7 for real GDP and openness data. The Penn World Tables include two different definitions of "openness." We chose OPENK as the most appropriate measure for our model. We coded the "island" and "landlocked" dummies ourselves. "Government Effectiveness" came from the World Bank's World Governance Indicators database. The infrastructure variable (road density per square mile, not used in the final model) came from the International Road Federation and author's calculations. Democratization (also not used in the final model) came from the Polity IV dataset. The regressions were run in R, using ordinary least squares (OLS). Table 2 shows the results of a regression relating trade openness to economic size, government effectiveness, and geography.

To calculate Trade Complementarity Index (TCI) between India and Pakistan, we used the following method:

$$TCI_{pi} = 1 - \sum [(|M_{gi} / M_i - X_{gp} / X_p|) / 2]$$

Where,  $M_{gi}$  = Imports of goods  $g$  by India

$M_i$  = Total imports of India

$X_{gp}$  = Exports of goods  $g$  by Pakistan

$X_p$  = Total exports by Pakistan

The index is 0 when no goods exported by one country are imported by the other and 1 when the export and import shares exactly match. A high degree of complementarity may indicate more favorable prospects for a successful trade relationship between the countries.

### 3.0 Discussion

#### 3.01 Trade barriers

Both India and Pakistan have relatively low trade shares of GDP. As shown in Table 1a, India, at about 48 percent, is below average for South Asia during 2009-2011. Pakistan, at less than 36 percent has the lowest ratio in the region. Furthermore, as shown in Table 1b, India's trade share has substantially increased since its unilateral liberalization in the early 1990s, while Pakistan's share has remained low and even declined, despite the era of globalization.

Table 1a. Trade Dependence of India and Pakistan in regional context (2009-2011)

Country	Trade-to-GDP ratios	Trade per capita (US\$)	Average applied tariffs (in percent)
Afghanistan	**	**	**
Bangladesh	50.6	341	14.4
Bhutan	108.0	2217	**
India	48.1	641	12.6
Maldives	110.0	7040	20.5
Nepal	46.2	246	12.3
Pakistan	35.5	375	13.9
Sri Lanka	54.9	1335	10.2

Source: WTO Trade Profiles, 2012; \*\*Data not available

Notes: *Trade per capita* (TP) is estimated as a country's total trade of goods and commercial services (exports + imports, balance of payments basis) divided by the population. In this table, TP is calculated on the basis of latest available data from 2009-2011.

*Trade-to-GDP ratio* (TGR) is estimated as a country's total trade of goods and commercial services (exports + imports, balance of payments basis) divided by GDP, which is measured in nominal terms and with market exchange rates. In this table, TGR is calculated on the basis of latest available data from 2009-2011.

Table 1b. Trade Dependence of India and Pakistan in historical context (1990-2012)

Country	Trade share of GDP (%)		
	1990	2000	2012
India	15	27	56
Pakistan	39	28	33

Source: World Development Indicators, 2013

Following the model developed by [Syrquin and Chenery \(1989\)](#), we checked to see if the relatively low trade shares of GDP of the two countries were a result of easily identifiable socio-economic or political characteristics. Table 2 shows the results of a regression relating openness (expressed as the trade share of GDP, as in tables 1a and 1b above) to economic size, government effectiveness, and geography. As expected, large economies tend to be more diversified and trade less, while government effectiveness promotes trade and island nations typically have no choice but to depend on trade.

In the year 2000, the degree of openness predicted by the model greatly exceeded the actual openness measured in India and Pakistan. For India, the model predicted a trade share of GDP of 51 percent, compared to an actual level of 27 percent. Note that in the following decade, India did in fact “catch up” and now has approximately the trade share of GDP one would expect from a country with its economic, political, and geographic characteristics. Pakistan, however, had a predicted level of openness of 70 percent in the model, far in excess of its actual trade share. In fact, Pakistan qualifies as an outlier, with a prediction error in the top 10 percent of the sample. Furthermore, Pakistan has barely begun to close the gap in subsequent years, unlike India.

Table 02: Predicting openness based on economic size, governance and geography	
Dependent Variable: Openness [(X+M/GDP)]	
GDP (million US\$ 1996)	-0.00001*** (0.00000)
Government Effectiveness	11.808*** (4.051)
Island	12.421 (10.087)
Constant	86.101*** (4.317)
Observations	129
R <sup>2</sup>	0.136
Adjusted R <sup>2</sup>	0.116
Residual Standard Error	42.683 (df = 125)
F Statistic	6.573*** (df = 3; 125)
Source: Computed by authors.	
Notes: ***, ** and * implies estimated coefficient is significant at 0.01, 0.05, and 0.10 level respectively.	

It should be noted that in addition to the variables shown, infrastructure quality (proxied by road density per square mile) and democratization were dropped from the initial specification, due to lack of significance, caused in part by fewer available observations in the complete dataset. As described below, we believe that the poor quality of infrastructure in these countries, particularly the infrastructure to facilitate cross-border trade, helps to explain the low levels of actual trade, relative to the model predictions.

As shown in Tables 03, the low levels of bilateral trade result from a combination of low trade with the world (especially Pakistan) and low shares of trade with each other (especially India). Are these low levels of trade the result of a mismatch in economic structure, explicit trade barriers, political tensions, or other factors?

Table 03: India's major trading partners 2010-11 (as % of share in world total exports)			
Country	Exports	Country	Imports
<b>India</b>			
European Union (27)	18.1	China	12.0
United Arab Emirates	12.4	European Union (27)	11.9
United States	10.9	United Arab Emirates	7.7
China	5.5	Switzerland	6.8
Singapore	5.2	Kingdom of Saudi Arabia	6.1
Pakistan	1.0	Pakistan	0.12
Total (US\$ Billion)	304.5	Total (US\$ Billion)	462.6
<b>Pakistan</b>			
European Union (27)	25.0	United Arab Emirates	15.6
United States	15.1	China	14.8
Afghanistan	10.5	Kingdom of Saudi Arabia	10.7
United Arab Emirates	7.6	European Union (27)	10.4
China	6.6	Kuwait	8.9
India	1.7	India	6.0
Total (US\$ Billion)	25.3	Total (US\$ Billion)	44.0
Source: WTO Trade Profiles, 2012; Economic Survey of India, 2011-12; Federal Bureau of Statistics, Government of Pakistan, 2011-12.			

Trade potential between the two countries is determined by a range of economic variables: trade complementarities, trade-related infrastructure, and the nature and strength of other facets of economic interaction, such as FDI, tourism, and migration. How much of this potential is realized depends on the nature and severity of trade restrictions, attitudes of businesses and consumers towards that country and its products, and many other political, cultural, and social factors. Nonetheless, several studies have applied gravity models to predict how much trade ‘should’ be taking place between a given country pair. Gravity models basically explain bilateral trade as being directly linked to the product of GDP of the trading partners and inversely related to the distance between them. Based on this model, there are several estimates of potential increase in bilateral trade that vary in

the range between 0.5 times and 27 times increase of actual trade between India and Pakistan (Batra, 2004; Baroncelli, 2007; De, 2009; Gul and Yasin, 2011; Pasha and Imran, 2012; Rahman, Shadat, Das, 2006). While these estimates are useful, they are not accurate predictors of the potential of trade between India and Pakistan. In particular, two shortcomings of the gravity model in the context of India-Pakistan trade are worth noting here. First, despite their geographic contiguity and the resultant short distance, transport and other transaction costs of trading between India and Pakistan remain very high (Taneja, Ray, Kaushal, Chowdhury, 2011). Second, the application of the gravity model, or for that matter any econometric model, remains weak when it tries to explain the exact nature and volume of trade that is based on a ‘positive list’ approach as found in the case of India and Pakistan. We discuss these issues in the following section.

### 3.02 Trade barriers

Despite the potential trade benefits estimated above, numerous economic barriers exist between India and Pakistan. Traditional economic analysis typically starts with an assessment of tariffs and other non-tariff barriers to trade. As one can see in Table 1a, average tariffs in the two countries are typical for the region. Tariffs under 15 percent are generally termed ‘revenue tariffs,’ with modest distortionary impact on trade flows. Particularly for India, much of the benefits from trade liberalization have already been captured, as their average MFN tariff remained over 30 percent through the end of the 1990s.<sup>i</sup> While individual tariff ‘peaks’ – as opposed to a commonly practiced ‘binding overhang’ by many developing countries and East Asian countries -- may severely restrict trade of specific items, particularly manufactured products, we will have to look elsewhere for an explanation of the overall dearth of trade between India and Pakistan.<sup>ii</sup>

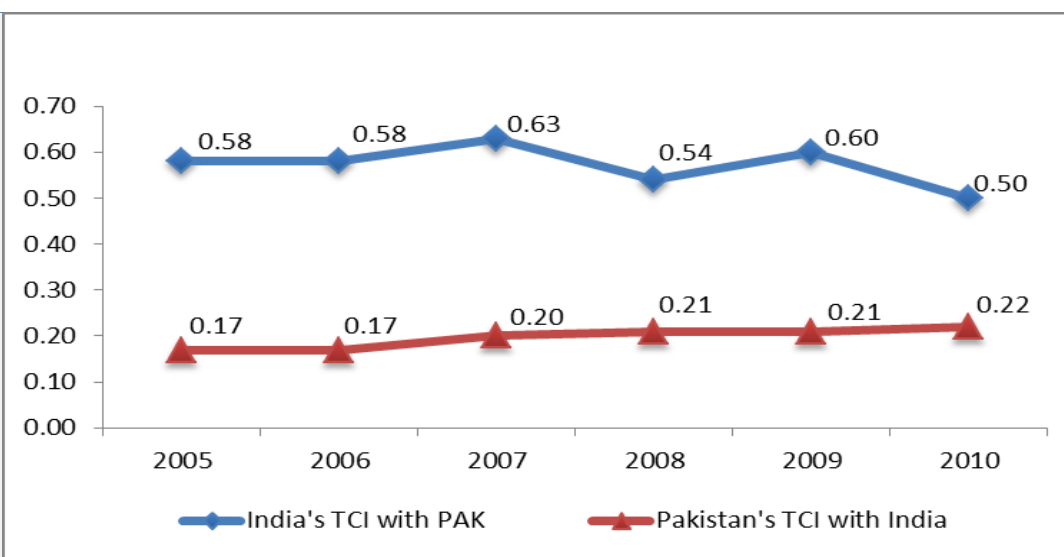
Pakistan maintained a ‘positive list’ of products for which trade with India was allowed (Khan, 2010), only recently converting to a negative list of products for which trade is prohibited (Pasha and Imran, 2012).<sup>iii</sup> India has a list of ‘sensitive’ products (a negative list) that have been excluded from regional trade expansion efforts such as SAARC Preferential Trading Arrangement (SAPTA), which cover more than half of its imports from South Asia (Taneja, Ray, Kaushal, Chowdhury, 2011). Transforming a positive list to a negative list (products for which trade is prohibited) forces officials to justify each instance of trade restriction and allows the private sector to quickly exploit trading opportunities in new product areas as they arise. Negative lists should then be periodically reviewed, with an eye towards shortening them over time. This policy change could have a significant impact on trade flows, both directly and by changing attitudes.

Transportation infrastructure between the two countries remains both weak and restricted by policy. While historical considerations preclude the idea of superhighways and pre-screening of goods and passengers on the pre-2001 U.S.-Canada model, steps could be gradually taken to improve the quality of infrastructure, streamline customs procedures, and eliminate capricious regulations, all of which combine to restrict trade. Currently, no direct flights ply the Islamabad-New Delhi route, railcars carrying goods must return home empty, and ships must stop at an intermediate port before docking at their trading partner. In addition, numerous potential border crossing spots are closed, discouraging both bilateral and transit trade while encouraging smuggling.

Yet not all the differences between India and Pakistan causing anemic levels of trade can be addressed through domestic policy changes or international negotiations. Could it be that there simply is little trade complementarity between the two countries? Is there little India has that Pakistan wants, and vice versa? History seems to argue against that point, given the high shares of bilateral trade prior to the conflict in 1965, but both economies have changed considerably since that time.

Figure 01: Trade complementarity index between India and Pakistan





Source: Author's calculation based on UN Comtrade (2007, 2009, 2012).

Note: TCI<sub>ip</sub> can be and is, in the case of India and Pakistan, quite different from TCI<sub>pi</sub>.

A useful tool in this regard is the Trade Complementarity Index (TCI). TCI calculations in Figure 1 show that India's exports match Pakistan's imports much better than Pakistan's exports match India's imports.<sup>iv</sup> As further evidence of this asymmetry, one can point to Pakistan's growing trade imbalance with India as shown in Table 4. Yet several caveats should be introduced before concluding that the economic structures of the two countries are not conducive to greatly expanded trade, particularly Pakistani exports to India.

Trade relationships are complex, multidimensional and dynamic. If neighbors both produce and export similar agricultural goods, they are indeed more likely to compete in third country markets than to exchange different varieties of tea, for example. Yet similarities in manufacturing production and export do not preclude trading opportunities, for three main reasons. First, broad trade categories may conceal very different market niches. Quality differences in textile material and workmanship, for example, create complementarities rather than redundancies.<sup>v</sup> Secondly, aggregation levels may hide even greater differences; auto or electronics parts may flow in one direction, and finished assemblies in the other. Lastly, measures such as revealed comparative advantage and TCI are based on the observed, heavily distorted, flow of trade, rather than the full range of potential trade. In dynamic terms, the absence of trade relations between these neighbors has understandably caused the economies to grow apart. A resumption of open trade would encourage the development of complementarities that are not apparent today.

Table 04: India's trade balance with Pakistan (US\$ million)

Year	India's exports to Pakistan (X)	India's imports from Pakistan (M)	Trade balance (X-M)
1980	2.0	76.4	-74.3
1985	12.0	27.9	-15.8
1990	43.4	44.8	-1.3
1995	70.4	37.3	+33.0
2000	163.3	65.0	+98.2
2005	647.1	158.4	+488.7
2010	2250.8	321.3	+1929.5

Source: IMF Direction of Trade Statistics, 1987, 1995, 2003, 2011; United Nations Comtrade Database.

Notes: Plus (+) means trade balance in favor of India; minus (-) means trade balance in favor of Pakistan.

Data exclude mineral fuels.

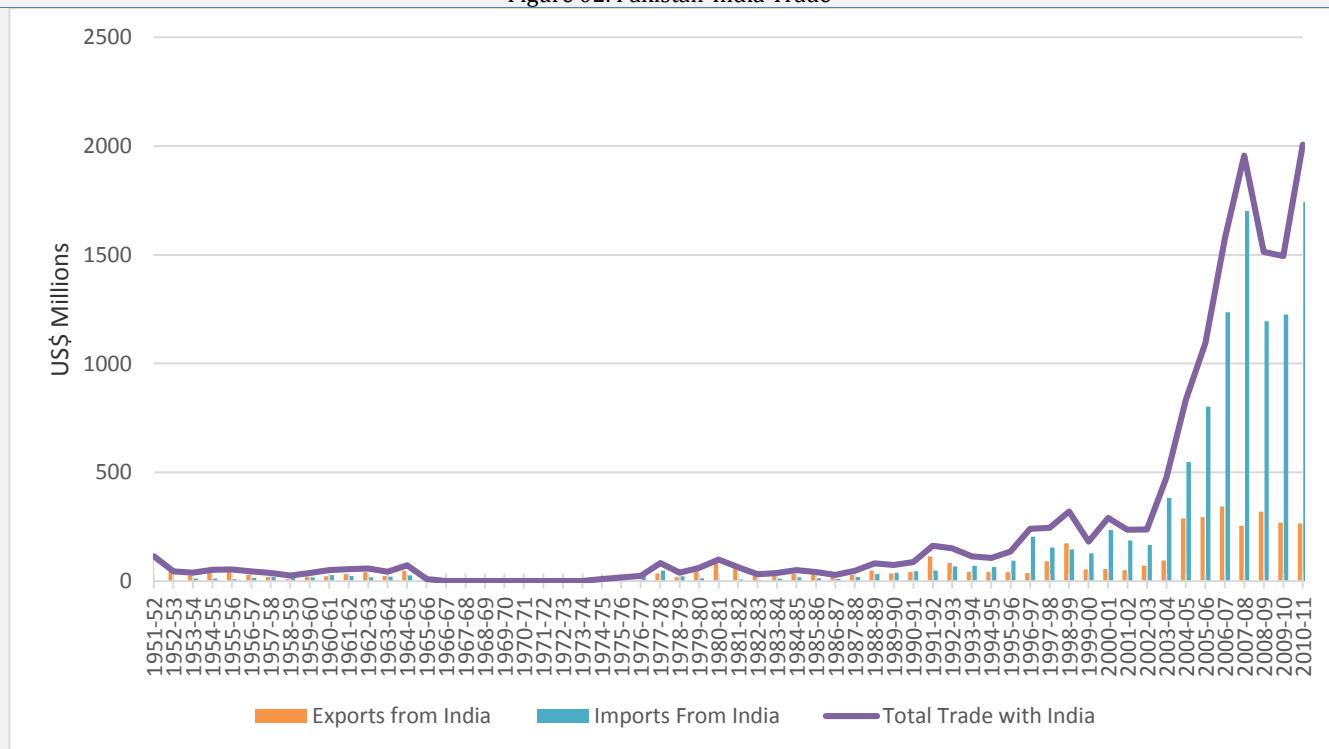
In Pakistan, India's economic dominance of the region is nearly as envied as its military dominance. Experimental economists use a tool called the ultimatum game to explore human behavior.<sup>vi</sup> In bilateral trade relations, we can extend this tool to suggest that expanding trade relations, despite clear mutual benefit, will only take place if the distribution of the gains is considered fair by each partner. If the 'unfair' share of benefits is seen as enriching a potential economic or military threat, the reluctance to expand trade grows. A detailed political economy analysis would also look at the distribution of gains within each country. In many developing countries, trade expansion has been shown to increase the skill premium and thus wage inequality.<sup>vii</sup> Finally, if increased trade might lock one country into a disadvantageous pattern of specialization according to its current comparative advantage, perhaps as a supplier of primary products and raw materials, while fueling the industrialization of its trading partner and strategic rival, trade may be blocked.

#### 4.0 Rivalry and trade relations

Within the scholarly literature, economic transactions in terms of trade flows are generally conceived to be lower among countries that are rivals.<sup>viii</sup> A rivalry is generally treated as a dyadic phenomenon, existing between a pair of states in competition with each other. The rivalry relationship is characterized by military confrontation and war, with both sides formulating foreign policy in militaristic terms (Diehl and Goertz, 2001). The linkage between war and decline in trade is well established in the liberal peace literature (Anderton and Carter, 2001; Barbieri and Levy, 1999; Diehl, 2001; Dorussen and Ward, 2010; Gowa, 1994). However, it is important to note that all rivalries do not necessarily experience open war during the rivalry, but instead can experience a protracted period of low intensity conflict. The inherent mistrust, conflict, violence, and competition that characterize rivalries would suggest that trade expansion would be very far down the policy agenda of rival states. Instead, trade disruption becomes the expected outcome of intense rivalry. Based on the trade disruption premise in the liberal peace literature, one would expect less bilateral trade to take place between a pair of rivals (Anderton and Carter, 2001; Barbieri and Levy, 1999). A review of figure 2 that graphs the decline in bilateral trade following each major hostility between India and Pakistan since 1948 supports this argument. For example, trade between India and Pakistan plateaued following the Indo-Pak war in 1965. There was practically no trade between the two countries until 1974 when a new protocol was signed following the Shimla peace agreement of 1972 to resume trade. In 1996, India granted Most Favored Nation (MFN) status to Pakistan and trade between the two countries seemed to have increased. Kargil war in 1999 slowed down the trade between India and Pakistan. Trade between the two countries came to a halt following the attack on Indian Parliament by the militants in December 2001. The bilateral trade again plummeted following the Mumbai attack in November 2008. It is only after three years, both India and Pakistan decided to resume their bilateral trade by opening an Integrated Check Post at Attari-Wagah border.

Pakistani and Indian policymakers' recalcitrance for strengthening their trade cooperation can be explained by the intense rivalry that has defined their relations since independence (Dash, 1996). This rivalry is based on primarily three factors: Pakistan's objective to achieve balance of power with India; the Kashmir dispute; and cross-border ethnic identities.<sup>ix</sup> Since independence, Pakistan's regional policy has revolved around two objectives: to achieve balance of power vis-a-vis India; and to liberate Kashmir to prove the validity of the Two-Nation Theory (Bose and Jalal, 1998). In order to achieve these two objectives, Pakistan has always sought external mediation and support that run counter to India's desire to maintain a hierarchical regional order. The intense rivalry between India and Pakistan in South Asia's regional system can be partly explained by the *security dilemma*<sup>x</sup> framework, the net outcome of which has been an unhealthy arms race, including nuclear weapons development, and disruption of trade between India and Pakistan.

Figure 02. Pakistan-India Trade



Source: Trade data computed from Pakistan Federal Bureau of Statistics, 2005-6; Economic Survey of Pakistan, 2010-11.

Note: Trade is measured as the sum of exports and imports.

Dispute over Kashmir, the contested region over which India and Pakistan have gone to war three times since 1947, remains a major source of rivalry. Pakistani ruling elites' policies of internationalization and external mediation of the Kashmir dispute over the past decades, despite the Shimla agreement of 1972 in which both India and Pakistan agreed to resolve their dispute through bilateral negotiations, are presumably designed to achieve two objectives: to gain legitimacy over Kashmir, and to limit India's sphere of influence in South Asia. However, this policy has proven counterproductive as it has hardened the attitude of the Indian leaders towards reaching any meaningful resolution, making economic cooperation between the two countries a prime casualty.

Finally, cross-border ethnic identities contribute to India-Pakistan rivalry. Since the Muslim minority in India has close affiliation with their kinfolds in Pakistan, ethnic conflicts in one state draw natural support from the co-ethnic groups in neighboring states, contributing to the growing strength of ethnic subnationalism, or as Etzioni (1992) describes, 'micronationalism' in both India and Pakistan. This trans-border spillover effect has led, on many occasions, to a proliferation of separatist movements with considerable pressure on governments in India and Pakistan. Not surprisingly, India accuses Pakistan of encouraging separatist movements in Kashmir and Punjab, while Pakistan blames India for the separatist movements in Pakistan's Sindh province. Such ethno-political dynamics have led to an accentuation of distrust toward each other, limiting prospects for economic cooperation between the two countries.

## 5.0 Domestic politics and trade policy outcomes

Based on the two-level game framework (Putnam, 1988), we argue that while bilateral trade agreements involve bargaining and negotiation among governmental actors at the international level, the speed and nature of these trade agreements are likely to be determined by the political leader's strategic calculation of domestic win-sets—acceptability of all trade agreements by domestic constituency. The support of key domestic actors for the trade agreements is essential for two important reasons: (1) domestic actors' ability to politicize issues, thereby making ratification and implementation of trade agreements more difficult; and (2) the leaders' concern for political survival (Solingen, 1996; Milner, 1997). While the power-retaining objective is vital, the willingness of political actors to pursue trade agreements can vary with the relative strength of governments (Huelshoff, 1994).<sup>xi</sup> While it is possible for strong governments to take initiatives for trade cooperation, weak governments face different domestic political dynamics. Because of their lack of broad public support and social base, the leaders in weak governments are less able to design and implement trade policies independently without the support of dominant domestic actors. Thus, it is reasonable to argue that unless trade arrangements serve the parochial political and institutional concerns of most relevant domestic actors, it is difficult for policymakers in weak governments to pursue cooperative trade policies with another country.

In India's parliamentary democracy, the Congress party's domination at the national level for three decades provided its leaders with a substantial degree of autonomy to pursue relatively independent foreign and economic policies. However, the decline of the Congress Party associated with the formation of coalition governments at the national level since the 1990s, lack of unity among party members, unpopular political leaders, inter-party strife, and lack of legislative independence have contributed to the successive government's weakness. Given their limited popularity and domestic political insecurity, the leaders of these coalition governments have often relied on three strategies—scapegoating (i.e., blaming the neighbors, particularly Pakistan); combative regional postures; and nationalist policies to advance their domestic agenda. Consequently, as summarized in Table 5, Indian leaders' bilateral trade policy initiatives with Pakistan have remained inconsistent and tentative.

Table 05: Domestic politics and bilateral trade policy

	Pakistan			India		
	1950-1970	1970-1990	1990-2010	1950-1970	1970-1990	1990-2010
Political regime	Military regime	Military regimes followed by brief periods of quasi democracy	Quasi democracy from 1990-98; military regime from 1999-2008	Parliamentary Democracy with Congress Party's domination	Parliamentary Democracy with decline in Congress Party's domination	Parliamentary Democracy with coalition governments at the center
Legislative independence	Yes	Yes for military regimes and No for quasi democracy	No for quasi democracy; yes for military regime	Yes	Yes	No
Strategies toward neighbor	Military confrontation Scapegoating Externalization of bilateral issues	Military confrontation Scapegoating Externalization of bilateral issue	Military confrontation Scapegoating Externalization of bilateral issues	Regional domination Opportunistic scapegoating	Regional domination Opportunistic scapegoating	Scapegoating Combative regional postures Nationalist policies
Bilateral	Inconsistent	Tentative	Stop-and-go	Tentative	Tentative	Stop-and-go



## trade policy

Pakistan has been ruled by its powerful military for over half of its sixty-seven years of independence. As Solingen (1996) argues, military regimes, when in conflict with a neighboring democracy, tend to engage in military confrontation, scapegoating, externalization of bilateral problems, and support for external mediation in resolving bilateral disputes. Since independence, Pakistan's four wars with India, most recently in Kargil in 1999, have either been initiated by military regimes or decided by intense military pressure on civilian regimes. Pakistan's military rulers have often resorted to scapegoating, as manifested in a series of militant anti-India postures, to remain in power and to acquire legitimacy. They also often sought external engagement in resolving Pakistan's bilateral disputes with India. Such policies of externalization and external mediation of bilateral problems, which Indian political leaders oppose strongly, have prevented closer interactions between India and Pakistan, making economic cooperation goals difficult to achieve.

In between several military regimes, Pakistan has experienced what can be described as 'quasi-democracies' that are fragile political systems where the political leaders, despite their election through popular vote, are critically dependent on the support of the military for foreign and domestic policies. Unlike mature democracies in Western Europe and North America, where political leaders can take bold initiatives on foreign policy issues with wide public support, leaders in quasi-democracies are severely constrained to formulate or implement only those kinds of policies that are supported by the military and the bureaucracy. In Pakistan, democratically elected leaders have often lost their power when their policies were inconsistent with the military leaders' goals and objectives. The intervention of the army in securing the resignation of two elected Prime Ministers, Benazir Bhutto and Nawaz Sharif, in the 1990s and the dependence of Asif Ali Zardari administration on military support from 2008 to 2013 testify to the continuing domination of the military in Pakistan's politics.

With their narrow popular base, a multitude of domestic problems, and continuous pressure from the fundamentalist religious groups and the military establishment, successive Pakistani administrations have pursued the ideology of Islamic Nationalism. The central thrust of this ideology is to promote the collective solidarity of the Muslim Pakistanis by constantly nourishing hostility toward the Indian Hindus. For the Pakistani ruling elites, this ideology has served two principal strategic functions: (1) provide a strong rationale to maintain a well-financed and powerful military as a defense against India; and (2) justify the use of force to silence domestic opposition. However, the ideology of Islamic Nationalism appears to have intensified Indian policymakers' mistrust toward Pakistan and has become counterproductive for the growth of economic cooperation between the two countries. Not surprisingly, over the past six decades, both India and Pakistan have pursued a stop-and-go pattern of trade cooperation. In such a pattern of trade cooperation, some trade policy initiatives have been taken followed by protracted period of stalemate, during which implementation of trade agreements have remained inconsistent and uncertain.

## 6.0 Key issues for trade expansion

In the context of this low volume of trade, four major issues can be outlined here to explain why and where India and Pakistan should take additional steps toward greater trade expansion.

### 6.01 Market Access

Trade analysts agree that market access remains the heart and soul of any trade agreement between countries. India's economic liberalization policies since the early 1990s have produced significant economic growth and export opportunities. Previously, until the mid-1990s, India had achieved only limited access to the markets of Japan, North America, and Western Europe due to these countries' protectionist policies and nontariff barriers against Indian products (Rizvi, 1993). And with the collapse of the Soviet Union and the gradual incorporation of Eastern Europe into the Western European economy, India has lost two of its privileged market links. In an effort to expand its market links, India has taken several initiatives including its active diplomatic role in the formation of the Indian Ocean Rim Association for Regional Cooperation (IORARC) in March 1997, involvement in the Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation (BIMSTEC), signing of India-ASEAN Free Trade Agreement in August 2009, willingness to join the Asia-Pacific Economic Cooperation (APEC) and East Asian Summit (EAS), and renewed focus on the 'Look East' policy as reflected in its involvement in a wide range of bilateral trade agreements with Singapore, Thailand, Vietnam, Japan, China, and South Korea.

From India's perspective, although it makes sense to explore markets in other regions, it can no longer ignore its own base in South Asia. Not surprisingly, in the post-1990 period, India has shown increased willingness to implement SAPTA (South Asian Preferential Trade Agreement) and to expedite the process of the SAFTA (South Asian Free Trade Area) agreement.<sup>xii</sup> India's growing preference to boost trade ties with South Asian countries has been shaped by the so-called 'Gujral Doctrine,' named after I. K. Gujral, India's Prime Minister from 1996-97. The

doctrine, which is the basis of India's recent push for a policy of positive unilateralism, stipulates that India, as the region's dominant power, should be willing to grant its neighbors concessions without expecting reciprocity. India's push for free trade agreements with Bangladesh, Nepal, Bhutan and Sri Lanka is motivated by this principle and by its growing desire for greater market access. Given Pakistan's shifting trade policy toward India in recent years – as can be seen in Pakistan's decision to grant India most-favored-nation (MFN) status in November 2011,<sup>xiii</sup> it makes sense for India to include South Asia's second largest country in its expansion of greater market access. Moreover, wider trade with Pakistan opens up possibilities of transit trade and market access beyond Pakistan to the markets of Central Asian countries.

Similarly, Pakistan's need for market access has led it to sign bilateral free trade agreements with China, Sri Lanka, and Bangladesh, forge a closer economic partnership with Malaysia, and join trans-regional economic cooperation arrangements like the Economic Cooperation Organization (ECO) and the Organization of Islamic Countries (OIC). While useful, these markets pale in comparison to India's huge market potential for Pakistani goods. In addition, India shares the largest common border with Pakistan and thus offers immediate access to Pakistani goods if border barriers are removed.

## 6.02 Trade liberalization

Economic theory suggests several ways in which smaller countries actually gain more from international trade than larger ones. First, countries gain from trade based on differences between domestic prices and international prices: the larger the difference, the greater the gain. Large countries set those international prices, and small countries can export large amounts without significantly lowering those prices. Secondly, small countries' firms remain small and unable to lower their costs through scale economies if they do not engage in international trade. Countries that tightly restrict trade invariably restrict technological inflows as well. Finally, consumers reap large benefits from trade liberalization in small countries, as new varieties of products are introduced and domestic monopolies or oligopolies are broken up, lowering prices.

The case for liberalizing Pakistan's trade policy, particularly vis-à-vis India, is complex and multifaceted. It requires taking a long view, which is often a problem for politicians. India's economic liberalization in the early 1990s followed the successful liberalization of its strategic rival, China, a decade earlier. The short-run disruptions of liberalization are offset by long-run gains in efficiency and competitiveness. Pakistani officials may also fear a short term reduction in tariff revenues following liberalization and complaints from potential losers from trade expansion. However, if trade volumes and values increase, much more revenues can be generated in the long run from lower tariff rates. These revenues can be used to assist impacted workers and firms in their adjustment to open trade. Also, the IMF loan announced in July 2013 may provide the fiscal breathing space for Pakistan's current government to tackle the trade problem.

Trade represents a macroeconomic problem for Pakistan, as the current trade deficit of about \$12 billion is unlikely to be supported by shrinking inflows of FDI and U.S. aid. Thus, export promotion must be a priority, and ignoring India's rapidly growing middle class as a market would be counterproductive. Indeed, over the past two years the Pakistani rupee has slid by over 16 percent against the U.S. dollar. This rupee depreciation may help increase export competitiveness of some Pakistani industries – leather goods and textile in particular.

Another approach to Pakistani reticence would be to point out that the status quo has allowed the massive shift in the balance of trade observed in Table 5. One could strongly argue that India's unilateral trade liberalization towards the world, as well as its loosening of FDI restrictions, has made its industries more competitive over the last 20+ years, while Pakistan's attempt to protect its industries largely explains why they have remained small and inefficient. Short term political expediency contributes to missed opportunities for long run growth, and may explain a significant part of the reversal in the bilateral trade balance. Other arguments for trade expansion require drilling down below national aggregates to specific sectors. Textiles and garments make up a large share of Pakistan's manufactured exports and employment. This sector would be crucial to any major expansion of exports in response to new market opportunities. Despite doubters in Pakistan's government and private sector, there are indications that production and exports could expand, if other constraints such as power were addressed.<sup>xiv</sup> A major study by Husain (2011) points out that of 176 items with comparable export unit values, Pakistan held a price advantage over their India counterparts on 128 items, over 70 percent.<sup>xv</sup>

Other segments of Pakistan's manufacturing sector are likely to gain from further trade liberalization. Specifically, surgical and sports goods from Sialkot, light engineering goods such as electric fan from Gujranwala, and leather products from Kasur in Pakistan will find ready markets in India (Burki, Hashwani, Khan, and Sulaiman, 2006). India plans widespread improvements in its infrastructure, and cement from Pakistan could feed into projects in the Northwest. Second, trade liberalization would change the present illegal trade transaction between India and Pakistan. Legalization of Indo-Pak trade in goods would result in substantial reduction of transportation costs and

transit time, benefiting consumers of both countries. One study estimates that annual welfare gains to Indian consumers by importing certain products from Pakistan would be US\$4 billion while importing certain products from India would benefit Pakistani consumers by US\$280 million to one billion.<sup>xvi</sup>

Trade liberalization would also facilitate rapid normalization of broader economic relations between India and Pakistan, facilitating cross-border investments in several areas including information technology. This would bring substantial benefits to Pakistan's emerging IT industry through potential partnership with the Indian IT industry. Since this industry does not depend on the movement of goods, establishing research and development facilities across the border would benefit IT and Business Process Outsourcing industries in both countries. In this context, recent decisions by several Indian IT majors—Infosys, Tata group, and Godrej—to expand their cross-border investment in Pakistan appear promising (Crabtree, 2012). In addition to generating employment, such investments by Indian companies will also help boost Pakistan's IT and knowledge infrastructure, enhancing its attraction for foreign investment. The recent establishment of Pakistan's first IT University in Punjab and Microsoft Innovation Center at Punjab's Arfa Karim software technology park, a joint collaboration between Punjab government and Microsoft Corporation, are welcome initiatives that can help promote information technology and information technology-enabled service activities in Pakistan. Given their expertise, the Indian IT majors are certainly capable of playing an important role in investing and promoting IT industries in Pakistan once the trade relations between the two countries are normalized.

Finally, expanded trade between Pakistan and India would go a long way to promote intra-regional trade, facilitating growth of the South Asian Free Trade Agreement (SAFTA). As the experiences of European integration after the Second World War and Mercosur in the mid-1980s demonstrate, trade liberalization to promote closer economic ties between two major economies in a region—France and Germany in case of European integration; Brazil and Argentina in case of Mercosur—is often necessary for the growth of regional trading arrangements (Doctor, 2012). Similarly, trade liberalization between India and Pakistan is likely to promote not only increased trade between the two countries but also serve as an engine of growth for SAFTA and support the least-developed member countries in their adjustment to a free trade area. Without further trade liberalization between India and Pakistan, SAFTA, much like its predecessor SAPTA, is unlikely to succeed, in promoting intra-regional trade.

### 6.03 Energy cooperation

One of the greatest benefits of normalizing trade relations between India and Pakistan would be in the area of energy cooperation. Over the past decades, India's energy needs have grown dramatically. Pakistan can play an important role in fulfilling this need by providing a transit route for energy from Central Asia and Iran. In this context, the recent signing of a \$7.6 billion Turkmenistan-Afghanistan-Pakistan-India (TAPI) gas pipeline project in May 2012—backed by the U.S. and Asian Development Bank—is significant. The United States supports this project as an opportunity to bolster Afghanistan's economy and, more importantly, as an alternative to the proposed Iran-Pakistan-India (IPI) pipeline. The U.S. opposition to IPI is based on its geopolitical strategy to isolate Iran from substantial economic linkages with South Asian countries. While the U.S. objective has been partially achieved because of India's decision to pull out of this project under the pressure from Washington, Pakistan has continued to support this pipeline project on the ground of energy security. In addition, Russia and China also support the IPI project. India's civilian nuclear cooperation agreement with the U.S. in 2005 along with growing Indo-U.S. economic and military cooperation are some of the important reasons that explain India's strategic distance from the IPI project.

The proposed 1,680-kilometer TAPI pipeline project—originating at Turkmenistan's Yoloten-Osman gas field, will pass through Herat and Kandahar provinces of Afghanistan, and Multan and Quetta of Pakistan before ending at Fazilka (Punjab) in India—will allow Turkmenistan to supply 33bn cubic meters of gas to both India and Pakistan for a 30-year period, benefiting both countries in meeting their growing energy needs (Fontanella-Khan, 2012). Pakistan will also most likely benefit because of transit fees and foreign exchange earnings. More importantly, TAPI will test Islamabad's commitment to normalize trade with India by allowing safe passage of the gas through the pipeline passing through its territory. India appears to support this agreement as an important avenue for importing oil from Central Asia. But poor security, longstanding political hostility with Pakistan, and the absence of credible guarantees from the Pakistani government have increased India's concern about the viability of this project. Not surprisingly, policy makers in New Delhi have sought a firm security guarantee from the United States to ensure a smooth flow of gas through TAPI gas pipeline. At the same time, Indian leaders have also welcomed the recent decision by Bangladesh to join the TAPI project primarily for two reasons: (1) Bangladesh's membership will help build a credible five-country consortium to manage the project for mutual benefits; (2) given the friendly relations between Pakistan and Bangladesh, the latter's inclusion as an additional stakeholder in the project is likely to deepen Pakistan's commitment to the success of the project, thus mitigating any future political risk of disruption. The United States also welcomes Bangladesh's membership in this project as it will help achieve the U.S. vision of a New Silk Road strategy in the region. The New Silk Road strategy, as articulated by Hilary Clinton during

her visit to South Asia in October 2011, represents a fresh narrative of the U.S. regional strategy that focuses on building networks of trade, transit and infrastructure corridors to promote economic opportunity and stability in the region. From the U.S. perspective, Bangladesh's inclusion in the TAPI project will create more of a Central-South Asian cooperation scheme and thus is likely to increase the prospects of success.

Energy cooperation between India and Pakistan acquires added significance in the context of worsening electricity deficits in Pakistan. Although India's power generation capacity is still not sufficient to meet its own growing domestic demand for electricity, the problem is much greater in Pakistan. Given Pakistan's total electricity deficit of an estimated 6,000MW, Pakistani policymakers seem to believe that there would be a significant cost advantage in importing electricity from India. The importance of this is evident when Pakistan announced its decision to import 500 MW of electricity from India on the same day as it granted MFN status to India. Although it is too early to say, this move could mark a new era of regional energy cooperation between India and Pakistan that would be enhanced by improved trade relations.

#### 6.04 Regional stability

Several studies suggest that increased bilateral trade between India and Pakistan can be a valuable confidence building measure, leading to a decrease in conflict between the two countries.<sup>xvii</sup> These findings shed light on 'rational signaling' as the primary mechanism through which economic interdependence reduces the severity of conflict. As trade between two states increases, the variety and range of signals sent increases greatly. Increasing signals through increased dyadic trade provides rivals more tools through which to communicate and lessen hostility (Morrow, 1999). Trade expansion between China-Taiwan, India-China, U.S.-China, and U.S.-Russia, despite their political tensions, illustrates the point that trade cooperation remains an effective instrument in improving inter-state relations. In this context, Pakistan's willingness to embrace the 'India-China model' of economic cooperation, as agreed by Pakistani President Asif Ali Zardari during his visit to India in April 2012, remains a positive move. This model provides a pragmatic approach to engage in mutually beneficial trade ties while simultaneously pursuing negotiation on contentious bilateral issues. Pakistan's willingness to embrace the 'India-China model' represents a shift in its long-held 'Kashmir-first-and-trade-later' policy preference. This shift could strengthen trade ties between India and Pakistan and could provide the necessary impetus for the resolution of the Kashmir issue.

Further, the economic benefits associated with trade might halt the decline of Pakistan towards 'failed state' status by allowing time for stakeholders to gain in strength in order to fight the destabilizing elements in the Pakistani society. Alternately, lack of trade cooperation with India, combined with Pakistan's pique over unresolved political issues and continuing support for terror activities in its soil and across the border, might cause India to withdraw from its current path of engagement with Pakistan. While such a course of action would be a dangerous mistake and counterproductive for regional stability and development, its adoption by India cannot be ruled out.

From the Indian perspective, however, expanded trade with Pakistan is likely to provide an opportunity for India to counter China's growing influence over Pakistan and the South Asian region. China's rising influence in South Asia, which seems to be an indictment of India's past policy of benign neglect toward its neighbors, appears to have increased a fear of encirclement among Indian leaders. In the post-1990 period, New Delhi's anxieties have been exacerbated by China's growing investment in all of India's neighbors. China, for example, has built roads and deep-water ports in Sri Lanka, Pakistan, and Bangladesh, roads in Nepal, oil and gas pipelines in Myanmar, two nuclear power plants in Pakistan, and it supplied fighter jets, guided missile frigates, weapons-grade fissile material, and bomb designs as a part of its nuclear support to Pakistan (Lamant and Kazmin, 2009). Indian leaders seem to be convinced that the major strategic objective of China's 'string of pearls' policy is to throttle India's influence and increase China's sphere of influence in South Asia and the Indian Ocean region. Senior officials in New Delhi's policy circle compare China's strategy of growing investment in South Asia with its strategy in the ASEAN region where China has increased its trade and investment considerably as a means of directly offsetting Japan's economic influence in the region.<sup>xviii</sup> Concerned with these new developments that directly challenge its long-held policy of strategic autonomy in South Asia, India has shown active interest in boosting trade ties with Sri Lanka, Bangladesh, Nepal, and Bhutan in the post-2000 period. The same logic should guide Indian policymakers to improve trade ties with Pakistan. Recently, Indian policymakers have started talking about the need for India to create an 'integrated neighborhood' to address effectively several challenges caused by climate changes, population growth and increasing inequalities.<sup>xix</sup> Operationalization of this scheme requires inclusion of Pakistan. Normalization of trade relations with Pakistan would not only help India counter China's growing influence in South Asia, but would also enhance the prospect of integrated neighborhood contributing to regional stability.

#### 7.0 Conclusion and Policy Implications



This article has identified several economic and political conditions explaining the limited trade relations between India and Pakistan over the past six decades. Our analysis has addressed a broad range of evidence that suggests that trade expansion can play a role in promoting economic development and at the same time in reducing the severity of conflicts between India and Pakistan. While there are tangible economic and security benefits of expanded India-Pakistan trade through bilateral liberalization or a broader, regional free trade agreement, developing institutional arrangements to achieve this goal will not be easy. While Pakistan's announcement of MFN status to India is an important first step, the path of India-Pakistan trade expansion could well be determined by the events of the next several years (De, Raihan, and Ghani, 2013). A marked worsening of India-Pakistan tensions on border, terrorism, and economic transactions would have severe implications for regional peace and prosperity. Such developments would tend to confirm the assessments that discount any future constructive engagement between India and Pakistan and to anticipate a rapid growth of Chinese power and influence in South Asia. One result could be an acceleration of the present arms buildup in South Asia; another might be further strengthening of the alliance between China and Pakistan and its allies in the Gulf region to reduce India's sphere of influence in South Asia. Unwilling to accept such an outcome, India would be forced to develop and seek increasing military weapons from outside. These steps, in turn, could fuel the anxieties of Pakistan and lead to further marginalization of its commitment toward bilateral trade with India.

It is, however, important to argue that expanded trade cooperation between India and Pakistan will not only lead to mutual gains, but also may trigger a virtuous cycle of peace, stability and economic development for the entire South Asian region. Given this dynamic, a triadic cooperative framework – i.e., cooperation at bilateral, regional, and international level -- is necessary to achieve the goal of trade expansion. While expansion of trade between India and Pakistan requires a strong political will on both sides that will enable them to take bold steps toward deeper economic engagement, the international community could assist in funding and facilitating trade-related infrastructure projects along the border as a way to create momentum toward both trade and peace. Additionally, any incremental approach through the framework of the existing regional trade agreement -- South Asian Free Trade Agreement (SAFTA) -- although slow, is likely to help expand economic ties between India and Pakistan. Regional agreements promise to bypass not only some of the political rhetoric but also dilute some legitimate concerns, particularly on the part of Pakistan. A comparison can be drawn to trade liberalization in East Asia, where the only practical way for negotiations among China, Japan, and South Korea to proceed may be as part of 'ASEAN+3.'

The findings of this study have several important policy implications. First, this study supports the assumption underlying previous research concerning how expansion of bilateral trade helps reduce severity of conflicts between India and Pakistan, allowing them to overcome their tense and checkered relationship of the past (Khan, 2010; Mamoon and Murshed, 2010). However, bilateral relations need to stay on an even keel. We have shown how specific events can lead to a rise in regional tensions, mistrust, and populist rhetoric, precipitating a collapse of trade. It is important that both countries intensify their efforts to create multilevel channels of communication that can reduce potentially damaging misinformation across the border. This is necessary to help improve stability in the region that can facilitate trade flows between the two neighbors.

Second, considerable fear exists in both countries as to the consequences of trade liberalization, but particularly in Pakistan, since India has taken bolder policy steps towards liberalization in the recent past and now has a greater confidence in both the long term gains from liberalization and its ability to manage short term adjustment costs. Research on potential gains from liberalization can mitigate those fears, but only successful experience with policy change on the ground can dispel them.

Third, progress towards greater peace and prosperity may be easier to achieve if it is focused initially on specific, mutually beneficial, short-term targets. Energy cooperation, and specifically the TAPI pipeline project, could be a much-needed first step. In this context, the international community, including the World Bank Group and Asian Development Bank, can play a constructive role in funding and facilitating trade-related infrastructure projects along the border to create momentum toward peace and development.

Finally, bilateral rivalry can be reduced through multilateral initiatives such as SAFTA. This initiative would allow both countries to be magnanimous, claiming to be liberalizing their markets for the benefit of their smaller neighbors while actually reaping direct and indirect benefits from greater trade, economic growth, and political stability in the region. In addition to providing network benefits, regular meetings and negotiations at SAFTA forums can serve as an effective confidence building mechanism for Indian and Pakistani elites that may increase mutual interdependence by underscoring the high costs of hostility-related trade disruption.

## Notes:

<sup>1</sup> Note that halving a tariff rate removes approximately three quarters of the distortion, given the nature of welfare triangles.



- <sup>ii</sup> While tariff 'peaks' for manufactured products is commonly understood as a barrier for trade expansion in South Asia, particularly between India and Pakistan, many developing countries, including East Asian countries, practice a 'binding overhang'—the gap between bound and applied tariffs—to facilitate trade expansion between themselves (Bchir, Jean, and Laborde, 2006). For a detailed analysis of the positive effects of 'binding overhang' on trade expansion in East Asia, see Hale, 2010.
- <sup>iii</sup> This negative list was to be further reduced by the end of 2012, in conjunction with the granting of MFN status to India, but, as noted above, this has not yet occurred.
- <sup>iv</sup> This imbalance is found by other researchers as well. Pasha and Imran (2012) calculate TCI for Indian exports to Pakistan of 0.42 and TCI for Pakistani exports to India of just 0.082.
- <sup>v</sup> Typically, differences in quality are seen as differences in unit values, calculated by dividing trade values by quantities for a traded product and comparing the results between trading partners.
- <sup>vi</sup> According to the ultimatum game as used by experimental economists, one player issues an offer to the other, in the form of a take it or leave it ultimatum. Both players know the sum being played for and know the money will only be received by both players, in the shares proposed by the issuer, if the receiver accepts the offer. Economic theory postulates that any offer should be accepted, since any money received is more than the receiver had before. Yet experimental results indicate that offers perceived to be unfair will be rejected, in order to punish the issuer and thus discourage unfair behavior. This is especially true in repeated games, but also quite common in single instance, blind versions. Some economists opine that the stakes are not high enough, and with millions of dollars to be divided, as in the case of a potential trade agreement, behavior would differ markedly. For more details, see Thaler 1988.
- <sup>vii</sup> For a review of this literature, see Goldberg and Pavcnik, 2007.
- <sup>viii</sup> For an excellent review of this literature, see Waltz, 1993; Diehl and Goertz, 2001.
- <sup>ix</sup> For a detailed discussion of how these three factors contribute to intense rivalry between India and Pakistan, see Dash, 2008.
- <sup>x</sup> For insightful discussion on security dilemma, see Buzan and Rizvi, 1986; Wriggins, Gause, Lyons, and Colbert, 1992.
- <sup>xi</sup> A government is strong when it is led by political leaders with strong popular support, central decision-making authority as a result of constitutional arrangements and legislative independence. Weak governments, in contrast, are associated with political leaders that have narrow public support, division within the legislature, and/or constitutional order that limits the power of heads of government (Huelshoff, 1994).
- <sup>xii</sup> At the eighth SAARC summit in New Delhi (1996), the South Asian Heads of Governments took a decision to create SAARC Free Trade Area (SAFTA) by 2005.
- <sup>xiii</sup> Pakistan's decision to grant India most-favored-nation (MFN) status in November 2011 represents a significant policy shift in trade relations between the two neighbors. As of this writing, MFN status has yet to be realized. Note that India granted Pakistan MFN status in 1996.
- <sup>xiv</sup> See our later subsection on energy cooperation. Limited and unreliable energy constitutes the largest constraint for Pakistani industry.
- <sup>xv</sup> These items include: single yarn, cotton fabrics, denim, woven fabrics, ensembles, jackets and blazers, trousers, blouses, T-shirts, jerseys, men's swimwear, skirts, and other garments. The author notes that some differences may reflect lower quality products, but that many items, where available to Indian consumers, are viewed as equal to or better than Indian counterparts.
- <sup>xvi</sup> This estimate is based on the study by CUTS International (Mehta and Suleri, 2011). The one billion figure of potential savings for Pakistani consumers comes from State Bank of Pakistan, 2006. It is important to note that these benefits may involve improving border infrastructure and streamlining customs procedures, as noted earlier.
- <sup>xvii</sup> For a review of literature and insightful analysis, see Mamoon and Murshed, 2010.
- <sup>xviii</sup> Author's interview with senior officials in the External Affairs Ministry, New Delhi, January 18, 2012. Interestingly, this analysis is similar to the findings of several studies on motivations of China's trade policy with ASEAN countries. For insightful discussions, see Chin and Stubbs, 2010; Ravenhill, 2008.
- <sup>xix</sup> Speaking to a gathering of senior policy makers, prominent academics, and journalists from South Asian countries in New Delhi on October 17, 2012, Lata Reddy, India's Deputy National Security Adviser underscored the critical importance of India's role in creating an integrated neighborhood to achieve regional stability and address myriad development challenges facing South Asian countries. This reference to integrated neighborhood is quite common in New Delhi's policy circle as found out by author's interview.

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