India-Pakistan Trade Newsletter

October 2012

Foreword

Dear Reader,

India and Pakistan, South Asia's two largest economies, resumed their composite dialogue in early 2011. The objective of this dialogue is to discuss mutual interests and concerns, and build a co-operative and productive relationship between the two countries.

Stronger trade and economic relations have the potential to create stakeholding in each other's success so that we can build a healthy relationship. The recent liberalization of trade and investment policies of both nations gives us reason to be optimistic, but it is crucial that the momentum of the last few months is not lost.

In this background, we at ICRIER are embarking on a three-year project Strengthening Research and Promoting Multi-level Dialogue for Trade Normalization between India and Pakistan.

The objective of this project is to catalyze and inform a more participatory policy debate through targeted and practical research, and building platforms for multi-level dialogue. The project will work to bridge the knowledge gap, bring together policymakers, academics, and industry representatives from both countries for intensive and focused interaction on a regular basis, increase people-to-people contact, and help bring about a change in the outlook of the stakeholders in both countries towards each other.

The project activities will include in-depth policy oriented research papers, regional chambers of commerce roundtable, annual trade perception survey, distinguished lecture series, and an annual conference. We have launched a web portal, which will disseminate research as well as provide information on India-Pakistan trade and investment. The newsletter will be a regular platform for concise policy oriented analysis.

ICRIER has already established collaborative partnerships with the Lahore University of Management Sciences (LUMS) and the Sustainable Development Policy Institute (SDPI), Islamabad. We will also be regularly interacting with the policymaking community and business organizations in both countries over the course of this project.

I look forward to your active engagement with this project.

Isher Judge Ahluwalia

In this issue

Liberalizing India-Pakistan Investment Flows

Nisha Taneja

Samridhi Bimal

In recent months India and Pakistan have unveiled a number of unprecedented trade and commerce initiatives aimed at normalisation of bilateral economic relations. The two countries now seem to be at a point where both understand the importance of economic engagement as a means to improve peace prospects.

The announcement by the Indian Government on August 1, 2012, to allow Foreign Direct Investment (FDI) from Pakistan has given yet another fillip to Indo-Pak economic relations in the somewhat uncertain environment that was beginning to emerge. There are still some unanswered questions, but once addressed India and Pakistan would have covered yet another milestone in their journey towards normalising trade and economic relations.

Until recently, India had Sri Lanka, Bangladesh and Pakistan on the negative list; however in 2006 and 2007, India permitted FDI from Sri Lanka and Bangladesh respectively, making Pakistan the only country from where India did not permit any FDI inflows. The recent announcement to allow FDI from Pakistan marks a significant change on two counts. First, India no longer has any country on its negative list of foreign investors in its FDI policy. Secondly, the announcement has restored confidence among those who perceived a slowdown in the momentum of normalising the economic relationship between the two countries following a series of events starting May 2012. This included the postponement of the liberalization of the visa regime between India and Pakistan and the delay in following up on India's Commerce Minister Anand Sharma's promise in April this year to allow FDI from Pakistan.

Another dampening factor was the "inconclusiveness" of energy talks that the two countries had started in March this year. Trade in energy can bring about a quantum jump in India-Pakistan trade. The opening of a US$ 4 billion plant in April 2012 on the northern border with Pakistan at Bhatinda by Mittal Energy Investments and Hindustan Petroleum was expected to gain significantly from the energy talks.

The slowdown in the process of strengthening trade and economic relations between the two countries was reversed on August 1, 2012 when India's Department of Industrial Policy and Promotion (DIPP) notified changes in the consolidated FDI policy to allow investment from Pakistan in sectors/activities apart from defence, space and atomic energy through government route and made the requisite amendment. Following this, India recently removed Pakistan from the negative list under the Foreign Exchange Management Act, paving the way for investment from Pakistan.

Even in the case of outward FDI flows from India to Pakistan, the FEMA regulations had been an inhibiting factor. Pakistan, on the other hand, has maintained a liberal investment policy with no restrictions on inward investment from, and outward investment, to India.
In this context the circular issued by the Reserve Bank of India (RBI) allowing Indians to invest overseas in Pakistan under the "government" route is an important confidence building move. This opening up of investment opportunities has been hailed by businesses on both sides and will likely open up other multi-dimensional opportunities.

There is no doubt that encouraging two-way investments will enhance business confidence on both sides. An enabling business environment between the two countries will promote joint ventures and allow firms to access technologies, which in turn will lead to productivity improvement, generating growth and employment opportunities.

The private sector is expected to step in to assess bilateral investment possibilities. Though at the moment it appears that investment possibilities for Pakistani investors are limited. If we look at the year 2011, Pakistan's total outward FDI flow was only US$ 62 million while India's was US$ 14.8 billion. Further, Pakistan's inward FDI flow for 2011 was US$1.3 billion while that of India was US$31.6 billion.

The chambers of commerce in the two countries have identified clothing, clothing accessories, fabric, surgical instruments, and cutlery as some of the possible sectors for Pakistani investment. There are larger possibilities for Indian investors in Pakistan in sectors such as chemicals, pharmaceuticals, automobile components, and information technology.

In the seventh round of talks on Commercial and Economic Co-operation held in Islamabad between the commerce secretaries of India and Pakistan on September 20-21, 2012, the Pakistani side recognised efforts by India to remove restrictions on inbound and outbound investment to Pakistan. However, they raised concerns about the "government" route and its implications for Pakistani investors in India.

Under India's FDI policy, an Indian company can receive foreign direct investment under two routes – automatic route and government route. According to the RBI guidelines, under the automatic route, investors do not require any prior approval from either the government or the Reserve Bank of India. On the other hand, under the government route, investors require prior approval from the Foreign Investment Promotion Board (FIPB), Department of Economic Affairs, Ministry of Finance. The FIPB is the government body that provides a single window clearance for foreign investment proposals into the country that are not permitted via the automatic route. This agency discusses and examines proposals for investments in sectors that are not allowed via the automatic route under FDI policy.

For investors from Pakistan and Bangladesh, the "government route" applies to all sectors. The investors from these countries are concerned on two fronts – transparency and time taken for approvals. However, it needs to be noted in India an e-filing facility was introduced in March 2012 to enhance the efficiency and transparency of decision-making under the government route. Under this facility, investors can apply for approvals directly and complete applications filed three weeks prior to a scheduled FIPB meeting are taken up for consideration. The FIPB meetings are held on a regular basis, usually once in 4-5 weeks, to clear applications. The committee declares the approved cases, deferred cases, and the cases that have been rejected. It also provides comments to enable investors to revise and resubmit their applications. These decisions are publicly available on the FIPB website. These systems in place for investments under the government route will enable the two countries to assess the status of applications made by Pakistani investors on a regular basis.

The next step for the governments of India and Pakistan should be to set up an institutional mechanism that would guarantee each other's investments. The countries should work towards signing a bilateral investment treaty that protects and promotes investments of investors on a reciprocal basis and includes provisions on fair and equitable treatment, protection from expropriation and national treatment.

Another important issue that needs to be addressed in facilitating bilateral trade and investment between the two countries is allowing banking operations on a reciprocal basis. This would also promote further economic interaction. Action on this front has already been initiated with the commencement of talks between the Reserve Bank of India and the State Bank of Pakistan earlier this year.

As India moves towards completing the important task of liberalizing investment flows, it will reinforce its commitment to the trade and investment agenda laid down by the two countries in April 2011. Stronger and deeper economic ties will not only benefit the two countries, but will also serve as a powerful means of confidence building and, in time, of peaceful bilateral relations.

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Pakistan's FDI in India: Potential and Prospects

Vaqar Ahmed

The recent announcement by the Indian Government regarding opening up of the country's Foreign Direct Investment (FDI) regime for Pakistani investors comes at a time when India-Pakistan trade normalization process is progressing at an encouraging pace.

It is no surprise that investors from both countries have been working closely in joint ventures in third countries, but have not been able to progress in terms of bilateral investments because of political barriers. However, there were some who managed to bypass such barriers; more recently, Pakistani businessmen based and registered in places like Dubai and Malaysia have started investing in India through partnership agreements with Indian resident businessmen.

Investors on both sides are ready to employ competitive advantages in their neighbourhood and reap economies of scale. The examples of India's Tata group showing interest in Pakistan's energy sector (particularly Thar Coal) and Pakistan's Mansha group showing interest in India's banking sector (particularly consumer banking) show that, on both sides, the business community has done its homework towards exploring its niches.

Academia and development partners have long demonstrated through empirical methods how supply chain development in South Asian countries can benefit the region as a whole. Sadly, not much research exists specifically for India and Pakistan at the sectoral level. However, the recent experience of Pakistani investors in Bangladesh proves the win-win case that will be possible for India and Pakistan. Around 2008, several Pakistani textile firms opened branches in Bangladesh to reap the benefits of Least Developed Country (LDC) status, which allows Bangladesh duty free access or reduced tariffs in foreign markets, particularly the EU and US, where major market exists for Pakistan's readymade garments. Data for 2010 on Pakistani firms that opened branches in Bangladesh show employment creation for Bangladesh's labour force, technology transfer for Bangladesh's textile sector, increased royalty for Pakistani investors and increased exports of raw material (such as dyes, chemicals and threads) to Bangladesh. A similar story has been observed in the case of Pakistan's investments in Sri Lanka (both countries have signed a bilateral investment treaty) in sectors such as food processing and construction materials.

Replicating the regional experiences for India-Pakistan should not be difficult given the sheer size of the two economies and the opportunity presented by a large – and growing – domestic demand in both countries. While Pakistan is soon expected to reciprocate India's decision to open up FDI, several complementary reforms may also be required to ensure smooth flow of investments between the two countries.

First, the home departments on both sides should ensure that the recently agreed visa liberalization policy between the two countries is implemented fully and expanded to other cities on an expedient basis. Allowing physical capital to move while human capital is curtailed does more harm to the production process, and prevents future cash flows. This happened last year when Pakistan's government drastically reduced the sensitive list and liberalized trade with India. While this allowed steel manufacturers in Pakistan to import machinery at much reduced rates from India in comparison to other parts of the world, such machinery has been lying redundant for weeks, sometimes months, because of delays in allowing visas for Indian engineers who were to come to Pakistan to install the machinery.

Second, there is a need to harmonise product standards with the rest of the world. For example, in a discussion with auto part manufacturers in Pakistan it was pointed out that while they were interested in investing in this sector in India, the two industry standards followed by India – Bharat 1 and Bharat 2 – are seen in no other country in the world. Such standards act as barriers to entry for producers who can genuinely enhance consumer surplus in India. The consumer rights organizations in both countries should take note of standards that curtail trade and investment, leading to a decrease in consumer welfare.

Third, a natural path in the economic integration for both countries should be to move towards a bilateral investment treaty. This will boost both the safety of investments and boost investor confidence. Under such a treaty, investment from the other country should be treated on par with domestic investors. Similarly, country-specific bias in competition policy and other sector-specific policies needs to be removed. Such treaties allow transfer of investment-related funds into and out of a host country without any delay at the open market exchange rate.

Fourth, and a point related to the above, is the need for a sovereign guarantees framework, at least in the short term. If both countries are serious about hosting each other's investments, then physical and financial capital migration must be protected against the risk emanating from a possible political upheaval. Most investors we have come across in Pakistan were fearful that future political friction between the two countries could affect their business in India. This points towards the short-term need to provide sovereign guarantees to investors from Pakistan (and vice versa) that ensure full compensation if harm is caused to their investment in India (or Pakistan) due to actions related to foreign or defence policy. It is important to note that such a measure would be unnecessary if the two countries move towards a comprehensive bilateral investment treaty.

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Project Activities

September 8-15, 2012 The ICRIER team, led by Professor Nisha Taneja, visited Pakistan to hold consultations with research institutions and business organizations. The team also met with senior government officials and briefed them about ICRIER'S project. The visit was utilised to establish contact with these key stakeholders in Pakistan and firm up collaboration on various aspects of the project.

September 24, 2012 ICRIER held a stakeholder consultation on **Enhancing India-Pakistan Trade** in Srinagar. The meeting brought together academics, government agencies and traders engaged in cross-border trade at the LoC (Line of Control) to discuss prospects and challenges to cross-LoC trade.

The project web portal on India-Pakistan trade is now functional. It provides regular updates on current policy developments, macroeconomic data and project's research activities. Please visit the ICRIER website www.icrier.org for the link or access it directly at:

www.indiapakistantrade.org

Forthcoming Events

Regional Chambers of Commerce Roundtable, Lahore
November 2012

The roundtable is organized by ICRIER in collaboration with the Lahore Chamber of Commerce and Industry (LCCI) and the Lahore University of Management Sciences (LUMS).

India-Pakistan Trade and Investment Indicators

Indicator Name	INDIA			PAKISTAN		
	2009	2010	2011	2009	2010	2011
Trade Indicators						
Exports of goods and services (% of GDP)	20.1	22.8	24.6	12.9	13.6	11.9
Exports of goods and services (current US$) {billion}	274.0	383.5	455.3	20.8	24.0	25.1
Imports of goods and services (% of GDP)	25.5	26.9	29.9	20.4	18.8	15.9
Imports of goods and services (current US$) {billion}	347.1	453.5	551.6	33.0	33.2	33.6
Trade (% of GDP)	45.6	49.7	54.5	33.3	32.3	27.8
Investment Indicators						
Foreign direct investment, net (BoP, current US$)** {billion}	19.7	11.0	-	2.3	2.0	-
Foreign direct investment, net inflows (% of GDP)	2.6	1.4	-	1.4	1.1	-
Foreign direct investment, net inflows (BoP, current US$) {billion}	35.6	24.2	-	2.3	2.0	-
Foreign direct investment, net outflows (% of GDP)	1.2	0.8	-	0.0	0.0	-

Source: WDI, World Bank; Pakistan Economic Survey 2011-12, Ministry of Finance, Government of Pakistan; Economic Survey 2011-12, Government of India

Notes:

Definition: Foreign direct investment, net (BoP, current US$) **: Foreign direct investment is net inflows of investment to acquire a lasting management interest (10 per cent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows total net, that is, net FDI in the reporting economy from foreign sources less net FDI by the reporting economy to the rest of the world. Data are in current US dollars.

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