World Bank Group

PAKISTAN@100

REGIONAL CONNECTIVITY

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GLOSSARY

APEC	Asia-Pacific Economic Cooperation
APTTA	Afghanistan Pakistan Transit Trade Agreement
ASEAN	Association Of Southeast Asian Nations
BIMSTEC	Bay Of Bengal Initiative For Multi-Sectoral Technical And Economic Cooperation
BRI	Belt and Road Initiative
CARs	Central Asian Republics
CASA-1000	Central Asia-South Asia Electricity Transmission And Trade Project
CGE	Computable General Equilibrium
CPEC	China-Pakistan Economic Corridor
CPEC	China-Pakistan Economic Corridor
ECO	Economic Cooperation Organization
FTA	Free Trade Agreement
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
HDI	Human Development Index
IPI	Iran-Pakistan-India
MFN	Most Favored Nation
NAFTA	North American Free Trade Agreement
NATO	North Atlantic Treaty Organization
NDMA	National Disaster Management Authority
NTBs	Non-Tariff Barriers
PTA	Preferential Trade Agreement
SAARC	The South Asian Association For Regional Cooperation
SROs	Statutory Regulatory Orders
TAPI	Turkmenistan-Afghanistan-Pakistan-India Gas Pipeline Project
TIR	International Road Transport
TUTAP	Turkmenistan-Uzbekistan-Tajikistan-Afghanistan-Pakistan
WTO	World Trade Organization

INTRODUCTION

Throughout Pakistan's 70-year history, dysfunctional governance and periods of military rule have weakened democratic values and institutions, produced declining human development indicators, and adversely affected the country's near- and long-term growth prospects. Today, however, Pakistan has just completed its second consecutive democratic transition—a landmark event that presents an opportunity to look ahead and move to establish a firmer pro-growth and pro-development policy trajectory based on democratic and civilian institutions. As Pakistan looks ahead to marking its first 100 years, it would benefit by prioritizing human development as a central focus of government. This report argues that such a development-centric shift in policy cannot preclude regional cooperation.

Pakistan sits at a pivotal geostrategic location: at the intersection of energy-rich Central Asia, two of the world's largest economies (China and India), and the Indian Ocean. By becoming a trade and transit hub, it can capitalize on this position. Liberalizing regional trade in merchandise alone could result in a threefold increase in trade for Pakistan.[1] By connecting resource-rich Central Asia to an energy-starved South Asia and developing synergies between this axis and the China-Pakistan Economic Corridor (CPEC), Pakistan would not only relieve its internal energy constraints and earn revenue through rents and transit fees, but also improve its strategic footing by creating regional stakes in its stability. Equally, other regional states stand to benefit tremendously by facilitating Pakistan's efforts – the region is poised to rise as a whole.

In seeking to transform the country over the next three decades, Pakistan's decision-makers must address three realities: (i) a business-as-usual approach will continue to leave Pakistan behind as the region forges ahead; (ii) traditional Western sources of international support are shrinking; and (iii) the greatest untapped potential for Pakistan to achieve its people-centric agenda lies in economic cooperation with South Asia and the larger neighborhood. In this context, this report puts forth a vision of Pakistan at 100 years, in which the country exploits its geostrategic position, both contributing to and benefitting from a more connected, peaceful, and economically prosperous region without necessarily incurring the strategic costs that have traditionally held Pakistani planners back from taking a proactive approach to regional integration.

Section 2 discusses Pakistan's current strategy and the factors that have contributed to it, arguing that continuing with the current paradigm is unsustainable. Section 3 explores the current state of regional connectivity, and Section 4 focuses on the economic and political advantages Pakistan would gain from moving toward a strategy of greater regional cooperation. Section 5 discusses the constraints to achieving this goal. Finally, Section 6 provides recommendations.

[1] The business-as-usual model assumes that Pakistan continues to grow at the average rate of the last five years.

CHAPTER 1: AN UNSUSTAINABLE STRATEGY

Although Pakistan is one of the world's most populous countries and boasts the world's sixth-largest military and a nuclear weapons capability, it has some of the lowest socioeconomic indicators in the world. This reflects the predilection of successive Pakistani governments, dating back to the country's founding, to address perceived vulnerabilities by developing and maintaining strong military capabilities. But in recent times, global security policy discourse on security has increasingly emphasized the need for also addressing economic and human development to maximize national potential. In *Vision 2025*, Pakistan has articulated a commitment to human security to benefit all citizens of Pakistan through the "revival of sustainable and inclusive growth." Such a vision represents an important transition from the approaches of the past, and if fully implemented it would provide a sounder basis for the nation's future development.

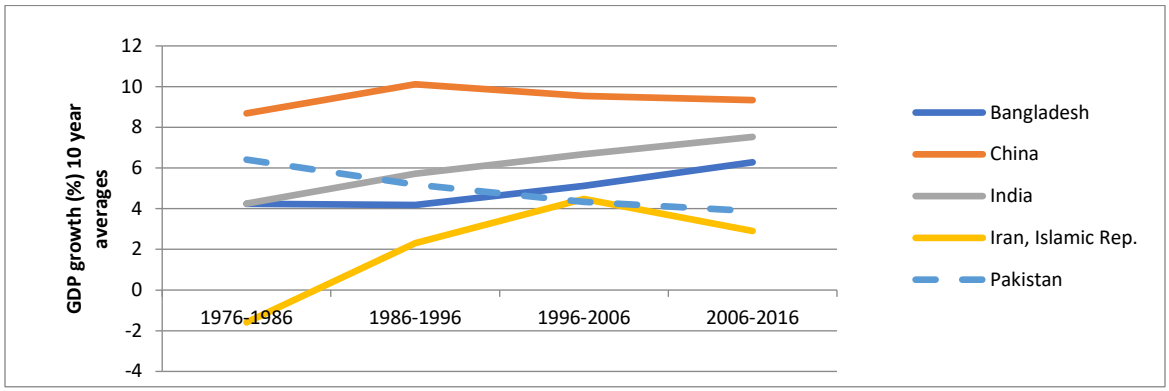
The bias toward security is fundamentally driven by Pakistan's perception of threats from the neighborhood, principally India. This perception, and a history of multiple wars with India, has led Pakistan to allocate large amounts of resources to bolstering its security sector. The military has driven this national security paradigm. The military has directly ruled the country for three of the seven decades of Pakistan's existence; but even when the military has been out of power, the absence of clear policy guidance from the civilian authorities has left a foreign policy vacuum that the military has filled.

Today, as Pakistan embarks on its third consecutive terms of democratic rule, the structural institutional imbalance between a powerful military and an underdeveloped political system continues to dominate the policy landscape and, too often, leads to traditional thinking about regional security. This traditional policy approach, however, is becoming increasingly unsustainable.

1.1 GROWING ECONOMIC DIFFERENTIAL BETWEEN PAKISTAN AND ITS NEIGHBORS

In the first three decades after Partition, Pakistan's economic performance, as measured by growth in GDP, surpassed India's. In the 1950s and 1960s, as India's growth hovered around 2-3 percent annually, Pakistan grew at around 5-6 percent annually, with a per capita income significantly higher than India's. A major contributor to this growth was a commodity boom in the 1950s, which helped foster industrialization. However, with the 1970s this initial growth spurt petered out, and there has been a secular decline in GDP growth rate ever since. Except in the 1980s and the early 2000s—periods in which large surges in aid money created brief consumption-led booms—Pakistan's average growth has been steadily falling over the last four decades and is now one of the lowest in the region (see Figure 2-1).

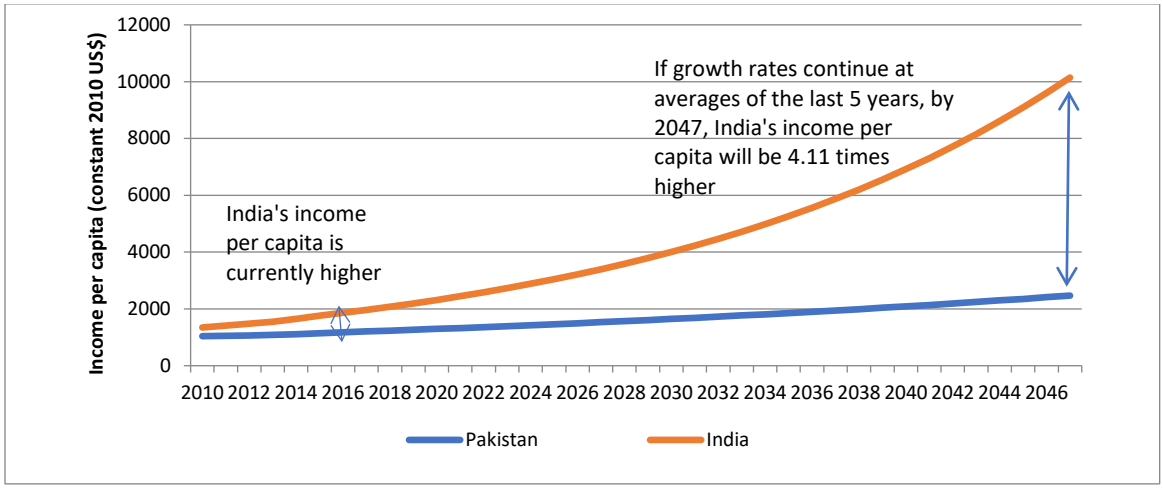
Figure 1. Divergence in GDP Growth



Source: World Development Indicators.

Meanwhile, India undertook major economic and structural reforms. Liberalization of the economy in the late 1990s resulted in a sharp and sustained rise in capital inflows. Moreover, increasing export earnings propelled India's GDP growth to almost 7 percent annually, much higher than Pakistan's. The widening differential in growth performance between India and Pakistan has led to a continued divergence in per capita income. If current trends continue, by the time Pakistan turns 100, its per capita income will be less than one-fourth of India's (see Figure 2-2).

Figure 2. Growth and Income Per Capita Differential: India and Pakistan in 2047



Source: World Development Indicators. Projections by authors.

There are several reasons for Pakistan's low economic growth—not only the deterioration of the security situation after 2006 and crippling energy shortages, but also endemic and structural factors. One is the abysmally low saving rate, which has been declining since the 1990s, in contrast to other countries in South Asia. Another is that Pakistan's export competitiveness relative to neighboring countries has fallen, particularly in the last five years. Pakistan's exports in 2016 accounted for only 12 percent of GDP—the lowest level in four decades. The situation is not much

different for the services trade. Although the services trade represents the fastest-growing sector of the world economy, the share of Pakistan's services trade has stagnated at less than 0.1 percent of total world exports since 2000 (UNCTADSTAT, 2016). Moreover, overall trade as a percentage of GDP is also low in Pakistan—25 percent, compared to the South Asian average of almost 40 percent—a fact that indicates an overall lack of openness to trade. Pakistan has an average most favored nation (MFN) applied tariff of 12.1 percent; while this is high relative to global tariffs, it is still lower than the tariffs of some South Asian neighbors (see Table 2-1).

Table 1. Pakistan's Tariffs Relative to Those of Other Countries

Country	MFN applied tariff (simple average) %
Bangladesh	13.9
Afghanistan	13.6
India	13.4
Pakistan	12.1
Thailand	11
China	9.9
Sri Lanka	9.3
Indonesia	7.9
Malaysia	5.8
European Union	5.2
United States of America	3.5

Source: WTO

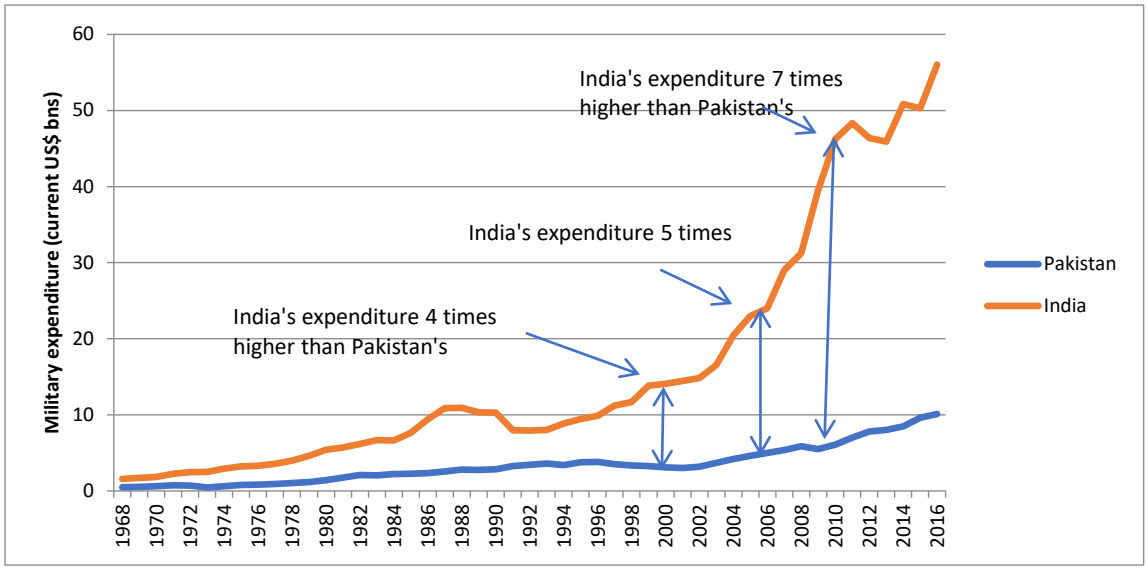
With investments, exports, and overall GDP growth falling, Pakistan is in a precarious economic situation. The country has a burgeoning population, and its youth bulge pushes millions into the labor force every year. Pakistan would require an additional 1.5 million jobs every year to keep unemployment at its current rate. To absorb the growing workforce, a minimum average growth rate of 7 percent is essential (Government of Pakistan, 2014). The economic challenges are compounded by internal security threats and worsening relations with both eastern and western neighbors, which increase security-related expenditures and add pressure on fiscal resources.

1.2 GROWING DIFFERENTIAL WITH INDIA

To the extent that Pakistan's security expenditure is premised on the potential for conflict with India, the nation was always going to face an uphill task, given India's larger population and resource base. Pakistan's original defense allocation was over 70 percent of the total government expenditure (Askari Rizvi, 2000). Today it is 32 percent, which is still higher than India's allocation of 21 percent of the national budget. Even though India's annual defense expenditure, at 2.5 percent of GDP, is considerably lower than Pakistan's 3.6 percent, in absolute terms, India is now

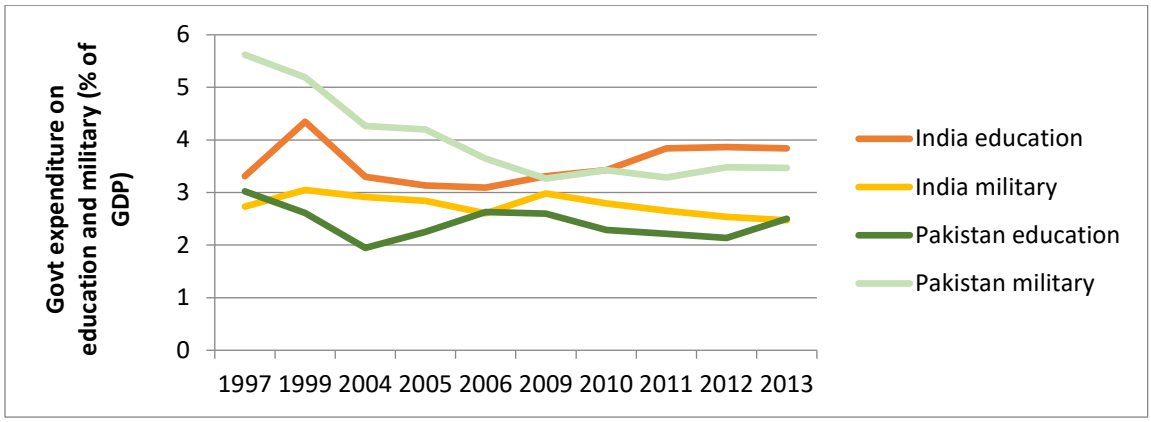
able to build a decisive advantage. India's current allocation to the military is almost seven times more than Pakistan's, and the differential is growing (see Figure 2-3). This trendline is important, and worrisome, for Pakistani security planners, given their quest to maintain some level of balance with India. On the one hand, a fast-growing differential with India implies a greater need for resources to maintain requisite military strength; on the other Pakistan cannot afford such resource diversion without harming its long-term economic prospects.

Figure 3. Differential in Military Expenditure – Pakistan and India



Source: World Development Indicators.

Figure 4. Military vs. Education Spending in Pakistan and India



Source: World Development Indicators.

To achieve long-term growth and prosperity, Pakistan must allocate more of its budgetary resources to building its human capital. Pakistan does poorly on key indicators of both education and health, slipping in the Human Development Index (HDI) ranking to 147 (India is at 131).

Pakistan's social sector spending is already among the lowest in the region (see Table 2-2). Also, as a share of GDP, Pakistan spends more on its military than on education (see Figure 2-4).

Table 2. Comparing Health and Education Outcomes – Pakistan and Its Neighbors, 2015

HDI rank	Country	Human Development Index (HDI) (value)	Life expectancy at birth (years)	Expected years of schooling (years)	Mean years of schooling (years	Gross national income (GNI) per capita (2011 PPP $)
169	Afghanistan	0.479	60.7	10.1	3.6	1,871
147	Pakistan	0.550	66.4	8.1	5.1	5,031
139	Bangladesh	0.579	72.0	10.2	5.2	3,341
131	India	0.624	68.3	11.7	6.3	5,663
73	Sri Lanka	0.766	75.0	14.0	10.9	10,789
69	Iran (Islamic Republic of)	0.774	75.6	14.8	8.8	16,395
90	China	0.738	76.0	13.5	7.6	13,345

Source: UNDP Human Development Indicators

The point is not to argue that Pakistan should invest in education or the military. Rather, it is to highlight that with the current economic situation and growth trajectory, Pakistan will find it increasingly difficult to keep India's military expenditures in sight; increased allocations would come at a very large socioeconomic cost, weakening state and society. While internal constraints such as poor governance, corruption, and high costs of doing business impede investments and growth, these alone do not entirely explain Pakistan's sluggish economic performance. Lack of peace and stability in the neighborhood and internal security challenges have been a tax on long-term sustained growth in the country and are a major source of uncertainty, making any short-term growth spurt highly fragile. This report posits that improved intra-regional trade and East-West and North-South connectivity would help create the right economic conditions and political environment for long-term sustained growth in Pakistan. To be sure, the argument is not simplistically derived from liberal trade theory that establishes a direct correlation between economic interdependence and peace (Doyle, 1997 & Copeland, 1996). Rather, the report offers a political economy perspective aimed at creating a win-win situation in which regional connectivity leads to greater economic prosperity while also creating positive incentives for Pakistan and its neighbors to improve political relations to optimize gains from the enhanced economic activity.

1.3 SHIFTING GLOBAL ALLIANCES

The international political and economic environment is in a state of flux; changing alliances and strategic realignments by major powers will have serious ramifications for the region and for Pakistan. During the Cold War Pakistan had three major international sources of support to meet its financing needs. First, it benefited significantly from U.S. funding. Concerned about Soviet ingress into South Asia, the U.S. poured over $44 billion in economic and security assistance into Pakistan (USAID, 2017a). This funding greatly assisted Pakistan's economy and defense needs. Second, the GCC countries proved to be a major source of diplomatic and economic support, with Saudi Arabia by far the most significant donor over time. A direct function of Pakistan's "look west" foreign policy, Pakistan's Middle Eastern ties helped keep Pakistan's differences with India in international fora like the Organization of the Islamic Conference. Pakistan's third source of support was its security-focused relationship with China, which will be discussed further in Section 3.

Emerging geostrategic alignments are likely to diminish the first two sources of support for Pakistan. While China may well be Pakistan's largest partner in the future, the U.S. has been cast in that role—often, uneasily for both nations—in the past. The U.S.-Pakistan relationship has gone through ups and downs. From Washington's perspective, Pakistan has benefited from significant financial support (USAID, 2017b) while providing sanctuary to America's enemies. From Islamabad's perspective, it has provided significant support to U.S.-led wars, suffering greatly in doing so, without much recognition or support going beyond Washington's most immediate needs. In reality both countries have benefited from the relationship over the past decades.

The relationship between Pakistan and the U.S. is likely to continue to be unsteady. However, the trendline of increasingly close economic and security ties between India and U.S is likely to continue. In the more immediate future, the convergence of views among the U.S., India, and Afghanistan over the conflict in Afghanistan will also put stress on Pakistan's relationship with the U.S. The longer the conflict in Afghanistan lasts, the more enduring the damage could be to Pakistan's relations with the U.S.

Even in the Middle East, where Pakistan remains a key actor, India's economic rise has led to a strengthening of its relations with Pakistan's traditional Arab partners. The UAE and Saudi Arabia, two of Pakistan's staunchest allies in the Gulf, have had unprecedented interactions with India's government in recent years, developing strategic partnerships (Hussain, 2017). Even though the recent U.S. pullout from the Iran nuclear deal and fresh sanctions on Iran may affect some of the positivity, India's relationship with Iran is even stronger, as it participates in the development of a major new port at Chabahar, which will provide an alternative transit link to Afghanistan and Central Asia that bypasses more traditional and direct routes through Pakistan.

Equally importantly, with the changing nature of global energy demand and the resulting decrease in the salience of oil-producing economies, Saudi Arabia and other Middle Eastern states may not be willing to continue providing the same level of economic support for Pakistan in years to come. For Pakistan, remittances from migrant workers in the Gulf—amounting to almost US$19.8 billion (in 2016) or 7.1 percent of Pakistan's GDP—have served as a reliable anchor and safeguard against balance of payments crises, especially in a time of declining exports

and capital inflows. However, with the fall in oil prices and increased layoffs of migrant workers in the Middle East, this dependable source of foreign exchange is at risk (World Bank, 2017). Pakistan's economy may have to adjust to both the shock of a fall in remittances and a large influx of returning migrants. That adjustment is bound to be painful unless new opportunities for foreign exchange earnings, employment, and income generation are created in the near future.

The last decade has seen major shifts in global economic power: China and India together constitute a burgeoning share of the global market for trade and foreign direct investment, accounting for 19 percent of gross world product in 2016 (World Bank, 2017). Pakistan's geostrategic location, in the immediate neighborhood of the two Asian powerhouses, remains grossly unexploited. While Pakistan has historically forged strong North-South economic links, much is left to be desired in terms of galvanizing East-West relations.

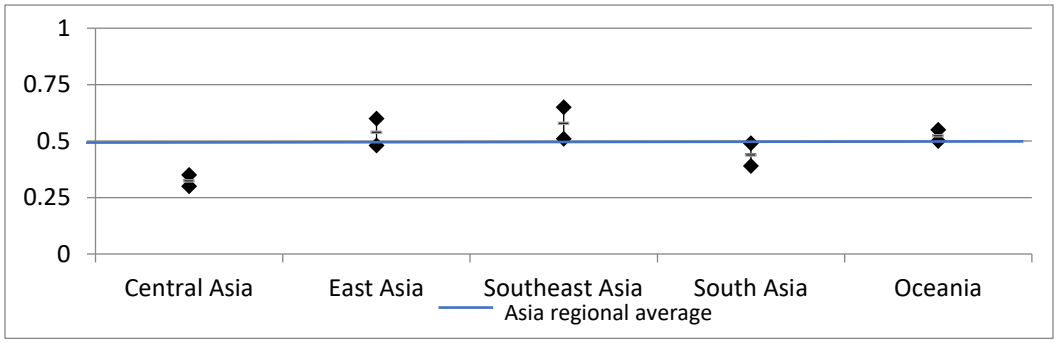
CHAPTER 2: CURRENT STATE OF REGIONAL COOPERATION

South Asia is one of the least integrated regions in the world, not only in terms of trade, but also in terms of investment, money and finance, movement of people, infrastructure and connectivity, regional value chains, and institutional and social integration. Historically tense political relations, especially between India and Pakistan, have prevented meaningful economic and political cooperation in the region.

The long-standing hostility between India and Pakistan has led both to squander the true benefits of South Asia's geostrategic location. While the debate on the importance of Pakistan's location has historically been couched in security terms, its real potential was always economic—Pakistan's ability to connect China to the Arabian Sea, as it is now doing, and to connect Central Asia and South Asia. Even as regional trading arrangements mushroomed from the 1990s onwards, demonstrating the benefits of trading among neighbors situated at short distances, regionalism all but bypassed South Asia. The South Asian Association for Regional Cooperation (SAARC) got off on the wrong foot as "India perceived it as an attempt by the smaller neighbors to gang-up against it, while the latter, especially Pakistan, feared that India would use it as a vehicle to impose its hegemony in the region." (Behera, 2009)

Arguably, Pakistan has been the biggest loser. Apart from Pakistan, all other countries in South Asia have normal and, in some cases, preferential trade relations with India. Yet because of the rivalry between South Asia's two largest countries, the region remains one of Asia's least economically integrated regions (see Figure 3-1).[2]

Figure 5. Asia Pacific Regional Cooperation and Integration Index, By Sub-Region

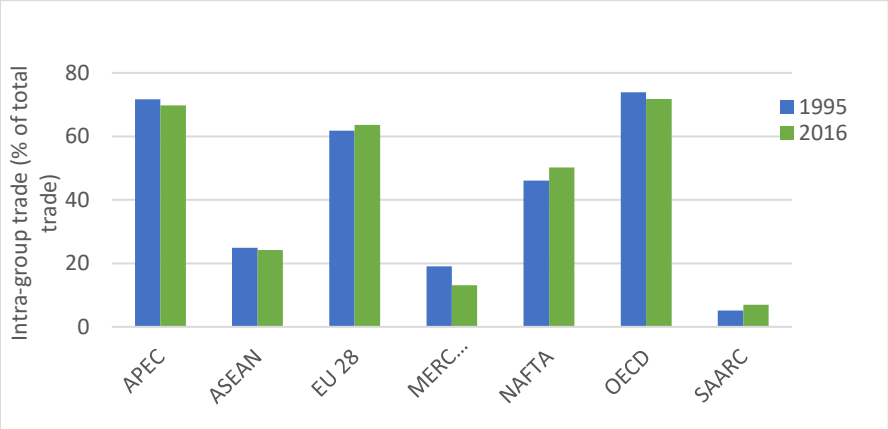


Source: Asian Development Bank, 2017

[2] The Asia-Pacific Regional Cooperation and Integration Index is a weighted average of 26 socioeconomic indicators categorized into six different dimensions to measure the diversity of regional cooperation and integration efforts. The six dimensions are trade and investment, money and finance, movement of people, infrastructure and connectivity, regional value chain, and institutional and social integration.

This lack of regional integration is even more apparent if we compare SAARC with more functional regional trade agreements such as APEC, ASEAN, and NAFTA. The total intra-regional trade of South Asia over the past two decades is a meager 7 percent of total trade, a fraction of that under other regional trade agreements (see Figure 3-2).

Figure 6. SAARC In Comparison with Other Regional Trading Blocs, 1995-2016

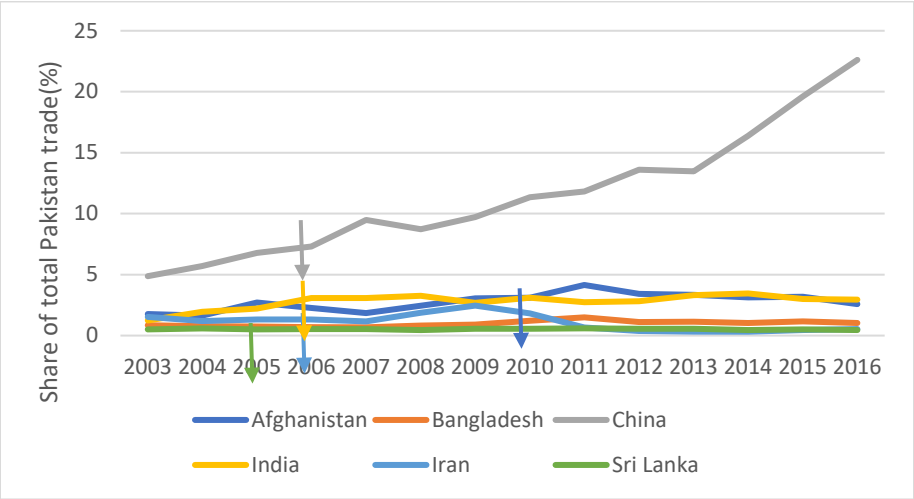


Source: ITC TradeMap.

Pakistan remains the least integrated country in South Asia. Notwithstanding various bilateral trade agreements, Pakistan's trade share with neighbors—except China—is negligible (see Figure 3-3).[3]

[3] China is Pakistan's largest import partner, representing 29.11% of its imports, followed by UAE (13.2%). The other import partners contribute less than 5% each. In terms of exports, the United States represents 16.7% of Pakistan's exports, followed by China (7.75%) and the UK (7.59%); Germany, Italy, and Spain together represent 13.11% of exports.

Figure 7.Pakistan's Regional Trade by Trade Agreement, 2003-2016



Note: Arrows correspond to the year a trade agreement was signed with partner, as applicable.
Source: ITC TradeMap.

China is Pakistan's largest regional trading partner. Pakistan's dependence on the Chinese economy increased exponentially in 2006, when it signed a free-trade agreement (FTA) with China. The agreement led to a compound annual growth rate of almost 11 percent in imports from China. However, contrary to expectations, Pakistan's exports to China picked up only marginally—from 18 percent before the FTA to 19 percent after it (World Bank, 2016). By 2016, China had an import share of 29.1 percent in Pakistan, and an export share of around 7.7 percent of Pakistan's total exports (ITC, 2018). While Chinese exports to Pakistan grew significantly after the FTA came into effect, Pakistan's exports to China did not grow as fast, partly because of the competitiveness differential between the two countries. This limited success in accessing the Chinese market has been the reason behind Pakistan's efforts of 2017-18 to renegotiate the terms of the FTA with China.

Pakistan's trade with India is extremely low, and trade barriers between India and Pakistan remain high. Tariffs are only part of the equation. Indian non-tariff barriers and internal duties remain high, and the result is low bilateral trade, with a trade balance in India's favor. Although bilateral trade rose remarkably, from around US$357 million in 2003 to over US$2 billion in 2011—largely because of a peace process that lasted from 2003-07 and led to significant improvement in the political and economic climate—it remains marginal in relative terms. Pakistan's share of exports to India has been less than 2 percent of its total exports, and for India, imports from Pakistan are not even 0.5 percent of its total imports. This situation is in contrast to the initial trade relationship at independence, under which 70 percent of Pakistan's exports were directed to India and 63 percent of Indian exports went to Pakistan.

Pakistan's relationship with its western neighbors, particularly Afghanistan, has been somewhat volatile. Nonetheless, economic and social links between Pakistan and Afghanistan have remained strong. Since the late 1970s, Pakistan has hosted millions of Afghan refugees who have

contributed to bilateral trade (formal and informal) and Pakistan's local commerce. The extent of formal trade between the two countries remains high, and in 2016 Pakistan was Afghanistan's top export partner. Pakistan has always maintained a trade surplus with Afghanistan.

Trade with Afghanistan reached its peak in 2010-11, coinciding with the peak of the U.S./NATO military presence in Afghanistan. Since then exports from Pakistan have declined by approximately 45 percent—a decline that has been attributed mainly to the frequent closure of Pakistan-Afghan border because of security concerns, favorable market access conditions for India and Iran, decreasing aggregate demand due to withdrawal of NATO forces, and declining numbers of international donor-funded projects in Afghanistan (PAJCC, 2018). Also to blame for this downturn is the swift deterioration in Afghanistan-Pakistan political relations due to tensions over the alleged use of each other's territory by terrorists destabilizing their respective countries.

Pakistan's relations with Iran have been more stable, but Iran's internal conditions have precluded greater trade with Pakistan. Although the two countries have committed to increase their trade to US$5 billion by 2021, (Arshad, 2018) trade between them has decreased significantly in the last six years: in 2016 it totaled $359 million, only 0.05 percent of their combined 2016 GDP (WDI, 2017). Pakistan's exports to Iran have been to some extent displaced by exports from China and Turkey, as both countries began aggressively targeting Iran after 2010. The decline in exports has also been attributed to a rise in tariffs that Pakistani exports face in Iran (sometimes even export bans), despite Pakistan's 2006 Preferential Trade Agreement (PTA) with Iran. Historical trade ties have been low, not only because of Iran's high tariff barriers, but also because of poor border infrastructure and security, opaque import procedures, and the effects of U.S. sanctions—lifted in 2016 but now being reapplied after the U.S. pullout from the nuclear deal with Iran—on normal banking channels. Once goods are traded using official channels, trade volumes could rise, provided tariffs and tariff dispersion are lowered and trade is conducted in local currency, rather than dollars. The Pakistan-Iran FTA, which is to be finalized in 2018, is likely to address some of these critical issues (Iran Financial Tribune, 2017). Similarly, Pakistan's trade with the Central Asian Republics (CARs) has been minimal—less than $50 million, or a meager 0.13 percent of Pakistan's total trade, and not even 0.1 percent of the CARs' total trade (ITC, 2018).

In terms of regional trading partnerships, both India and Pakistan have joined sub-regional and extra-regional groupings without participation by the other country. Pakistan, however, has had to pay the higher cost of this mutually exclusive pattern of involvement in trading blocs, given the greater attractiveness of India's economic market for potential partners. The most obvious example is BIMSTEC, a South Asian/Southeast Asian sub-regional grouping involving Bangladesh, India, Myanmar, Sri Lanka, Bhutan, Nepal, and Thailand, but not Pakistan. The South Asia Growth Quadrangle—Bangladesh, Bhutan, India, and Nepal—is another economic grouping championed by India without Pakistan. Further away, India has become an important actor in ASEAN while Pakistan has struggled to make inroads in one of the most successful regional trading blocs, either with Southeast Asia or with the Persian Gulf states. Pakistan, for its part, has traditionally been forced to look west. It joined the high-profile Economic Cooperation Organization (ECO) along with Iran, Turkey, and later a number of CARs and Afghanistan, without India, but ECO has failed to realize its

full potential. More recently, Pakistan has become part of an alternative North-South configuration, the China-Pakistan Economic Corridor (CPEC).

Some in Pakistan believe CPEC could offset the limited impact of other regional initiatives and the need to galvanize East-West connectivity that includes India. Skeptics of opening up economically to India argue that even if Pakistan benefits from such a move, its gains will be outweighed by India's, with its larger and stronger economy. This report argues that such a substitutive approach to North-South versus East-West connectivity is suboptimal. Although the gains from further consolidating the historical North-South link (Pakistan and China) are not disputed, they would be lower without East-West connectivity. An approach that sees the North-South and East-West connectivity as complementary could help to mitigate reservations countries like India and others have raised about CPEC and the Belt and Road Initiative (BRI) more broadly, arguing that a trans-regional project of this magnitude required wider consultation. This may prove to be crucial for CPEC's smooth progress and success.

2.1 CHINA-PAKISTAN ECONOMIC CORRIDOR

The move toward connectivity with China is Pakistan's single most significant political and economic development in recent years. Traditionally, the China-Pakistan relationship was heavily skewed toward security-sector assistance. Today, Sino-Pakistani relations seem to be intensifying while the U.S. engagement in the region seems to be shifting from Pakistan to India. The 3000-km CPEC is a project of the Chinese "Belt and Road Initiative," which envisages connecting China to Europe, the Middle East, and Africa.

At a time of significant geopolitical changes, CPEC has added a new dimension to the friendship between Pakistan and China, raising the hope of greater connectivity and economic cooperation among countries in the region. From purely strategic and security cooperation spanning more than five decades, the China-Pakistan relationship has now evolved into a dynamic economic and commercial partnership as well. China considers the CPEC a "flagship project" to be completed by 2030. Of the total investment, roughly 70 percent is for energy, 20 percent for infrastructure, and 10 percent for the development of the Gwadar port and nine industrial zones along the route. Infrastructure projects include roads, ports and airports, railways, mass transit, and information and communication connectivity. It is expected that the energy projects will be completed by 2020, infrastructure by 2025, and the industrial zones by 2025-2030 (Hussain, 2017c). This provides Pakistan an estimated timeline for arranging the capacity, planning, and coordination required to internalize the benefits from CPEC.

Because CPEC is ongoing and data on project implementation and future plans are lacking, it is difficult to quantify the probable gains from the initiative. As the major share of investment is in energy projects, the impact on Pakistan's energy deficit is considered first. It is estimated that Pakistan loses 2 percent of its GDP each year to energy shortages. It stands to reason that Pakistan could potentially add more than 2 percent per year to current levels of GDP (if the energy elasticity

of output exceeds 1) through the planned US$35 billion worth of energy projects. With early harvest projects to add up to 10,000 MW of energy by the end of 2018, gains could materialize in the next five years. In addition, lowered heavy fuel oil imports could save Pakistan an estimated minimum of US$1 billion per year. Moreover, assuming that better energy availability raises Pakistan's export competitiveness, export earnings could increase. Of course, the financing of energy projects must also be considered. They are financed by Chinese equity and debt. It is unclear at this stage how Chinese financing for CPEC projects will affect Pakistan's balance of payments. However, at least for some of the energy projects, it appears that Pakistan is obligated to ensure a 17 percent return (in dollar terms) on the equity portion of the Chinese investment (Hussain, 2017e). At the same time, to address the fiscal deficit, Pakistan must settle on a uniform energy policy to tackle the problem of circular debt and create conditions of competition in power supply and exchange (Hussain, 2017d). These obligations will almost certainly translate into liabilities on Pakistan's foreign exchange reserves in the future.

Pakistan's transport sector would also likely benefit. Some estimates indicate that as many as 100,000 trucks could be required at the national level to move construction material, tradeables, and expanded goods trade because of increased connectivity, though these estimates are difficult to verify (Hussain, 2017e). CPEC represents an opportunity for transport and logistics businesses— if they invest in capacity today— to become part of a national industry that could be worth as much as US$6 billion per year, even if CPEC manages to divert only 5 percent of Chinese international cargo from its western provinces (The Express Tribune, 2016). At the same time, China sends 70 million containers of cargo to Europe each year; even .01 percent flowing through Pakistan, it would result in an increase of 70,000 containers—a boon for Pakistan's transport and logistics sectors, provided Pakistan undertakes strategic investments (Esteban, 2016).

Exports from Pakistan are expected to increase because of increased economic activity in the Gwadar Special Economic Zone and the planned nine industrial zones, through joint ventures between Chinese and Pakistani businesses. However, for Pakistan to reap the benefit of co-locating with Chinese firms in these economic zones, investment in labor, management capacity, and quality is critical. Otherwise, China will prefer to use its own labor, managers, and raw materials to manufacture goods in these zones, repatriating its profits. At the same time, the incentives offered to Chinese firms in the planned industrial parks must also be extended to Pakistani firms, and adequate infrastructure must be in place before possession is given.

More critically, CPEC would generate positive spillovers for Pakistan's trade ties with neighbors through a dense and modern network of roads, highways, railways, and ports. For instance, CPEC could finally unlock Pakistan's trade potential with the CARs through this improved connectivity. Studies suggest that Gwadar could offer the CARs the cheapest option for imports and exports, as long as certain conditions are met—a more stable Afghanistan, improved regional infrastructure, and minimal tariffs. The CARs could access Gwadar by connecting to the western portion of the CPEC route (Hussain, 2017b).

The CARs represent a sizable potential market for Pakistan—about 70 million people in 2016 (WDI, 2018). Pakistan's trade with CARs has historically been low because of transit disputes with Afghanistan, as well as inadequate trade infrastructure and services. Renewed focus on regional

connectivity by China and the global community will help Pakistan take advantage of the proposed economic and energy corridors. In the medium term, Pakistan can expect to access the CARs through projects such as CPEC and the Central Asia Regional Economic Cooperation Program (2010). A second round of services-related economic activities will also be generated—for example, for transporters, distributors, traders, and tourists. By investing in trucking, freight-forwarding, and logistics (especially warehousing and cross-border cold-chain) capacity, Pakistan could become an attractive trade destination, using its existing trade agreements with CARs and entering new markets.

Iran has also assumed strategic significance for China's BRI, if trade flows from India to Afghanistan and the CARs are diverted through Chabahar port in Iran. With China increasingly viewing Iran as a critical link for BRI, Pakistan should expect to benefit from greater regional cooperation with Iran through CPEC. Of course, true gains from trade with both Iran and CARs would be achieved by stabilizing trade ties with Afghanistan, even if CPEC offers Pakistan an alternative without Afghanistan. Already, China has expressed interest in extending CPEC to Afghanistan, a move that could further solidify Afghanistan-Pakistan economic ties. CPEC could then serve as a game-changer not only for Pakistan, but also for the entire region.

However, seen from the narrower perspective of bilateral rather than multilateral gains, CPEC could end up being an enabler of continued regional competition, rather than a catalyst for breaking the barriers to regional connectivity in the greater South Asia region. India's outright opposition to the initiative has complicated matters and further irked the sensitivities of those wary of Indian intentions vis-à-vis Pakistan. There is also a strong feeling in Pakistan that the U.S. may be lukewarm, if not uncomfortable, with CPEC, given its resurgent global competition with China. This mindset precludes the possibility of a proactive effort to get the U.S. and China to work together in making CPEC a truly regional initiative with benefits for Pakistan, Afghanistan, and the broader region. As long as CPEC continues to be seen through a competitive lens, its outputs will likely remain suboptimal in terms of delivering gains for South Asian citizens or fostering peace in South Asia.

CHAPTER 3: A FORWARD-LOOKING STRATEGY: A REGIONALLY CONNECTED DEVELOPMENT- CENTRIC STATE

This section estimates the potential gains from increased connectivity in the region, which includes bilateral trade in goods and services, transit trade, and energy trade. As data for bilateral trade in merchandise are readily available, the section first looks at current and potential bilateral trade between Pakistan and each of its neighbors. These data are then used to calculate the consequent effects on income under three different scenarios: liberalizing trade with China alone, liberalizing trade with both China and India, and full trade liberalization with the whole region. This is followed by a discussion of Pakistan's strategic location as a corridor for both transit trade and trade in energy.

3.1 MERCHANDISE TRADE

For this report, merchandise trade is estimated using Ghemawat's gravity model,[4] which predicts trade between partners as a function of economic size (GDP), common borders, shared culture, colonial history and language, participation in trade agreements, and distance. The results are within the range estimated in earlier studies using gravity estimates and computable general equilibrium (CGE) modeling.

[4] This model is available at https://ghemawat.com/cage.

Table 3. Potential Trade Estimates

Country	Current trade with Pakistan (2015) (US$)	Predicted trade with Pakistan (US$)
China	12,953,931,121	18,870,219,582
Afghanistan	2,112,616,630	2,112,616,630*
India	1,981,570,462	35,637,743,064
Bangladesh	760,816,411	760,816,411*
Sri Lanka	332,270,224	332,270,224*
Iran	293,187,399	293,187,399*
Turkmenistan	22,878,000	22,878,000*
Kazakhstan	16,561,000	24,441,417
Tajikistan	4,074,000	4,317,138
Uzbekistan	3,097,000	14,919,881
Kyrgyzstan	914,000	3,809,115
Total regional trade	18,481,916,247	58,077,218,861
Total international trade	66,078,662,766	105,673,965,380[a]

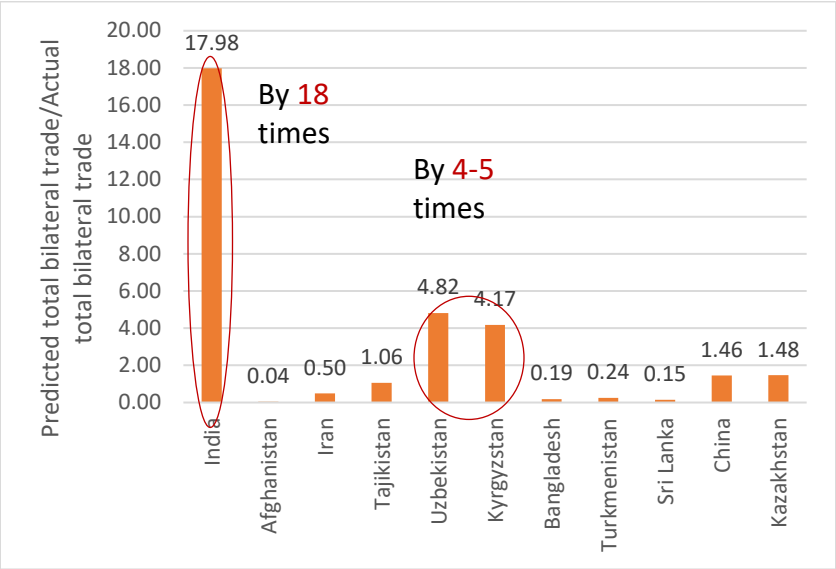
Source: Author's calculations, using Ghemewat's CAGE model.

[a] This is the predicted value of Pakistan's international trade from increasing regional trade with the countries shown in the table only. It shows, in the perspective of Pakistan's total trade volume, the scale of the impact that liberalizing regional trade might take.

* For these countries, current trade is already more than predicted trade, so current trade is reported instead of predicted trade. Trade is predicted using a gravity model that uses cross-country data to estimate what bilateral trade could be, based on variables such as GDP size and distance. It does not account for peculiar circumstances between two specific countries. If because of such peculiar circumstances trade is already higher than predicted values, we would not expect it to fall after further liberalization. In this case, since we do not have an estimate of how much it could rise, we report the current trade values, under the assumption that trade would remain *at least* as much.

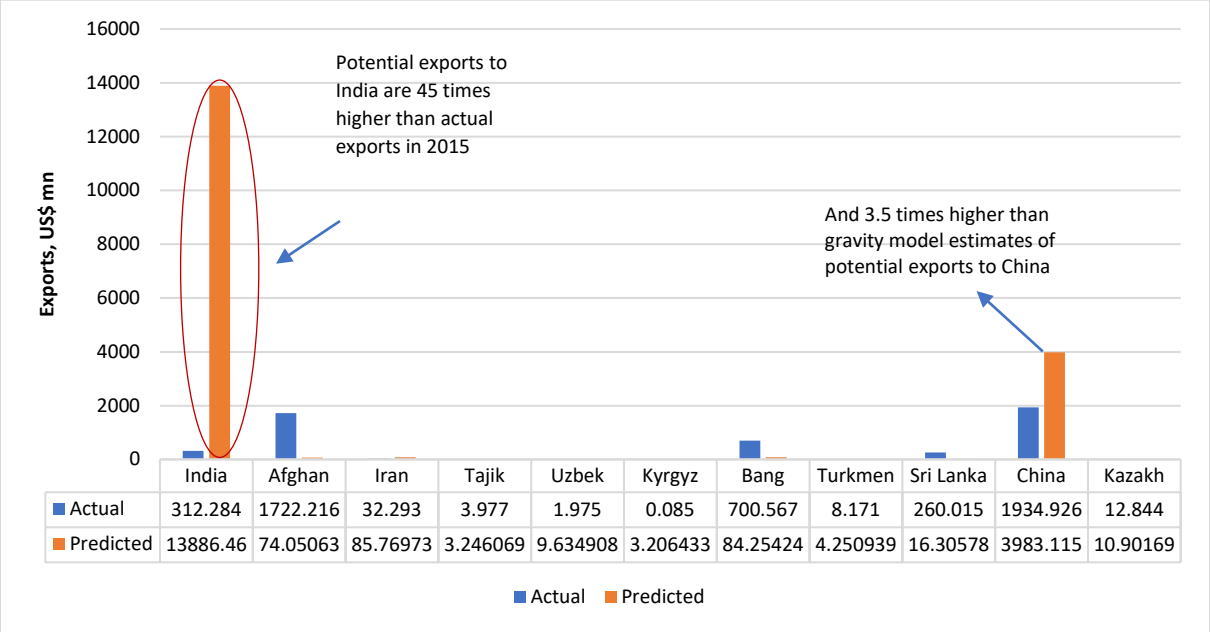
Table 4-1 shows that the estimated total trade potential between Pakistan and all its immediate and near neighbors, including the CARs, is US$58 billion—three times more than its current merchandise trade. The highest potential for trade is with India. There is not much difference between actual and predicted trade with China, thanks to the near-complete realization of import potential following the FTA, although there is still substantial unexploited export potential for Pakistan (as discussed earlier). The total amount of trade between Afghanistan and Pakistan is far more than projected by gravity estimates, primarily because of Afghanistan's economic dependence on imports, which emanates from peculiar historical circumstances that are not accounted for in standard gravity models. Among the CARs, the most promising markets seem to be Kazakhstan, Uzbekistan, and Kyrgyz Republic, with exports in the last two rising potentially by factors of 4 to 5 (see Figure 4-1). It must be noted that these are estimates of goods trade and do not include services trade. Given the increasing share of services in the economies of the region, these figures underestimate Pakistan's total potential trade with its neighbors.

Figure 8. Potential Pakistan Trade with the Region (Compared To 2015 Trade)



Source: Author's calculations, using Ghemawat's CAGE model.

Figure 9. Potential Pakistan Exports (US$ Million) To the Region (Compared To 2015 Exports)



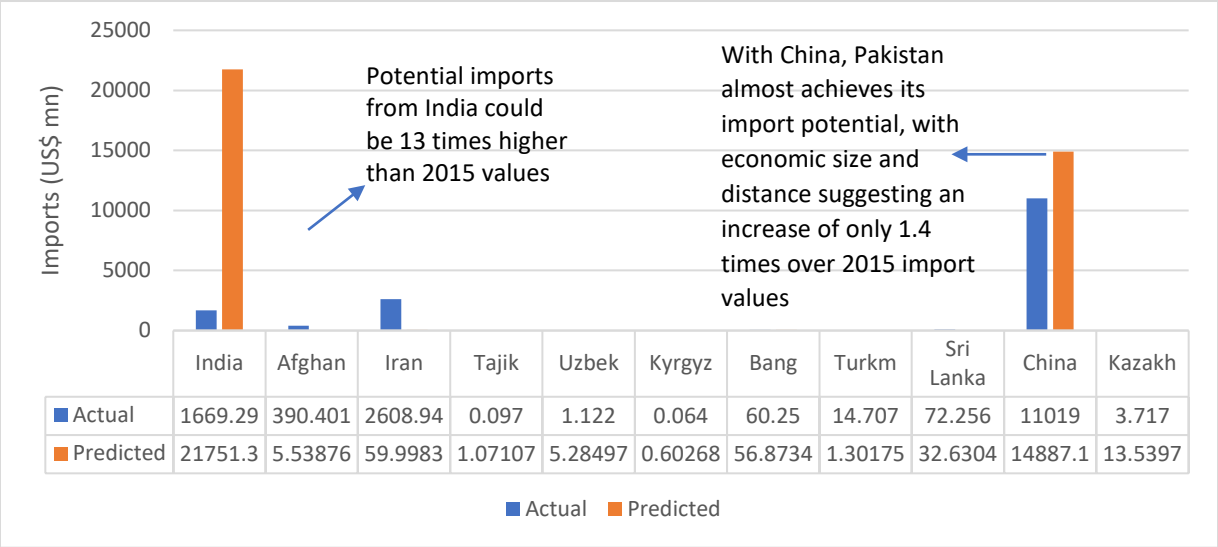
	India	Afghan	Iran	Tajik	Uzbek	Kyrgyz	Bang	Turkmen	Sri Lanka	China	Kazakh
Actual	312.284	1722.216	32.293	3.977	1.975	0.085	700.567	8.171	260.015	1934.926	12.844
Predicted	13886.46	74.05063	85.76973	3.246069	9.634908	3.206433	84.25424	4.250939	16.30578	3983.115	10.90169

Source: Author's calculations, using Ghemawat's CAGE model.

Gravity estimates of Pakistan's potential exports to its neighbors are shown in Figure 4-2. What is most apparent is the predicted exports to India, which are 3.5 times higher than those predicted for China. The proximity and size of the Indian economy, along with common cultural factors such as language, are the main reasons behind this high estimated export potential. What needs to be kept in mind is that although India gave Pakistan MFN status in 1996, Pakistan's exports

to India are not even a fraction of this predicted amount. This is primarily a market access issue: while India has lowered tariffs overall, it still retains a list of sensitive items, along with high non-tariff barriers (NTBs) that protect its domestic industry. Although the Indian Government claims that these NTBs are not specific to Pakistan, they substantially reduce the market access of Pakistan's exports. It could be argued that if Pakistan were to give MFN status to India (colloquially known in Pakistan as non-discriminatory market access, or NDMA), it would be in a much stronger position to negotiate with India to reduce NTBs that specifically curtail Pakistan's exports.

Figure 10. Potential Pakistan Imports (US$ Million) From the Region (Compared To 2015 Imports)



	India	Afghan	Iran	Tajik	Uzbek	Kyrgyz	Bang	Turkm	Sri Lanka	China	Kazakh
Actual	1669.29	390.401	2608.94	0.097	1.122	0.064	60.25	14.707	72.256	11019	3.717
Predicted	21751.3	5.53876	59.9983	1.07107	5.28497	0.60268	56.8734	1.30175	32.6304	14887.1	13.5397

Source: Author's calculations, using Ghemawat's CAGE model.

The estimated import figures (Figure 4-3) tell a similar story: the gravity model predicts sharp increases—as much as 3 to 11 times—from all Central Asian states except Turkmenistan. However, the most significant increase in imports would be from India—US$49 billion compared to US$34 billion from China. China's projected imports are not much higher than the actual numbers, suggesting that the bilateral trade between the two countries is now quite close to its potential. It is possible that some of the estimated increased imports from India would displace higher-cost imports from China, owing to the lower transportation costs of goods from India. This would significantly reduce the trade diversion that is arising solely from the preferential trading relations with China under the FTA. At the same time, normalizing trade relations between India and Pakistan would provide a positive spillover effect or "peace dividend" for all aspects of South Asian cooperation. CGE models estimate that there would be a 0.5 percent decrease in transaction costs between trade partners in South Asia (Ghani et al. 2013).

A simple simulation exercise has been used to assess the effect these estimated increases in trade would have on Pakistan's income trajectory. This simulation is based on the seminal paper by Frankel and Romer (1999), (Frankel, 1999) who use cross-country regressions to estimate that

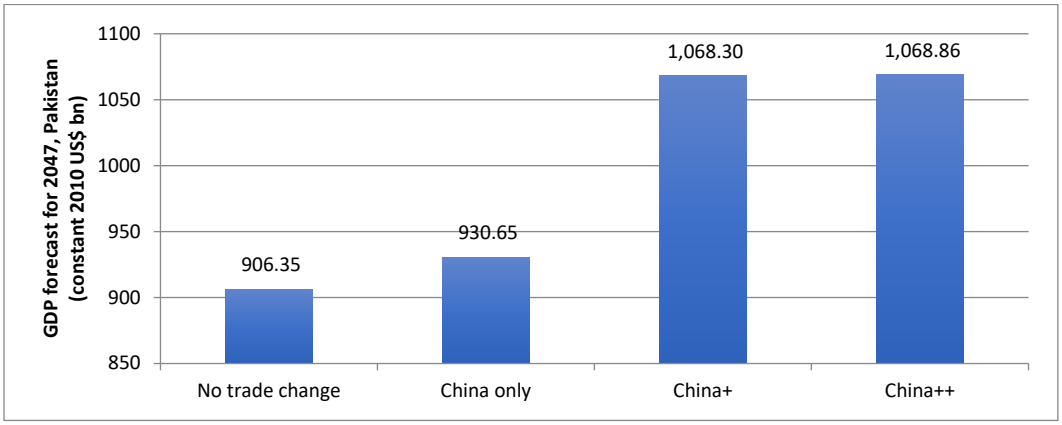
an increase in trade share of one percentage point raises income per person by 0.5-2 percent. This allows the calculation of both lower bound gains (at 0.5 percent change) and upper bound gains (at 2 percent change).

The results of the estimated gravity model are applied to three scenarios: liberalizing trade with (i) China only, (ii) China + (China and India only), and (iii) China ++ (full regional trade). The objective of this exercise is to evaluate the extent to which trade with China, and the CPEC infrastructure, offset the need to pursue a wider liberalization agenda. CPEC is already under way, and the resulting domestic infrastructure gains will be accrued regardless of the liberalization strategy. Taking that as a given, we estimate the *additional* trade impacts that could be realized if trade policy were to complement the CPEC investments. The growth trajectories shown are based on results of the gravity framework and partial equilibrium cross-country regression analysis. The gravity framework assumes complete free trade between countries and "average" trade relations across partners, while the cross-country regression implicitly generalizes characteristics across countries.

The predicted increase in GDP for the "China only" strategy ranges from US$3 billion to US$12 billion (1-4% of Pakistan's GDP). Spreading this gain out evenly until 2047 results in a cumulative change by 2047 of US$6-24 billion (due to the additional compounding effect of the average annual growth rate of 4.56 percent), compared to the GDP forecast based on growth at the average rate over the last five years. Under the China + scenario, if trade with both India and China increased, the gains to income are much higher: GDP would increase by US$19.7-87 billion (7-29% of GDP), and the cumulative gains by 2047 would be US$40.5–162 billion. Under the China ++ scenario, trade is liberalized with the full set of regional trade partners (China, India, Iran, Afghanistan, Sri Lanka, Bangladesh, and CARs). Calculating the impact of the estimated threefold increase in regional merchandise trade gives an increase in GDP of US$20-80 billion (7-30% of Pakistan's GDP). The cumulative increase in GDP by 2047 would be in the range of US$41-163 billion.[5] The result is not, however, substantially different from that in the China+ strategy (see Figure 4-4).

[5] Compared to the business-as-usual forecast for 2047.

Figure 11. GDP Projections under Different Scenarios of Trade Potential Realization



Source: Author's calculations.

Notes: 1. "No trade change" forecasts GDP based on Pakistan's average GDP growth rate of the last five years (4.56%). 2. Full regional trade model includes China, India, Iran, CARs, Afghanistan, Sri Lanka, and Bangladesh. 3. Only upper bound estimates for each scenario are presented here for ease of illustration; see text for lower bound figure.

It is clear that the potential gains from liberalizing trade with India dominate the total potential gains for Pakistan; 85 percent of the unrealized regional potential trade for Pakistan is with India, while 15% is with China, the CARs contribute 0.014%, and trade with Iran and Afghanistan is already higher than the levels predicted by the gravity model. Although these estimations and trajectories are bound to have a certain margin of error, it seems clear that for Pakistan, opening trade and economic links multilaterally (with all neighbors) would be better in terms of economic gains—income and welfare—than a skewed or bilateral opening (with China only). Moreover, this simple simulation has taken into account only the estimated increases in trade in goods, which is a small part of trade and economic ties between countries. Adding service trade would magnify these effects.

Accounting for informal and indirect trade through third parties would further enlarge the potential gains. High barriers to importing products from neighboring countries have led to rampant informal trade through the porous borders, as several recent studies have documented. Taneja and Bimal (2016), for example, calculate informal trade of US$4.71 billion between Pakistan and India alone (Nisha and Bimal, 2016). Similarly, some US$1.5 billion, or 40 percent, of Afghan trade is believed to be unrecorded, mainly because of weaknesses in border security and customs on both sides (Rocha, 2015). Illegal trading is also rampant in areas along the 900-km border with Iran. As long as normal trade ties and banking networks can be disrupted through sanctions, traders in both countries seem to prefer informal channels. Reducing barriers to trade by liberalizing trade would re-route this informal trade through formal channels, raising customs revenue. Of course, it would also be necessary to lower tariff rates; otherwise, unofficial channels would continue to remain attractive because of the high tariff and transactional costs of formal trade.

3.2 TRANSIT TRADE

South Asia has historically been one of the worlds most connected and open regions because of the famous Silk Route, which fostered mutual dependencies and prosperity. As China and the U.S. express renewed interest in reviving the ancient Silk Route, Pakistan stands to resume its historical significance on the East-West trade nexus as the gateway to Central Asia and onward to Europe. To take advantage of this transit trade opportunity, Pakistan would have to ensure the implementation of transport and transit agreements and fast-track the operationalization of the International Road Transport (TIR) convention.

The first step Pakistan took in this direction, in 2010, was to include in the Central Asian Region Economic Cooperation a "network of multimodal transport corridors." Today, however, most of Pakistan's transit trade is with Afghanistan. Landlocked Afghanistan has been dependent on Pakistan for access to other countries—a dependence that was formalized in the 2010 Afghanistan Pakistan Transit Trade Agreement (APTTA), under which Afghanistan can import goods free of duty through the Karachi port. The APTTA also covers processes and modalities regarding Pakistani exports to the Central Asian states. Over the past years, Pakistan has benefited not only from Afghanistan's growing commercial import needs, but also from an increase in transit trade associated with International Security Assistance Force (noncommercial) military cargo that served the military bases in Afghanistan.

Afghanistan's economic dependence on Pakistan has also been a source of tension between the two countries. Pakistan does not allow Indian goods, other than fruit and vegetables, meant for Afghanistan transit or access through its territory, arguing that any trade with India must be part of a more comprehensive discussion of Pakistan's bilateral relationship with India, and that it will not see transit rights to India in isolation. Afghanistan has reciprocated by not allowing Pakistan access to CARs, thus hampering the potential of trade and economic links with a resource-rich and growing region. This worsening relationship hurts both countries economically. In an important setback to regional cooperation, in December 2017 Afghanistan unilaterally withdrew from APTTA, seeking instead a new trade accord that included India. Further, Kabul threatened to challenge Pakistan in the World Trade Organization (WTO) on the frequent closure of Pakistan's borders with Afghanistan. In addition, in the wake of increased terrorist attacks in Pakistan, there has been a push to tighten border security. An outcome of Pakistan's approach is the trilateral transit trade agreement of 2016 among Afghanistan, India, and Iran, centering on the Chabahar port. India will invest in rail links in both countries to effectively bypass Pakistan to reach the CARs (The News, 2016). October 2017 marked a first, as India shipped goods to Afghanistan through Chabahar port, which reduces shipping distances substantially compared to Bandar Abbas.

In light of Pakistan's renewed interest (from 2013) in deepening connectivity with the CARs, the CPEC is even more promising. Pakistani authorities argue that the CPEC road infrastructure opens up opportunities for Pakistan to trade with the CARs while avoiding restive Afghanistan. The first step was taken in 2017 by formally including Tajikistan in the existing Quadrilateral Transit Trade Agreement (2004) among China, Pakistan, Kazakhstan, and Kyrgyz Republic. This would allow

Pakistan access to the CARs through the CPEC-expanded Karakoram Highway, extending from Gilgit-Baltistan to Xinjiang province in China (Bhutta, 2017).

Expanding CAR-Pakistan trade flows through China is quite an ambitious venture, and more direct transit and trade options exist through Afghanistan. But the China option to deepen regional trade may be viable if the Afghan conflict persists, substantial infrastructure envisioned under CPEC is completed (especially the Kashgar-Gwadar rail link), and Pakistan takes steps to implement the TIR carnet (a single harmonized manifest) requirements that all CARs apply. Under such a scenario, CARs could re-route their existing trade to Pakistan from ports in the Baltic States, Turkey, Iran, China, and Russia, providing a further boon to the Pakistani economy. The CPEC multimodal infrastructure can therefore be used for both East-West and North-South connectivity.

3.3 ENERGY TRADE

South Asia is one of the most energy-poor regions of the world. Billions of people are still using traditional fuels, with an especially harmful impact on the health of women and children. Empirical studies show that HDI is highly correlated with modern energy consumption, and South Asia has the lowest per capita electricity consumption in the Asia-Pacific region, although demand is expected to rise by an estimated 3.5 percent each year for the next 20 years (UNESCAP, 2017). At the same time, South Asia has the world's lowest per capita levels of electricity production, so it is highly dependent on relatively expensive and volatile oil imports from the Middle East (UNESCAP, 2017). Offsetting this unsustainable dependence will require alternative regional natural gas and hydropower sources. Thus, increased regional energy connectivity is a development imperative for the people of this region.

Energy connectivity—both trade and infrastructure—offers the most immediate returns to regional cooperation. In 2010 total energy trade within the region accounted for just 5 percent of intra-regional trade, but in 2012 it represented more than 42 percent of South Asia's global energy imports. Energy trade connectivity is mutually beneficial for the region, because the countries with the highest energy endowments (CARs) are not those where demand is growing fastest (India, Pakistan, and Bangladesh).

If South Asia is to meet its rising demand for electricity, it needs to triple its total power generation (increase by 750 GW). Today, less than 20% of South Asia's 325,000 MW hydropower potential is developed and Nepal alone accounts for 12.3 percent of this total. Along with developing its own potential, Pakistan could tap into the hydropower resources of northeast India, Nepal, and Bhutan (Timilsina et al. 2015). The first steps toward this greater energy connectivity would be to facilitate cross-border trade in energy using existing infrastructure, then trans-border energy transmission infrastructure, and finally development of a regional energy market. This will require investments in regional energy networks, which feasibility studies suggest are promising. Estimates of the direct benefits (in terms of fuel cost savings) of unrestricted full regional energy trade over 2015-2040 indicate that direct (discounted) benefits are 5 times greater than the costs of building power generation capability and the requisite cross-border infrastructure (transmission interconnections). This would imply the addition of 95,000 MW of energy, and annual energy cost

savings of $9 billion over 2015-2040. One study estimates that Pakistan could potentially export electricity to North India and import from its western grid (Timilsina, 2015).

Pakistan could also benefit from transboundary power trade with its western neighbors. Importing energy from Central Asia and Iran could allow Pakistan to meet its energy deficit, reduce emissions from coal-fired generation, and save money by using shorter import routes. At present, Pakistan's current energy imports all come from outside the region—but with one of the world's largest reserves of hydrocarbons (oil and gas) in the neighbourhood, that does not seem to be an economically prudent policy. Iran aims to increase its electricity exports to Pakistan from the current levels of 1000 MW to 3000 MW (Arshad, 2016). The most immediate gains to Pakistan will arise from the Central Asia-South Asia Electricity Transmission and Trade Project (CASA-1000). Apart from the construction of 1222 km of transmission lines and grid stations, it will have the capacity to transmit electricity generated in Tajikistan and Kyrgyz Republic to Pakistan. These two countries have 6000 GWh of surplus hydropower in the summer months of May to September, of which 1300 MW will be transmitted to Pakistan under the CASA-1000 project (through Afghanistan).[6]

This project is part of a larger vision to create a Central Asia-South Asia Regional Electricity Market through community uplift programs along the route of the CASA-1000. The TAPI (Turkmenistan-Afghanistan-Pakistan-India gas pipeline project) is an initiative linking CARs' gas resources to an energy-starved South Asia. TUTAP (Turkmenistan-Uzbekistan-Tajikistan-Afghanistan-Pakistan) is another ongoing electricity project. Similarly, under CPEC, a US$2.5 billion pipeline is envisioned to be constructed from Gwadar to Nawabshah to import gas from Iran, although specific plans have reportedly yet to be finalized (Deloitte, 2017). Gas exports could also pick up after the completion of the Iran-Pakistan-India (IPI) gas pipeline project, which could provide an extra 1 billion ft^3 per day of gas to Pakistan.

Table 4.Regional Energy Projects

[6] The potential gains from this energy trade are very large—Tajik hydel electricity costs are $15/MWh compared to $132/MWh of thermal IPPs used by industry in Pakistan.

Project	Energy	Origin	Destination	Costs	Benefits	Status
CASA-1000	Electricity	Kyrgyz Republic	Afghanistan	$1.17 bn	Transmission	Ongoing 2016
		Tajikistan	Pakistan		1300 MW-Pak	
IPI	Gas	Iran	India	$5-7 bn	2 bn ft^3	Approved
			Pakistan		2 bn ft^3	
TAPI	Gas	Turkmenistan	Afghanistan	$7.6 bn	180 bn ft^3	Inaugurated 2015
			Pakistan		490 bn ft^3	
			India		490 bn ft^3	
TUTAP	Electricity	Turkmenistan	Afghanistan		Transmission	Delayed
		Tajikistan	Pakistan		500 MW	
		Uzbekistan				

Source: Author compilation, various.

3.4 POLITICAL GAINS

For Pakistan, regional connectivity will generate additional economic growth and welfare gains, with their attendant benefits for domestic stability. In addition, the country stands to make tremendous political and security-related gains as regional integration gives hitherto competitive regional actors genuine stakes in Pakistan's security.

Energy is a key area in which regional cooperation will bring geopolitical gains. Projects like TAPI and CASA-1000 will generate a regional interest in the security and stability of areas hosting the infrastructure for these projects, including several restive areas in Afghanistan and Pakistan that are believed to be proxy battlegrounds for interstate competition in the region. The positive spinoffs generated by the stabilization of these areas could be significant. Even moves like allowing India an overland route to Afghanistan would generate Indian and Afghan (and Central Asian) stakes in ensuring the smooth flow of trade traffic through Pakistan. Likewise, if regional integration includes an agreement to allow countries to use each other's port facilities, significant business communities in northwestern India would depend on Pakistani facilities that would still offer them the most economical route. Similar interdependence would be generated between India and Pakistan as transnational energy projects reach fruition and millions of citizens in India (and Pakistan) begin to rely on these energy supplies.

Combining CPEC with the East-West corridor will diversify Pakistan's options for economic diplomacy. As the world increasingly moves toward multipolarity, the most successful countries will be those that can demonstrate their importance for multiple competing camps. The Sino-Indian relationship offers a pertinent example: despite border spats and strategic differences, China and India boast an annual trade worth $69.4 billion (2016), which is 4.5 times Pakistan's trade with

China.[7] Ironically, the burgeoning Indo-U.S. relationship will likely strengthen China's desire to continue engaging India. Even beyond South Asia, China's economy-first model has led to an inclination to continue working with countries it has fraught political relations with—for example, Japan, South Korea, and Taiwan. Apart from China, India, Iran, and Afghanistan are collaborating to offset Pakistan's ability to block overland access between India, Afghanistan, and Central Asia, despite the India-U.S. partnership and Washington's tensions with Tehran. For that matter, China, Pakistan, and the U.S. are ostensibly cooperating in Afghanistan, notwithstanding the growing estrangement between Washington and Islamabad.

More broadly, in altering its approach toward regional integration, Pakistan should view itself as a nexus for cooperation between powers. Connecting the North-South and East-West axes could even bring convergence between the otherwise competitive U.S. and Chinese visions for economic integration in South Asia. While China has championed BRI, the U.S. floated the largely East-West-oriented New Silk Road. Although that effort failed to take off, it shared the Chinese objective of using economic investment and connectivity to generate peace dividends for the region. As these initiatives may also put Afghanistan at the center of regional connectivity and contribute to its stability, other major players like Russia are also likely to support them, and Pakistan's role in facilitating them.

Active pursuit of regional connectivity as a policy priority will also help ease security pressures on Pakistan. Maintaining the status quo would imply the continuation of regional rivalries that have created strong incentives for states to refuse full cooperation in eliminating shared regional threats such as terrorism and mitigating the effects of climate change. A major source of tension is the presence of insurgents using sanctuaries in other countries' territories for cross-border attacks (Dawn, 2017; Times of India, 2018; Dawn, 2017). Accusations to that effect have significantly worsened relations between these countries, and Pakistan is suffering considerable international pressure as a result of these issues. The status quo will also keep alive the prospect of an escalating civil war in Afghanistan that gives the insurgents greater control of parts of Afghanistan and, in turn, boosts the militant groups fighting Pakistani forces in the tribal areas bordering Afghanistan.

On the other hand, normalized interstate relations and mutual economic dependencies should generate incentives for meaningful collaboration on mutually beneficial economic investment. Moreover, a move in this direction will begin to change Pakistan's acutely negative global narrative that Pakistan is responsible for holding out on economic integration, and in turn, undermining people's welfare in South Asia. This change is crucial, not only to improve Pakistan's international standing, but also because the negative perception has cost Pakistan dearly in terms of being able to generate global investor interest in the country.

[7] In fact, China is India's largest import partner and its fourth-largest export partner..

CHAPTER 4: CONSTRAINTS

This paper has stressed the need for Pakistan to exploit its geostrategic location by enhancing trade and economic ties with all its neighbors. This section discusses the potential challenges and problems in moving toward greater regional connectivity.

Some key economic constraints and challenges impede regional connectivity and could prevent Pakistan from realizing the gains from trade discussed above. Constraints that fall within Pakistan's policy domain are characterized as internal, and those that are not in the country's direct ambit or control are external.

4.1 INTERNAL CONSTRAINTS: BUSINESS LOBBIES, TRADE BARRIERS, COMPETITIVENESS, AND INFRASTRUCTURE

Generally, an economy's more competitive and export-oriented sectors tend to gain from increased trade and openness, while import-competing sectors that serve the domestic market tend to lose out. Import-competing sectors lobby governments for preferential treatment in the form of protectionist policies such as tariffs, quotas, and subsidies. Average tariff rates have fallen in Pakistan following the unilateral trade liberalization reforms of 2002-06. However, non-agricultural sectors continue to enjoy higher average protection, and some—such as the automotive sector—have been protected for extended periods. Aside from tariffs, sectors are also protected using Statutory Regulatory Orders (SROs). SROs circumvent legislated commercial or trade policy, allowing the Government or the Commerce Ministry to provide protection to sectors that can effectively lobby for it, bringing a high degree of uncertainty and arbitrariness to trade policy implementation. At the same time, export sectors in Pakistan, such as sports goods, garments, and surgical instruments, have always been proponents of enhanced trade and have suffered because of protectionist measures, as tariff escalation and more expensive imported inputs divert resources and investments toward the more inefficient rent-seeking sectors.

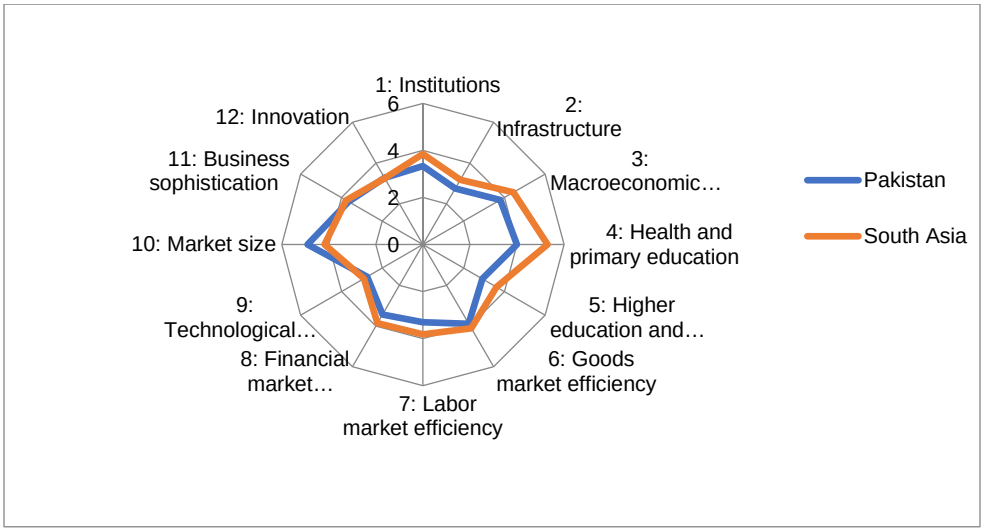
In the context of regional trade, in particular the Pakistan-India trade, a comprehensive stakeholder analysis was conducted as part of a series of research reports in 2012-13(Khan et at. 2014). These reports were meant to inform Pakistani policymakers of the impact of normalizing trade with India at the time when the Government had decided to give MFN status to India. The analysis covered the major export sectors/associations in the country as well as some of the sectors that were either skeptical or had voiced their concerns about trade with India—for example, the agriculture, automotive, and pharmaceutical sectors.

With few exceptions, the major Chambers of Commerce and the various manufacturing and export associations in Pakistan were very positive about normalizing trade relations with India. The traders and exporters saw the large, fast-growing Indian market as a tremendous opportunity to market and sell their products. Also, the exporters perceived the commonality of

language, culture, and preferences, especially between the border regions of the two countries, as a major marketing advantage. It is interesting to note that a prevalent view among manufacturers was that after they had weathered the storm of China's exports following the 2006 FTA, Indian manufacturing and exports were not much of a threat or a concern. They generally believed that the new opportunities provided by access to India's market would offset or even exceed the labor and employment effects. Even the key sectors identified as sensitive—agriculture, automobiles, and pharmaceuticals—advocated for a strategic or gradual opening of trade, not a continued prohibition. And finally, apprehension about opening trade appeared to stem from domestic market inefficiencies or government policy/institutional weaknesses. Addressing domestic constraints and bottlenecks, which impede the overall competitiveness of the economy, would go a long way in getting the maximum benefit from regional trade.

According to the World Economic Forum's Global Competitive Index,[8] in 2016-17 Pakistan ranked 122nd out of 138 countries. Over time Pakistan's competitiveness score has declined. Compared to South Asia, Pakistan does poorly on almost all 12 indicators (see Figure 5-1), especially security, infrastructure, and education. In fact, Pakistan is the worst-performing South Asian country in 5 of the 12 pillars: health and primary education, higher education and training, goods market efficiency, labor market efficiency, and financial market development. The gains from regional connectivity and trade will always remain suboptimal if these critical domestic constraints are not addressed.

Figure 12. Pakistan's Performance on the 12 Pillars of Competitiveness, Compared to South Asia



Data source: World Economic Forum Global Competitiveness Index 2016-17.

Although it would take considerable time and resources to resolve most of these constraints, some that directly affect trade across borders can be addressed in less time. The World Bank

[8] The Global Competitiveness Index ranks countries on 114 indicators that matter for productivity and long-term prosperity, and therefore assesses the competitive landscape of the countries surveyed.

Doing Business Indicators 2017 assigns low marks to Pakistan's performance in "Trading across borders."[9] In particular, relative to other South Asian countries it does very poorly in "customs," leading to inordinate delays and high costs for both exporting and importing. In the Global Enabling Trade Index 2016, Pakistan has slipped by three places since 2014, to 122/136 countries; and in the domestic market access subindex, Pakistan is ranked 133/136 countries (one place above India) (WER, 2016). If the countries of South and Central Asia can raise their performance in market access, business environment, infrastructure, and border administration to 50 percent of global best practice, they could increase their GDP by 8 percent (WEF, 2013).

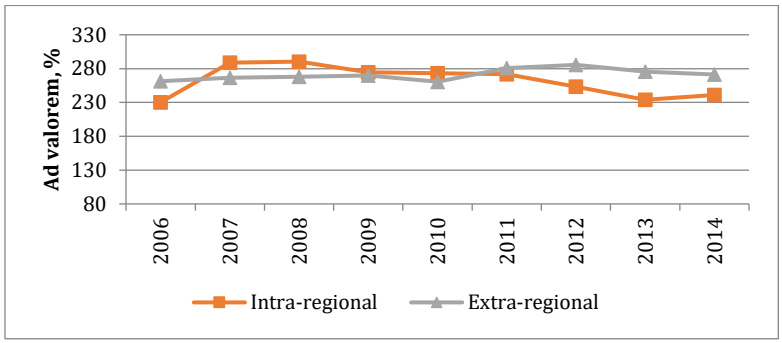
4.2 EXTERNAL CONSTRAINTS: TARIFFS AND NON-TARIFF BARRIERS

South Asia is the world's most restrictive trade region—it has the highest average MFN tariffs compared to other Asian regions and the Middle East. Within South Asia, as per the 2007 MFN total trade restrictiveness index, India ranks 115/125 countries (i.e. it is the 115th least protective country of a 125-country sample), while Pakistan is ranked 102/125 (Hussain, 2011). Looking at simple average MFN tariffs on agriculture and non-agriculture goods, Pakistan faces higher protection from its neighbors India, China, and Bangladesh than from the EU, UAE, and U.S. (see Figure 5-3). The same is true for NTBs, such as trade facilitation and customs procedures, sanitary and phyto-sanitary requirements, financial measures, and para-tariffs. In addition, the visa regime in both India and Pakistan countries is perhaps one of the most restrictive in the world: it severely limits people-to-people contact and is one of the most binding constraints on trade and economic links.

Overall, trading with Pakistan is quite costly (see Figure 5-2). Trading costs include tariffs, NTBs, border administration, international transport costs, direct and indirect costs due to different language and currencies, and import or export procedures. NTBs in South Asia have been estimated to lower trade within the region by as much as 8 percent (Kathuria and Shahid, 2017). Indeed, according to the WEF Opinion Survey (2015), tariffs and NTBs imposed the highest burden on Pakistan's importers, followed by complex import procedures and border corruption (WEF, 2017). Until 2011, regional partners faced slightly higher costs in trading with Pakistan than partners outside South Asia. While these costs have fallen recently, they remain at 241 percent of trade values in 2014. This means that in 2015 it was 49 percent cheaper to import from UAE than from India, and it was even 30 percent cheaper to import from UK and Malaysia than from India (ESCAP, 2018).

[9] Pakistan is ranked 171 out of 190 countries on "Trading across borders" in the Doing Business rankings. Overall, Pakistan ranks 147th on Doing Business

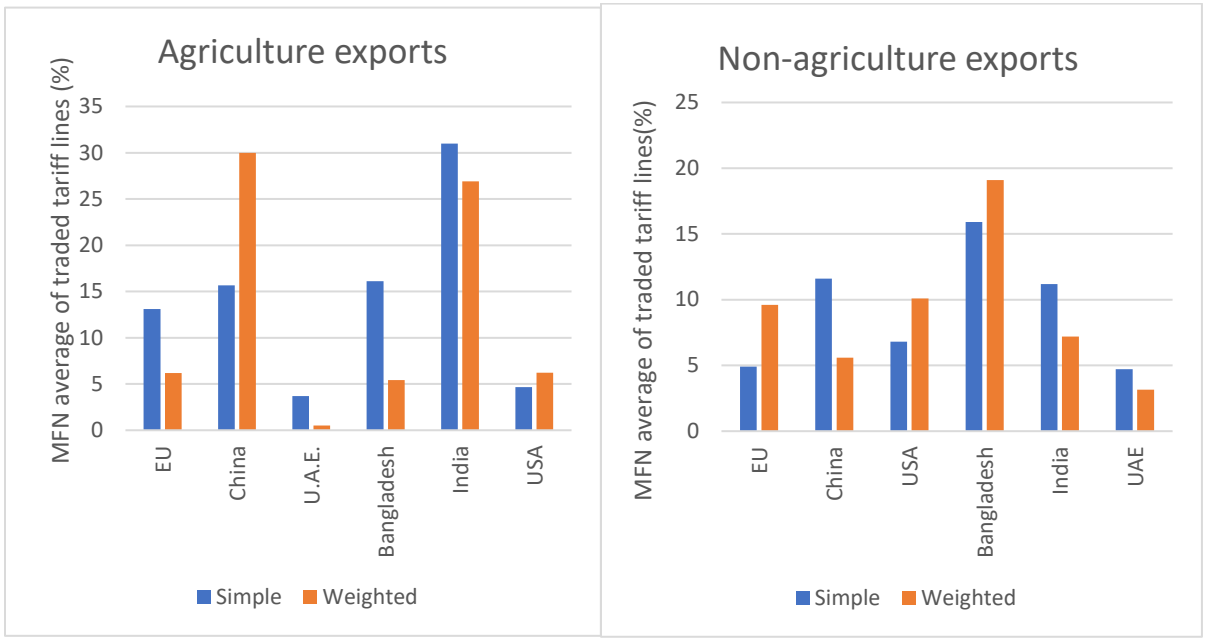
Figure 13. Average Trade Costs, 2006-2014



Source: ESCAP-WB Trade Cost Database.

Therefore, a necessary condition for normalizing trade links between Pakistan and its neighbors, particularly India, is a bilateral removal of these direct and indirect measures restricting trade. In fact, if trade relations between the two countries normalize, increased trade and contacts with traders across the border might lead to a gradual reduction in some of the NTBs, such as customs and border requirements, informational gaps related to procedural requirements, quality certification, and so on. So in some sense there is a bidirectional causality between trade and barriers to trade. To break the mutually enforcing vicious circle of protection and low trade, it is imperative to normalize bilaterally through MFN.

Figure 14. Tariffs (Average MFN) Faced by Pakistan's Agricultural and Non-Agricultural Exports, 2016



Source: WTO World Tariff Profiles, 2017.

4.3. NON-ECONOMIC CONSTRAINTS

Multiple geostrategic and domestic political and security constraints must also be addressed before the vision of regional connectivity can materialize. Regionally, the India-Pakistan rivalry remains the single biggest impediment. If the regional security environment and Pakistan's relationships with its neighbors remain tense, an active India-Pakistan competition is likely to continue.

Traditionally, Pakistan's civilian and military establishments have not forged a political consensus in favor of pro-development regional policies. Members of Pakistan's civilian elite are divided, and even those who champion the cause of a decisive paradigm shift seem unable to isolate this issue from larger political contests. While the mainstream parties have sometimes issued position papers favoring regional integration, they have failed to forge a common position and work with the security establishment to agree on a realistic way forward.

As long as regional tensions continue, those preferring the status quo in Pakistan will find enough space to discredit voices calling for a paradigm shift in favor of regional economic integration. Regional integration should increase Pakistan's leverage over time, as the country's regional relationships strengthen and its human development improves. This could provide a platform for Pakistan, a country invested in regional connectivity and acting as a transit hub for the neighborhood, to find, over time, solutions to some of its disputes with its neighbors.

Regional politics remain fraught. Pakistan's tense and deteriorating relations with Afghanistan also constrain the prospects of increasing trade with Central Asia, or unlocking Pakistan's potential as a regional transit hub for trade among South, West, and Central Asia. The potential for deteriorating security conditions in Afghanistan continues to be a risk to Pakistan's internal security as well. Possible remedies to these fraught regional relationships could be found by promoting linkages between CPEC and Pakistan's neighbors.

To be sure, while this paper focuses on Pakistan, the onus of cutting the Gordian knot of regional tensions does not rest solely with Pakistan. Pakistan's neighbors stand to gain tremendously from this vision. India's ambition to become a global power is hindered by its adversarial relationship with Pakistan. Afghanistan and the CARs will also benefit tremendously – Afghanistan economically, and in an ideal scenario, in terms of stability, and CARs by finding a ready energy market and economical access to sea – from an integrated South Asia. Pakistan's neighbors could offer important concessions to allay some of Pakistan's concerns, which could open up greater political space for Pakistani leaders to reciprocate. Presently, India and Afghanistan (and the U.S.) are tying bilateral dialogue with Pakistan to progress on political and security issues, specifically terrorism. Thus, the whole region is losing out on the economic advantages that would come by closer regional integration.

There is also a risk that CPEC could foster overconfidence among Pakistani civilian and military leaders, leading them to believe that broader regional integration is unnecessary. Ironically, China's massive investments in CPEC are unlikely to succeed if Pakistan is not able to

reorient its security policies. As this analysis has argued, Pakistan has relatively more to gain from improved economic ties with India than it does with China. China's stance on regional integration, and the extent to which it is willing to use its influence to improve regional integration in South Asia, would be crucial.

Non-state actors will continue to be potent spoilers to any move toward regional integration, and if Pakistan decides to advance a regional integration strategy it will have prevent such actors from disrupting any attempts to sabotage connectivity projects. Likewise, any Indian government looking to foster better relations with Pakistan will have to do significant work to tame the domestic political forces opposed to such efforts.

Finally, Pakistan's relationship with the U.S. is likely to remain fraught, and this will place significant constraints on Pakistan's development choices. The thorniest points of contention are those in the security arena, including U.S. charges of Pakistani support for militant groups such as the Quetta Shura Taliban and the Haqqani Network. Even here, developing synergies between the U.S., China, Pakistan, and Afghanistan on CPEC and broader regional connectivity could begin to open avenues for constructive dialogue even as the U.S and Pakistan continue to work out the difficult political issues in their bilateral relationship.

CHAPTER 5: RECOMMENDATIONS

The central message of this report is that enhanced regional connectivity would lead to long-term economic growth and stability for Pakistan. It highlights the additional and substantive economic gains from improved East-West connectivity that Pakistan would realize on top of the benefits from the CPEC-led strategy focused on the North-South link.

The rapid progress that is being achieved under CPEC creates an important opportunity for Pakistan's growth and development. But while CPEC as currently conceived can help Pakistan move beyond the energy crisis and create new transportation and infrastructure links to foster industrialization, job creation, and development, CPEC alone is not enough to change Pakistan's growth trajectory. As the political economic analysis presented in Section 2 argues, Pakistan faces a widening growth and prosperity differential with India that will make an expensive approach to the security relationship financially unsustainable.

The analysis in Section 3 examines the status of regional cooperation and architecture as it relates to Pakistan's current regional predicament. Today Pakistan is among the least integrated countries in South Asia, and South Asia in turn is the least integrated region in the world. Pakistan's trade share with most of its immediate neighbors is negligible. China is the notable and significant exception. The China-Pakistan trade relationship has grown dramatically since the finalization of a free trade agreement in 2005, but the relationship is unbalanced; our analysis indicates that while Pakistan's current level of imports from China are close to the level that the gravity model would indicate, Pakistan's exports to China fall far below potential. Growing Pakistan's export portfolio is crucial to unlocking growth opportunities.

This paper argues that Pakistan would benefit far more from opening to all of its neighbors, and not just China. CPEC could potentially be a platform for significantly increasing growth across the board, and could improve Pakistan's strategic position in the process. Under a scenario where Pakistan only leverages CPEC to open to China, our analysis indicates that a 1-4 percent boost in GDP is possible. Alternatively, if Pakistan leverages CPEC to open itself not merely to China but also to India and the broader region, a 7-30 percent increase in GDP is possible by 2047.

This report also argues that improved economic connectivity will contribute to mutually beneficial peace in the region. Better economic ties could lead to better political ties, and in time new opportunities and tools could emerge to produce realistic and mutually acceptable solutions to long-standing problems. The resulting "peace dividend" would promote Pakistan's long-term growth and would benefit its neighboring countries in equal measure.

This section presents some actionable recommendations—both economic and political—that would help Pakistan's policymakers move toward a strategy of greater regional connectivity. This process of unlocking Pakistan's regional promise must start with a consensus across Pakistan's leadership and between civilian and military leaders to focus on economic competitiveness and growth through constructive regional relations. This disruption to the current unsustainable trajectory will position Pakistan to take advantage of its full regional potential. In the medium term,

the promise of this more constructive regional approach will translate into meaningful benefits for the Pakistani people. These benefits will lead to an acceleration phase, in which expanded political support creates the possibility for deeper reforms and transformations. In the longer term, this transformation would lead to a more prosperous and secure Pakistani state that is at peace with its neighbors.

In the short term, the newly formed government has an opportunity to disrupt the traditional policy approach by forming a national consensus behind bolstering Pakistan's economic competitiveness. Given the widening economic differential between Pakistan and India, a new national consensus among civilian and military leaders, drawing on support from Pakistan's robust media and academic community, is critical to defining this new course.

In this near-term phase, we recommend that the new government consider a series of actions that would help in shifting Pakistan from its current unsustainable course to a new growth path. The most disruptive near-term actions involve liberalizing Pakistan's trade policy and reducing the interior barriers to export competitiveness. Pakistan's trade policy formulation and implementation remains an important constraint affecting businesses and trade. In Pakistan the ad hoc and arbitrary use of SROs to impose duties and tariffs on imports increases the uncertainty and costs of trade. Trade policy needs to give primary importance to manufacturing and exports and should not be aimed to protect rent-seeking monopolies or meet gaps in domestic revenue generation through ad hoc measures. The way forward is for Pakistan to simultaneously lower effective tariffs, eliminate NTBs, and undertake trade facilitation, moving away from ad hoc policy implementation through SROs. These economic actions are designed to complement each other and enable a virtuous cycle by improving the domestic competitiveness of Pakistani industries, and such a policy also puts competitive pressure on domestic sectors to become more efficient.

The second area of near-term action pertains to trade facilitation measures that are critical to unlocking both the full economic benefits of CPEC and broader regional connectivity. Poor competitiveness, arising from institutional and regulatory weaknesses, means that businesses are wary of reduced tariffs, fearing the onslaught of more competitive goods from neighbors with more facilitative business environments. These fears have less to do with trade liberalization per se than with a poor regulatory structure that does not ensure a level playing field. Improved inter-ministerial coordination, particularly between the Ministry of Commerce, Federal and Provincial ministries and departments of industries, and the Federal Tariff Commission are some of the governance and institutional reforms that are imperative for strategic trade policy formulation.

Without addressing the supply chains barrier to trade—that is, the infrastructure, institutions, policies, and services that enable trade across borders—Pakistan would not be able to participate in global value chains. Doing poorly on parameters such as logistics and connectivity raises trading costs by as much as 30-40 percent (Reis, 2016). A study estimates that addressing "supply chains barriers to trade" could multiply GDP by at least six times more than removing tariffs (WEF, 2013). Lowering tariffs would have a significant trade-creating impact on goods with tariff peaks—agriculture, textiles, cotton and leather garments, and footwear. Simply improving, streamlining, and expediting customs procedures is a low-hanging fruit that would reduce trade costs substantially. However, the benefits of trade facilitation are wider, and have

multiplier effects. For instance, Raihan (2012) shows that welfare gains from enabling trade between countries exceed those from even a free trading regime (Raihan, 2012).

Facilitating transit trade is also important. Located at the fulcrum of the ancient Silk Route, Pakistan could see improved economic activity and attendant multiplier effects from participating in a regional transit corridor. Of course, to reap the benefits from transit trade, Pakistan would have to ensure the implementation of transport and transit agreements and fast-track operationalization of the TIR convention. Pakistan must formalize modalities under TIR to allow the free movement of trucks, as all CARs are TIR signatories. Cross-border (hard) trade infrastructure, as well as "soft" connectivity measures such as electronic data exchanges and acceptance of TIR carnets (a single harmonized manifest) would ensure deeper transit trade connectivity for Pakistan.

The third area of near-term action revolves around political decisions to adjust Pakistan's relationships with several neighbors, including Iran, Afghanistan, and Central Asian states. The new government should consider leveraging the opportunity presented by CPEC to invest in improved economic relations with these states, all of whom have expressed interest in finding ways to better link into China's BRI. By inviting other countries to be full partners with China and Pakistan in CPEC, Pakistan has an opportunity to leverage CPEC to grow its economic relationships in multiple directions. This is particularly critical in the energy space: several Central Asian states, particularly Turkmenistan, Tajikistan, and Kyrgyzstan, have the potential to export inexpensive electricity to Pakistan. As CPEC is led and managed by China, this decision must also be a feature of early interactions between the new government and its counterparts in Beijing, along with other steps to grow the China-Pakistan bilateral economic relationship.

The fourth area of near-term action relates specifically to the Pakistan-China economic relationship. While in recent years Pakistan has benefited from growing quantities of Chinese investment and support, trade relations remain lopsided in China's favor. Finalizing negotiations on a modified FTA with China should be a near-term priority for the new government, particularly before industrialization takes place.

The fifth and final area for urgent consideration by the new government regards Pakistan's complicated relationship with India. This paper advocates for a responsible, mutually beneficial improvement in economic ties between India and Pakistan. The first steps toward normalization should be aimed toward reforming the basis of dialogue, including small steps toward normalization. These steps could include revitalizing the Pakistan-India Joint Chamber of Commerce, resuming efforts to normalize visa processing, including for business people, and entering into dialogue on trade liberalization measures. As a first step toward trade normalization, Pakistan should begin to create the basis for granting MFN/NDMA status to India, which it is obligated to do as a member of the WTO. It can be argued that if Pakistan gives MFN status to India, it would find itself in a stronger negotiating position to obtain tariff concessions on its potential exports to India and get some of the more Pakistan-specific NTBs removed. To make this move palatable and allay the fears of vulnerable sectors (agriculture, automobile, and pharmaceutical), the opening of trade in these sectors should be strategic, through bilateral sectoral agreements—an approach that was put forward by stakeholders in these sectors. While extending MFN/NDMA status to India would be beneficial in the

short term, it is understandable if Pakistani leaders choose to carefully negotiate the terms of normalization in the near term. Even small steps toward normalization with India can have an outsized benefit for Pakistan's economy.

The next set of actions focuses on the medium term, when the Pakistani government has an opportunity to accelerate the delivery of benefits from a pro-growth strategy. These accelerants would be aimed at reinforcing the political basis of support behind the reform agenda and creating space for more transformative measures in the future.

In this medium-term phase, Pakistani authorities would be positioned to leverage a more open and competitive business climate. For example, while Pakistan has improved its transport and logistical infrastructure over the years, it is still well behind China and India. A move to normalize trade with India would require opening up other border points, such as Khokhrapar-Munabao in Sindh and Sialkot in Punjab. At the same time, border infrastructure such as warehouses and improved cold storage facilities would be necessary to facilitate increased trade between the two countries. Railway links to carry both passengers and freight from borders and ports to Pakistan's major cities are needed to reduce transportation costs. This is an element of CPEC that has been anticipated, but to date has not been initiated. On the western border with Afghanistan, similar investments in improved border infrastructure, customs procedures, and road and rail connectivity would expand trade capacity and foster domestic manufacturing growth in Pakistan. The government could set an illustrative medium-term goal of reducing trade and transit costs by 30-40 percent from the current level.

Pakistan should become proactive in inviting multi-country involvement in CPEC (including India); consider politically viable ways to initiate discussions with India and Afghanistan on potentially offering India an overland route to Afghanistan in return for gaining access to Central Asia for itself; offer both Karachi and Gwadar ports for use to all neighbors, including India; and work with Iran to develop synergies and complementarities between the Gwadar and Chabahar ports. Pakistan should also push for the timely completion of connectivity projects already committed to by countries in the region, including India. The sooner these initiatives are completed, the sooner Central and South Asian states will develop genuine interdependence, with Pakistan acting as a pivotal transit hub whose stability will be of prime importance for all states that are party to these projects.

As this study lays out, India is the greatest source of economic potential for Pakistan. With an improved domestic economic and competitive basis, and a more stable political context, medium-term opportunities exist to substantially expand the economic benefits to Pakistan of that relationship. A move toward extending MFN/NDMA status to India, undergirded by bilateral agreements defining sectoral treatment and dispute resolution mechanisms, would be optimal measures.

To achieve Pakistan's long-term potential as a more economically vibrant, strong, secure, and confident state, Pakistani leaders have to transform the country's unsustainable policy course and prioritize pro-growth and development strategies. The ultimate outcome of such a transformation would be built in the context of a transformed set of regional relationships. CPEC could create the context for this transformation. Normalized trade relations with India, including

allowing Indian goods to transit Pakistan and Pakistani goods to transit India to find new markets, would make Pakistan the hub of a new regional trading network. Pakistan could become the nexus of a new regional energy market, leveraging transmission networks like CASA-1000, pipeline projects like TAPI or the Iran-Pakistan pipeline, and other initiatives to deliver reciprocal benefits to Pakistan and its neighbors.

Ultimately, economic integration will proceed only if there is a parallel improvement in political relations. Pakistan and its neighbors therefore must work together to improve the political atmosphere of the region, at least to the point that it does not actively impede improvement in regional connectivity. Continued dialogue, including on thorny issues such as terrorism and the various outstanding disputes between the regional countries, is necessary to have any hope of achieving this goal. All states in the region must strive to ensure such an improved atmosphere, irrespective of their disagreements. A change in perspective from Pakistan can open the door to this regional progress, but longer-term transformation can only be achieved in the context of cooperation with Pakistan's neighbors.

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