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Conclusion

Several recent events have tested relations between the United States and Pakistan. The discovery in 2004 of a nuclear proliferation network that supplied technology and materials to Iran, Libya, and North Korea, headed by renowned Pakistani scientist A. Q. Khan, and the mild response of Pakistan's government increased tensions. The killing of Pakistani civilians by US forces in January 2006 during an antiterrorist strike on the northwest frontier spurred a massive outburst of anti-American feeling. Anti-American sentiments were also displayed in February 2006, in the wake of the Danish cartoon incident, and again in March 2006 during President George W. Bush's visit to Islamabad. Other events continue to cast a shadow. Drug-related insurgents in Baluchistan and al Qaeda forces on the Afghan-Pakistan border are extremely troublesome. Iran's drive for nuclear weapons adds another concern, since geography and history contribute to close relations between Pakistan and Iran.[1]

These "negatives" are offset, however, by Pakistan's critical role as a Muslim ally in the US war against terrorism. Because of this important role, geopolitical considerations will take precedence over others—

1. In March 2006 President Bush clarified the US position on cooperation between South Asia and Iran. For the moment, the United States objects only to the prospect of nuclear cooperation with Iran, particularly in areas that could have a military application. The president's statement implied that the United States would not object to cooperation in other critical areas, and specifically mentioned fossil energy. "Our beef with Iran is not the pipeline, our beef with Iran is . . . they want to develop a nuclear weapon and I believe a nuclear weapon in the hands of the Iranians will be very dangerous for all of us" (BBC News, March 4, 2006).

including the economic issues examined in this book. In other words, geopolitics will largely determine the course of US-Pakistan relations—and the fate of any US-Pakistan FTA proposal. But a US-Pakistan FTA offers a vehicle for extending the bilateral relationship beyond mutual security concerns to the economic arena.

The case for increased trade and investment cooperation between the United States and Pakistan fundamentally rests on the proposition that closer ties could anchor the reform process in Pakistan. Economic reform, based on market principles, can create new and better jobs, and can, over time, serve as a bulwark against Islamic radicalism.

As we outlined in chapter 1, relations between Pakistan and the United States have alternated during the past 50 years between episodes of close partnership and sharp friction, reflecting the ups and downs of global and regional geopolitics. Since September 11, 2001, Pakistan's evolution has become a top US foreign policy priority, and the administration has repeatedly expressed a keen interest in Pakistan's *own* path toward political and economic reform. Both countries believe that democracy and freedom will play a decisive role in the struggle against radical Islam, a shared commitment cited by President Bush in a speech at the Asia Society, when he called on President Pervez Musharraf to deliver on his commitment to open, free, and fair elections in 2007.[2] The close relationship between the two countries has not been derailed despite instances of episodic violence such as those cited above.

The geopolitical considerations, together with Pakistan's evolution toward democracy, will decisively shape the prospects for an FTA. Beyond those preconditions, chapter 1 briefly addressed possible economic concerns. We argued that the new global wave of FTAs is less about forming tightly knit geographic units around a major power and more about criss-cross commercial networks spanning the globe. In this setting, a US-Pakistan FTA would complement the US strategy of competitive liberalization that in time could reshape commercial relations across South Asia. We observed that, because Pakistan is the second largest Muslim country in the world after Indonesia and an essential bridge between the Middle East and South Asia, a US-Pakistan FTA would reflect America's post–September 11 foreign policy priorities. We explained that an FTA can deliver real economic benefits to both Pakistan and the United States, as high barriers that limit trade in both directions are scaled back and eventually eliminated. We dispelled doubts concerning the issue of timing: A US-Pakistan FTA should not disrupt the last lap of the WTO Doha Round,

2. See White House press release, "President Addresses Asia Society, Discusses India and Pakistan," February 22, 2006, available at www.whitehouse.gov. However, in contrast to the high expectations encouraged by that speech, democracy featured less prominently during President Bush's subsequent visit to Pakistan in early March 2006.

since FTA negotiations and ratification would likely follow comparable milestones in the Doha process.

Many US critics of the endeavor will point to Pakistan's weak performance on corruption, as well as its labor and environment practices, as reasons for backing away from an FTA. Pakistani critics will dismiss an agreement that cements economic ties with the United States. But the proposed FTA provides a platform for building on the reform process in Pakistan, a process that encompasses social as well as economic issues.

Indicators of the current low intensity of bilateral trade and investment relations could be construed as a reason not to enter into an FTA. But this is a circular argument, as trade barriers share part of the blame for the low level of commercial interchange. In 2004, for example, US exporters faced high duties to enter Pakistan's market, and Pakistani firms were the fifth largest contributor of US custom duties relative to imports.[3]

Agriculture will challenge negotiators, as discussed in chapter 2. US producers will want maximum access to a market with high growth potential, whereas Pakistan will not want to disrupt activities that provide employment and sustenance for the majority of its population. The United States will therefore focus on lowering and eventually eliminating tariffs, while Pakistan will also seek assistance to improve its capacity to ensure clean and safe agricultural shipments.

Lower barriers will adversely affect some producers that are accustomed to high protection, but long phaseout periods should be designed to allow adequate time for adjustment. In Pakistan, the sensitive products are likely to be wheat, corn, poultry, and vegetable oils. Sugar and tobacco will be sensitive import products for the United States. The sensitive list will also include dairy items in both countries. However, Pakistan and the United States share a mutual interest in liberalizing cotton and rice. The computable general equilibrium (CGE) model predicts significant gains for the United States in processed foods, and an increase in Pakistan's exports of fruits and vegetables. While negotiations are under way, sanitary and phytosanitary (SPS) and other regulatory measures that limit US imports of fruits and vegetables should be examined, and steps taken both to improve Pakistan's compliance and to remove unnecessary barriers.

Trade in textiles and clothing, examined in chapter 3, holds the key to a successful agreement. Market access for textiles and clothing will be Pakistan's foremost commercial interest. Without substantial US concessions, a US-Pakistan FTA would be a lopsided bargain and not politically acceptable to Pakistan. Leaders in Pakistan will need to advertise convincing market access benefits to enlist support from domestic stakeholders, and the prospects of increased textile and clothing exports will be essential to that effort.

3. In 2004 Pakistan ranked 51st as a source of US imports and 17th as a source of US customs duties.

Liberalization is not a one-way street, however. Textile and clothing barriers are high in both countries. A US-Pakistan FTA will result in new market opportunities for US as well as Pakistani producers. The agreement should therefore be crafted to promote vertical integration between US and Pakistani firms, and to make Pakistan an attractive sourcing option for the US retail market—goals that will entail comprehensive reciprocal liberalization. Short phaseout periods of up to six years should be available for sensitive items. "Yarn-forward" rules of origin should be applied, to ensure market opportunities for US textile producers, with a high de minimis margin for nonconforming yarns and fabrics. The agreement should also contain strong language on customs cooperation and illegal transshipment.

In addition to textiles and clothing, significant trade opportunities exist in "other manufactures," discussed in chapter 4. US barriers are not overly burdensome to the vast majority of Pakistan's manufactured exports (apart from textiles and clothing), but Pakistan applies some very high tariffs to a few items. Empirical simulations indicate that liberalization in this area will generate large export gains for US firms (particularly in chemicals and in machinery and mechanical equipment) as Pakistan lowers its barriers. Some Pakistani firms will need to adjust by finding new markets and adopting new production methods. In other FTAs, the United States has accepted long phaseouts for a few truly sensitive manufactured products.

The parties should agree to an ambitious target of immediate liberalization of 95 percent of existing two-way trade in other manufactures.[4] While this will entail a greater effort in Pakistan than in the United States, it will balance US concessions on textiles and clothing. Pakistan should eliminate nontariff barriers, including local content requirements, on other manufactures. With very limited exceptions, the United States should grant immediate duty-free access to all imports of other manufactures from Pakistan, particularly leather goods. Long phaseout periods (up to 10 years) should be reserved for truly sensitive items.

Efforts to include environmental and labor standards in trade agreements have proven quite controversial, as discussed in chapter 5. The harmonization of environmental standards to the highest level (often the US level) can unfairly penalize countries with limited means, such as Pakistan. Most labor standards, particularly those directed at workers engaged in making nontraded goods and services, are best determined at

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4. Pakistan could go a long way toward fulfilling the liberalization target by granting immediate duty-free access on other manufactures that are not produced domestically or on items that currently enjoy duty-free treatment not reflected on the tariff schedule (e.g., aircraft and parts thereof). In fact, current US exports to Pakistan are not substantial for sensitive items such as construction materials, plastics and rubbers, articles and tools of base metals, and motor vehicles.

the national level. At the international level, fundamental labor and environmental standards should be agreed in international organizations or multilateral pacts, exemplified by the International Labor Organization (ILO) or the Montreal Protocol. Yet, since the 1990s, the US Congress has linked labor and environmental provisions with trade pacts, and a US-Pakistan FTA will follow this recent tradition.

With these practical realities in mind, we propose that a US-Pakistan FTA adopt the basic labor and environment standards and dispute settlement framework of the Central American Free Trade Agreement–Dominican Republic (CAFTA-DR), as discussed in chapter 5. Pakistan's federal and provincial governments should amend their statutes as necessary[5] and undertake more vigorous enforcement of labor legislation. Pakistani firms that export to the United States should adopt—and self-certify compliance with—codes of conduct for labor matters that reflect the ILO Declaration on Fundamental Principles and Rights at Work. Mechanisms for monitoring compliance with environmental regulations should be established and strengthened. This will require American support as well as the involvement of the Asian Development Bank.

Buy-national procurement rules and other restrictions exist at the federal and subfederal levels in both Pakistan and the United States, as summarized in chapter 6. The United States should grant unconditional most favored nation (MFN) rights for government procurement, at both the federal and state levels, to Pakistani firms, and Pakistan should reciprocate.[6] The United States should work toward extending its procurement coverage for products exported by Pakistan, such as textiles and clothing and medical instruments, with appropriate (but limited) waivers in the Buy American Act and the Berry amendment. Pakistan should become a signatory to the plurilateral WTO Government Procurement Agreement (GPA), with a schedule of commitments that mirrors those stipulated by the GPA for developing countries and those of CAFTA-DR for US partners.

Investment and services sector exchanges between Pakistan and the United States hold much potential, as discussed in chapter 7. While barriers and frictions in investment are relatively low, improving the confidence of foreign investors in Pakistan remains a paramount objective. The conclusion of a bilateral investment treaty (BIT) will be an important

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5. For example, the Industrial Relations Ordinance (IRO) should conform with the ILO conventions ratified by Pakistan.

6. The US-Peru FTA contains an alternative approach for state procurement rules: Firms based in a given US state can access government procurement in Peru only if that state grants equivalent rights to Peruvian firms. In our view, this is a second-best approach to unconditional MFN status.

step in this direction—and possibly a prerequisite to FTA discussions.[7] However, investment promotion will also require strong provisions addressing corruption. In fact, as part of the BIT text or as a separate codicil, we recommend that treaty benefits be denied to investors that engage in significant corrupt practices.

In the context of the proposed FTA, Pakistan and the United States should renegotiate the existing bilateral income tax treaty to reduce sharply the withholding rates on dividends, interest, and royalties. The government of Pakistan should encourage foreign direct investment in a more varied spectrum of sectors, by extending its privatization plans to encompass state-owned firms that are currently exempt from the Monopolies and Restrictive Trade Practices Ordinance. Pakistan should also commit to nondiscriminatory tax collection methods.

In the services sectors, the US-Chile FTA serves as a model for what could eventually be accomplished between the United States and Pakistan. A good start for Pakistan would be to reduce barriers that restrict foreign insurance and reinsurance firms, and then to consider privatizing the state life insurance company. As in the US-Singapore FTA, a US-Pakistan FTA could phase out local presence requirements, limits on the number of services providers and on the value of services transactions, and restrictions on the number of persons that may be employed by a foreign services provider.

Our econometric analysis, reported in chapter 8, gives results from two models: a gravity model and a CGE model. The overall gain in two-way trade that would result from a US-Pakistan FTA is estimated at about 40 percent by the gravity model. The CGE model calculates a possible expansion of 50 percent in two-way trade, but the increase is more moderate when other US FTAs are considered (35 percent). Both models agree that the bilateral trade expansion would be focused in agriculture and manufactures. The CGE model further calculates that an FTA could deliver an appreciable rise in Pakistan's income, estimated at 1.5 percent of GDP per annum.

Particular sectors that would benefit from the expansion of bilateral exports include for the United States, grains, processed foods, chemicals, and machinery and equipment (including electronic equipment) and for Pakistan, textiles and clothing. Trade diversion under the hypothesized US-Pakistan FTA will be small.

Pakistan and India are the bedrock members of the South Asian Free Trade Area (SAFTA), discussed in appendix A. South Asia is a region with some of the world's lowest intensity of trade flows, both within the re-

7. Unfortunately the US-Pakistan BIT was not concluded during President Bush's visit to Islamabad in March 2006. Negotiations will continue, as both presidents considered the agreement a "key step" to the expansion of US-Pakistan economic ties.

gion and with other regions. Low intraregional trade reflects the difficult relationship between India and Pakistan as well as the import substitution strategies pursued by all South Asian countries until the 1980s. In the happiest of outcomes, a US-Pakistan FTA would inspire all SAFTA members to liberalize at a faster pace, both to avoid undesirable diversion of trade and investment and to emulate the best commercial practices adopted by Pakistan. Accelerated liberalization among SAFTA members would in turn complement a US-Pakistan FTA. If trade relations are normalized within South Asia, and barriers are slashed, then the region will become that much more attractive for foreign investment not only by American but also by European and Japanese corporations.

If SAFTA becomes the driving force of Pakistan's liberalization, a US-Pakistan FTA could complement regional reform. The bilateral FTA would ensure increased competition in the Pakistani market for a range of manufactured goods, and probably go beyond SAFTA in liberalizing services and curbing nontariff barriers. Both SAFTA and the US-Pakistan FTA can make Pakistan more attractive to foreign corporations, and generate new opportunities for the country's firms at home and abroad.