
India Pakistan Trade Potential: Barriers and Opportunities to A Frozen Relationship

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Abstract

India and Pakistan share a 3,323 km border, and a history of economic division, but bilateral trade was only around US\$1.2 billion in 2024. Their potential trade is estimated at US \$37 billion, one of the highest unrealised trade gaps in the world, according to a World Bank study in 2018, "A Glass Half Full". This paper tries to identify the reasons for the persistence of the gap and the increase in it after the attacks in 2019 on Pulwama and in 2025 on Pahalgam. The paper is based on the liberal interdependence theory (Oneal and Russett, 1997) and the realist strategic rivalry and gravity model literature on South Asian trade (Taneja and colleagues at ICRIER) that categorises the barriers into institutional, instrumental and political shocks. It also looks at the parallel informal trade via third countries, which is estimated by the Global Trade Research Initiative to be about US \$10 billion per year. The paper contends that economics is not the only reason for the freeze trade. While the economic argument of normalisation, is in favour of particularly for Pakistan, but the political argument has always prevailed in both capitals. It is the consumers who suffer, the traders in the border regions and the greater cause of South Asian integration due to freeze trade.

Introduction:

South Asia is the least economically integrated major region in the world. Intra regional trade is less than 5 percent of total trade, while the European Union and East Asia have rates of more than 60 percent and 50 percent respectively. The foremost reason is the frozen trade between India and Pakistan. Official bilateral of Pakistan and India's trade reached a peak of approximately US \$2.41 billion in 2017-2018, while it declined to US \$1.2 billion in 2024 and was completely halted following the attack in Pahalgam in April 2025. Meanwhile, the informal trade via Dubai, Singapore and Colombo is estimated to be approximately US \$10 billion per year (GTRI, cited by Al Jazeera, May 2025). The market wants trade; the policy environment does not allow it.

Research questions:

1. What are the key institutional, policy and political impediments to India Pakistan trade and what have been the changed in these impediments since 1996?
2. What impact have the attacks on Pulwama (2019) and Pahalgam (2025) had on formal and informal trade?
3. What does the difference between the potential and actual trade explains about the limits of economic rationality?

4. What impact does informal trade with third countries have on the policy debate on formal normalisation bilateral trade?

Significance:

The paper is part of the liberal interdependence debate by looking at a dyad where trade and conflict have not been opposed to one another but rather have been intertwined. It also brings up to date the empirical record of India Pakistan trade in the context of the 2019 and 2025 crises.

Literature Review:

The classical liberals (Smith, Kant, Angell) are the first to be found in the literature on trade and conflict, and it is they who claimed that commerce is the reason for the blockage the way going to war. The modern empirical revival starts with Maoz and Russett (1992, 1993) on the democratic peace and then with Oneal, Maoz and Russett (1996) and Oneal and Russett (1997, 1999) on economic interdependence. Their large N statistical analyses find that trade has a pacifying effect on the likelihood of militarised disputes, independent of democracy. Barbieri (1996, 2002) argues that asymmetric interdependence may be a source of conflict. Liberal peace is defined by the three pillars of democracy, interdependence and international organisations, which is known as the "Kantian triangle" (Russett and Oneal, 2001).

There is a huge body of literature on the gravity model of South Asia, and various estimates. All the three authors, Batra (2004), Rahman, Shadat and Das (2006) and Gul and Yasin (2011) have highlighted the enormous potential of unutilised trade between India and Pakistan. The methodology was further elaborated in Taneja's ICRIER working papers (2006, 2013, 2017) which added the concept of "vulnerable items" and "opportunity items" through Revealed Comparative Advantage filters. In 2018, Kathuria synthesized this work in a World Bank study which estimated the potential number at US \$37 billion.

Using survey based methods, Taneja (2006) and Taneja and Bimal (2016, ICRIER Working Paper 327) estimated the informal trade channel is at around US \$4.71 billion. The estimate of the Global Trade Research Initiative is US \$10 billion, which is higher, possibly because of formal channels shrank.

This paper aims to fill the gap in the research by giving an integrated analysis of the period after 2019 and especially the crisis of 2025 in Pahalgam.

Theoretical Framework:

The paper employs three lenses and suggests an integrated framework that integrates them.

Liberal Interdependence

The liberal framework is based on three propositions: First, economic interdependence increases the opportunity cost of conflict; second, it generates domestic constituencies with material interests in peace; and third, repeated commercial interaction fosters trust. The framework, which is applicable to India–Pakistan, implies that moderate liberalisation would have a stabilising effect. The empirical shortcomings of the framework here are that both governments have been known to suspend trade after each major terrorism incident or political shock, suggesting that economic logic does not always prevail over political logic.

Realist Strategic Rivalry

Realists say that rivals are more interested in relative gains than absolute gains. If the weaker party benefits more from trade, the stronger party can use trade as a strategic instrument, if the stronger party benefits more from trade, the weaker party will resist. This is the reason why Pakistan has been

hesitant to grant MFN status, as they fear that the Indian products will impact the local industry, especially the automotive, pharmaceutical and textile sectors. It also throws light on India's calculations: even if the trade volume with Pakistan is at its maximum of US \$37 billion, it will still be a small part of India's total trade of around US \$800 billion, making the strategic benefit of not trading with Pakistan outweigh the economic cost.

Constructivist Identity Politics

Constructivism focuses on the importance of national identities and historical memory in the development of acceptable policy. The Partition history, Kashmir issue and regular terror attacks have created a sense of identity for each nation of South Asia with the other as the main external threat. MFN is not only an economic choice, it's an identity statement. That is why partial normalisation episodes (2011-2014) have not materialised, despite the economic rationale, and why informal trade through Dubai is politically acceptable, while formal trade is not.

Integrated Framework

The paper suggests that none of the three frameworks is adequate. The liberal framework is an explanation of the economic potential and the current demand. The realist framework is an explanation of the strategic calculation that trumps demand. The domestic political constraint is understood in the context of the constructivist framework. They construct a model of nested logics: economic logic at the bottom, strategic logic in the middle, identity logic at the top. Trade is frozen when any one constraint is binding and is possible when none of the three constraints are binding.

Methodology:

The paper is of qualitative type and uses a case study research design, descriptive quantitative data on trade flows, tariffs and product lists. The case is the India Pakistan trade relationship from 1996 to 2026. Process tracing is a method that uncovers causal mechanisms between political shocks and trade outcomes. There are three partial normalisation episodes (2011, 2012, 2014) and two full suspension episodes (2019, 2025) that are analysed for lessons to be learned.

The data have been collected from five sources: multilateral reports (mainly Kathuria 2018), official sources in India and Pakistan, research by ICRIER, credible journalism (Al Jazeera, Dawn, Business Standard, Deccan Herald) and informal trade estimates from GTRI and ICRIER.

The limitations are secondary data, the uncertainty of informal trade estimates, the still evolving post Pahalgam environment and the limited generalisability of a single case design.

History of the Trade Relationship:

India and Pakistan were the biggest trading partners after Partition in 1947. The two economies were split by the wars of 1948, 1965 and 1971 and the Kashmir issue. Formal trade had dwindled and become sporadic by the 1990s. As per the WTO rules, India had granted MFN status to Pakistan in 1996. Pakistan never reciprocated. This was the trend for the next 20 years, as India extended MFN and Pakistan refused. In 2004, both countries signed SAFTA, but each had a long list of sensitive items (884 items for India and 936 items for Pakistan) that offset the tariff concessions of the agreement.

The most serious attempt at normalisation was in 2011 & 2012. The cabinet of Pakistan announced in November 2011 that it would normalize trade. In March 2012, Pakistan liberalised its positive list of approximately 1,950 permitted items with a negative list of 1,209 banned items. India followed suit in August 2012 by cutting its SAFTA sensitive list by 30 per cent. The commerce Ministers agreed in principle in January 2014 to take steps towards "Non Discriminatory Market Access. The phase out was never put into practice.

At least 40 Indian paramilitary personnel were killed in a Pulwama suicide bombing on 14 February 2019. India withdrew Pakistan's MFN status and imposed a 200 percent customs duty on all Pakistani imports, marking the first withdrawal of MFN status by any WTO member. In 2024, the value of Pakistani exports to India fell by more than 99.9 percent compared to 2019, when it was valued at US \$547.5 million (Al Jazeera, May 2025). In August 2019, India scrapped Article 370 and Pakistan halted all bilateral trade.

Another terrible incident, A terror attack in Pahalgam on 22 April 2025 resulted in the deaths of 26 people, including many tourists. India shut down the Attari Integrated Check Post (especially designed for trade), suspended the Indus Waters Treaty and prohibited all imports, even through third countries. Pakistan suspended the Shimla Agreement, shut down its airspace till now and matched the trade ban. On 7 May 2025, India launched missiles (Operation Sindoor) and on 10 May 2025, Pakistan launched missiles (Operation Bunyan ul Marsoos). The same day a ceasefire was agreed. The war was over, but the trade didn't resume.

Analysis of Barriers:

Institutional Barriers

The institutional barrier is the MFN asymmetry. As of May 2026, India and Pakistan are the only two WTO members that do not provide MFN treatment to each other. This makes the functioning of SAFTA difficult, undermines SAARC and indicates that political differences can supersede multilateral pledges. The long sensitive lists under SAFTA were dominated by textiles, farm products and surgical instruments and absorbed the bulk of the gains of the agreement in the very areas where trade was most likely to be strong. The 1,209 items negative list, which was originally applicable to the automotive, electrical machinery, steel, pharmaceuticals and textiles industries, was redundant after the complete ban in 2025.

Instrumental Barriers

India's 200 per cent customs duty after Pulwama incident was not a real tariff, it was an effective prohibition. The nontariff measures (NTMs) on both sides, such as rigorous product testing, complicated import licensing, country of origin restrictions and mandatory labelling, contributed an estimated 15-25 percent to landed costs. The transport situation was also very tight. Even at the height of liberalisation, the Attari–Wagah land crossing allowed just 137 categories of goods to be transported by road. The World Bank's 2018 study revealed that Pakistan had just six weekly flights with India, while India had 147 flights with Sri Lanka and 67 flights with Bangladesh, which reflects the low level of business connectivity and commercial trust.

Political Shock Barriers

History tends to repeat itself: a short time of partial normalisation, a terror or military shock, and then a halt to trade. This pattern is visible after Kargil War (1999), and series of terror attacks particularly the Parliament attack (2001), Mumbai (2008), Uri (2016), Pulwama (2019), and Pahalgam (2025). Recoveries have been less complete and slower than previously. Political shock barriers also collapse in an asymmetric fashion. Pakistan's economy is smaller and more import reliant, which should make it more attractive for Islamabad to pursue normalisation, but the domestic political price of doing so has been deemed to be higher than the economic price of not doing so. There is still a lot of trade that is going on through third countries, although the formal suspensions. The unofficial estimate of informal Indian exports to Pakistan is about US \$10 billion per year, which is about five times the official estimate. Indian goods are legally exported to Dubai, Singapore or Colombo and then re-exported to Pakistan as "UAE origin" or "Singapore origin" goods in the bonded warehouses with a change of documents and labels. The previous ICRIER survey based research had estimated the value

at approximately US \$4.71 billion (earlier years) and the UAE had approximately 92 percent of informal trade. This channel has remained and it demonstrates four things. First, there is actual cross border demand. Second, the demand is price inelastic, so that consumers can cover the 15 to 30 percent mark up for third country routing. Third, formal restrictions do not stop trade, they merely shift rents from direct producers and consumers to intermediaries in other countries. Fourth, the political symbolism of the ban is maintained, and the economic reality of trade is maintained. This is a paradox in the political economy. The more the freeze lasts, the bigger the private constituency in third country hubs that benefits from it. Freight handlers, customs agents and exporters have a vested interest in the prevention of normalisation. This lobby is strengthened each year of the freeze and will be more difficult to liberalise.

Recommendations:

It is admitted fact that full normalisation of trade relations is not possible in the immediate post Pahalgam situation. Therefore, five measures are suggested in the best interests of both countries:

- Both countries should open a humanitarian goods list (medicines, cotton, basic food items) quietly and without politics.
- At the technical and sub political level at SAARC, both countries should minimize SAFTA sensitive lists.
- Reopen the Attari–Wagah border for a limited trade of essential goods, thus rejuvenating livelihoods on the border.
- Both countries should talk about trade through back diplomatic channels through China, Iran, Russia or Saudi Arabia.

Conclusion:

It is agreed that Trade with India will not neither resolve Kashmir issue nor it will bring back the soldiers, the tourists, the schoolchildren, or the families that have been broken by seventy eight years of hostility. Trade can do is small and quiet, but real. It can reduce the cost of medicine for unhealthy citizens. It can provide a market to the fruit grower in Indian Punjab which is 200 kilometres away rather than 2000 kilometres. It can sustain a cement factory in Sindh and a leather shop in Sialkot to meet the demand of the buyers in Amritsar. All of this is reflected in household budgets, employment statistics and the cost of living. This is what makes life more tolerable for the common man on either side of the line in the long run. This dyad has been a test of the grand liberal notion that commerce will overcome politics, and it has failed. Following each terror attack and each military crisis, the trade door has been shut quicker than it has been opened. The 1996 MFN grant, the 2012 negative list shift, the 2014 commerce talks, all of them were undone in a matter of days when politics demanded it. Thus, we need to be wary of the liberal mantra here. It's too much of a commitment for too little of a relationship. The other, more honest argument comes from other parts of the world. France and Germany were not friends because of trade, they traded because they didn't want to fight anymore, and trade helped them to maintain that decision. ASEAN did something like that. Little by little, there were small cross border contacts that created a constituency that did not wish for another war. Such a constituency is not there between India and Pakistan today. One of the few tools that can build it is trade.

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