SBP Staff Notes
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Dynamics of Pakistan's Trade Balance with China

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I. Introduction

While Pakistan and China enjoy historical trade relations, a turnaround was witnessed in the bilateral trade when both the countries signed a free trade agreement – China Pakistan Free Trade Agreement (CPFTA) on 24th November 2006, which came into effect in July 2007. The prime objective of this agreement was to promote bilateral trade and provide enhanced market access to the products on reciprocal basis. As per the Tariff Reduction Modalities (TRM), both sides offered each other elimination of tariffs on almost 36 percent of the total tariff lines during the first three years of implementation of Phase-I (which ended in 2012). The second phase of CPFTA negotiations started in 2013, which was aimed at further lowering tariffs and normalizing trade procedures. However, this phase is not yet concluded, and the negotiations on trade concessions are still continued.

Both Pakistan and China had great expectations from CPFTA, which was to open up numerous trade opportunities for the two countries. Particularly, the trade dynamics of Pakistan were expected to divert more towards regional trade mainly to exploit Chinese markets, as CPFTA was likely to address tariff/non-tariff barriers, augment comparative value of exports, and increase production capacity through technical cooperation and collaboration. In this backdrop, this paper intends to review the outcome of CPFTA, mainly to determine its effectiveness in improving the bilateral trade. This is likely to help identify the following: (a) the domestic sectors that benefitted from the CPFTA; (b) the areas in which Pakistan needs to seek market access in China mainly to boost its exports; and (c) the local businesses that are vulnerable to the external competition from Chinese products.

Rest of the paper is structured as: (i) an overview of Pak-China trade relations; (ii) an analytical review of Pak-China bilateral trade balance; (iii) the analysis of low cost imports from China on the local industry; (iv) a brief review of business opportunities under the Pak-China trade arrangements; and (v) concluding remarks.

II. Pak-China Trade Relations: An Overview

Pakistan and China entered into trade relations in 1950s, and have signed various agreements so far – the first formal bilateral trade agreement was signed between them in 1963. In 1982, Pakistan-China Joint Committee was established, which was aimed at facilitating trade and technology. Nevertheless, the start of this millennium witnessed a new era of trade relations, as both countries signed multiple agreements and MOUs. For instance, both countries signed six MoUs on trade in May 2001; established cooperation on Gwadar sea-port in May 2002; and signed seven agreements in the areas of trade, communication and the energy sector in December 2004. This paved the way for enhancing mutual cooperation on other important areas, when both countries signed 21 agreements and MoUs in April 2005 on defense, energy, infrastructure, social sector, etc. As a result, the bilateral trade between the two countries increased from US$ 1.07 billion in 1997 to US$ 4.26 billion in 2005.

The trade relations between Pakistan and China further strengthened with signing of agreement on Early Harvest Program (EHP), which became operational on January 1, 2006. This agreement was the first step towards establishing a free trade area, as both countries provided enhanced market access to each other on items of significant commercial interests.

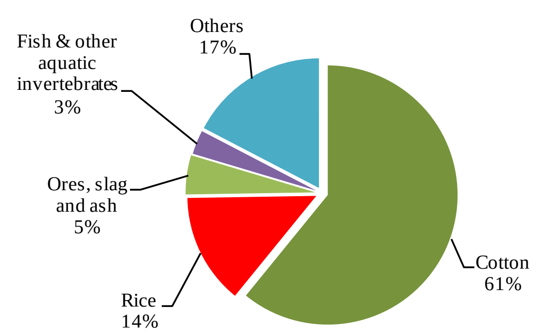
Presently, the China-Pakistan Economic Corridor (CPEC) is being considered as a game changer, not only for Pakistan and China, but also for the entire region. In fact, this is a planned network of roads, railways and energy projects which is aimed to link Pakistan's Gwadar port to the China's Xinjiang province, besides helping Pakistan in improving its supply side constraints. For China, this short route can also serve as an alternative to the sea route that passes through the *Straits of Malacca*. In this regard, both the countries are focusing on enhancing trade interaction with world through this new route.

Main Exports to China

China is ranked as the second largest export destination of Pakistan with a share of 7.7 percent in Pakistan's total exports, after the United States (16.7 percent). Nevertheless, Pakistan's exports to China are heavily concentrated in cotton and rice, which accounts for 75 percent of Pakistan's total exports to China **(Figure 1).** Notably, Pakistan's cotton exports to China increased from US$358 million in 2006 to US$968 million in 2016. Further, China is amongst the top importers of Pakistani cotton yarn followed by Bangladesh.

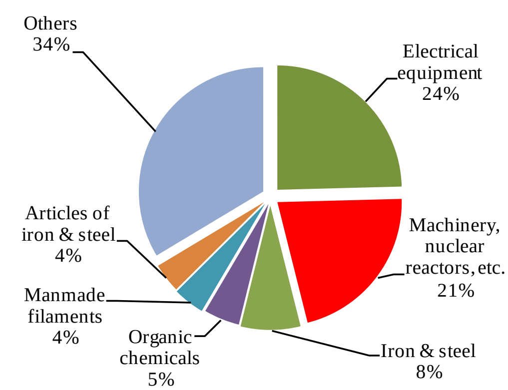
It may also be noted that the trade is not restricted to cotton only, as China is also ranked as one of the largest buyers of Pakistani rice. In fact, the dramatic increase in China's rice imports in 2012, which was driven by strong domestic demand and low international prices, paved the way for Pakistani rice to enter Chinese markets – share of Pakistani rice in China's imports jumped from 1.3 percent in 2011 to 24.4 percent in 2012, surpassing Thailand's exports of rice to China *(please see agricultural trade potential).* Other major Pakistani exports to China include ores, slag and ash, fish and other aquatic invertebrates, raw hides and skin, etc.

Figure 1: Pakistan's Major Exports to China (2016)



Source: International Trade Centre

Figure 2: Pakistan's Major Imports from China (2016)



Main Imports from China

China now occupies the largest share in Pakistan's total imports (i.e. 29 percent), followed by the UAE (13 percent). These imports mainly include electrical equipment, high-tech machinery, nuclear reactors, iron & steel, organic chemicals, manmade filaments, etc. **(Figure 2).** In fact, more than half of Pakistan's imports of electrical equipment and machinery come from China. A more lucid picture of these top import items from China may more aptly be captured when looked at the HS-2 import level data, as a substantial rise was exhibited in these products after signing of FTA in 2007.[2]

[2] For instance, the top import from China (Electrical, Electronic Equipment) has increased by 68 percent of all imports of that product from rest of the world.

Salient features of CPFTA

Pakistan signed a free trade agreement with China in 2006. The key objective of CPFTA was to strengthen the mutual friendship, encourage expansion and diversification of trade (within the parameters of WTO), eliminate barriers to trade, facilitate the cross-border movement of goods, provide fair condition of competition for trade, establish a framework for further bilateral economic cooperation to expand and enhance the benefits of the agreement. Further, the agreement was also expected to uplift the living standard of masses, create new job opportunities, and promote sustainable development in a manner consistent with environmental protection and conservation. Key elements of the CPFTA agreement are as follows:

a) The scope and coverage of CPFTA is restricted to trade in goods only. [3]

b) Each country accorded national treatment to the goods of the other country in accordance with Article III of the GATT 1994.

c) With certain exceptions (which are part of the CPFTA), each country was to gradually eliminate its import customs duties on imported goods.

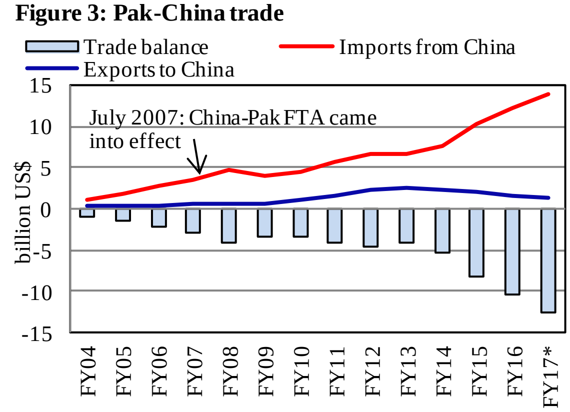
d) The tariff elimination schedule was subject to revision/review (after every 5 years)/modification under certain conditions, which were part of the agreement. Further, each country could request for an additional review at any time.

e) All fees and charges on import/export of goods were not allowed to indirectly protect domestic goods or a taxation of imports or exports for fiscal purposes. Further, list of the fees and charges and changes agreed to be made available through Internet or a comparable computer-based telecommunications network.

Tariff concessions offered by China

China granted Pakistan concessions on 7,550 tariff lines for the first five years after entering into force of the agreement. Out of these, around 35 percent of the products fall in the zero-rated category (within three years of implementation of FTA in 2007) such as cotton fabrics, marble, leather articles and medical appliances. However, 15 percent products were given no concession, which include fish, cotton, paper, plastic and textile items.

Figure 3: Pak-China trade



* data was available for Jul-May FY17
Source: Pakistan Bureau of Statistics

Tariff concessions offered by Pakistan

Similarly, Pakistan offered China concessions on 6,803 tariff lines for the first five years. Zero tariff rates were offered on electric and electronic products, machinery, chemicals and various raw materials crucial to Pakistan's industrial sector. However, no concession was granted on woven fabrics, synthetic fibers, paper and paperboard, machinery products and footwear. In fact, Pakistan excluded a list of products (92 tariff lines), which mainly include alcohol, drugs, arms and ammunitions.

Bilateral trade balance remains skewed more towards China

Pakistan's volume of bilateral trade expanded and reached US$ 13.8 billion in FY16, up from US$ 2.2 billion in FY05. However, the bilateral trade balance remained tilted in China's favour, as Pakistan's exports to China

[3] FTA on trade in services was signed on 21st February 2009 and is operational from 10th October 2009 (Source: Ministry of Commerce, Pakistan).

could not keep pace with its imports from the country – Pakistan's exports to China increased from US$ 0.4 billion in FY05 to US$ 1.7 billion in FY16. As against this, imports from China grew exponentially – increased from US$ 1.8 billion in FY05 to US$ 13.9 billion during Jul-May FY17 **(Figure 3)**. In fact, Pakistan's top imports come largely from China with the exception of oil.

The rise in imports from China is mainly attributed to: (a) the surge in machinery and equipments in the backdrop of development activities in Pakistan; b) diversion of import from other trading partners towards China **(Table 1)**; (c) the increase in demand for imported raw material due to emergence of local assembly businesses; (d) the robust demand for cheap goods; and (e) trade diversion from informal to formal channels after signing of CPFTA.

Table 1: Suppliers' share in some products imported by Pakistan

S.No.	Product/ Countries	2005 (%)	2016 (%)	Change (+/-)
1	**Telephone sets** (HS Code 8517)			
	China	*42*	*76*	*+34*
	Sweden	21	0	-21
	Germany	13	0	-13
2	**Electric shavers** (HS Code 8510)			
	China	*9*	*93*	*+84*
	Belgium	69	0	-69
	UAE	13	1	-12
3	**Diodes & transistors** (HS Code 8541)			
	China	*35*	*93*	*+58*
	Germany	9	0	-9
	Japan	16	0	-16
4	**Sewing machines** (HS Code 8452)			
	China	*18*	*56*	*+38*
	Singapore	15	3	-12
	Japan	18	13	-5
5	**Video games** (HS Code 9504)			
	China	*55*	*88*	*+28*
	UAE	24	2	-22
	USA	9	7	-2

Data source: International Trade Centre

Low cost machinery imports help Pakistan upgrade its local industry

Bulk of the imports from China fell under the category of capital goods, which could support Pakistan's economy in two ways:

a) Chinese machinery may help the local industry upgrade its technology, especially the textile and cement industries.

b) Public sector projects in power and infrastructure sectors (including those pertaining to CPEC initiatives) may utilize the imported machinery **(Table 2).**

These kinds of imports not only can help ease energy supply constraints, but also can support ongoing activities in the country's infrastructure development. In this process, the fiscal incentives, low interest rate environment, better law and order situation, and improved macroeconomic outlook of the country provide adequate support to the investors and business community.

Table 2: Pakistan's main imports from China (million US$)

	2005	2016
Total	**2,349**	**13,680**
Electrical machinery	429	3,364
Mechanical machinery	540	2,940
Iron and steel	41	1,061
Organic chemicals	119	636
Man-made filaments	93	556
Fertilizers	22	300
Articles of iron or steel	44	525
Plastics	66	364
Ceramic products	62	169
Vehicles other than railway	72	398

Data source: International Trade Centre

Cheap imported raw material and equipments benefits local production process

Pakistan also imports cheap raw material from China, which can benefit the local industry in many ways, such as: (a) filament yarn for usage by textile sector; (b) fertilizers and machinery being used by agricultural sector; and (c) cranes and other heavy transport equipments for construction sector.

Import of consumer goods helps flourish retail business across the country

The import of low-cost consumer goods has also surged over the time period, which could benefit local retail businesses. The anecdotal evidence suggests that various markets/shopping centers have been opened in the country selling Chinese imported goods as major product, especially electronic, automobiles, toys, electrical goods and accessories. Moreover, the Chinese goods are not only concentrated in wholesale markets and shopping malls, but also the small shops in key business areas/small markets are flooded with these goods.

Similarly, the consumer goods have also significance from the consumers' perspective. Particularly, a big segment of the society benefit from low-cost consumer items, such as computers, medical equipments, consumer durables, mobile phones, automobile spare parts, etc.

Pakistan's exports to China remain low

As against imports, Pakistan's exports to China could not gain adequately from tariff concessions under the agreement. Although, the exports exhibited a significant growth, its volume remained small. Following are the key reasons behind the low exports value:

a) Pakistan's potential export areas remain limited since China outpaced Pakistan in almost all of its major producing sectors. For instance, textile industry is the main pillar of Pakistan's exports. Since China itself is a major textile manufacturer, the trade volume could not be raised adequately; although Pakistan has been exporting low value-added products to China.

b) The country's export potential remained unutilized due to pursuance of non-innovative export approach by the local business community; this includes inadequate efforts to diversify export base and exploring new opportunities for products in the Chinese market.

c) Pakistan's margin of preference eroded due to China's FTA with other countries, especially with ASEAN members.[4]

d) The slowdown in Chinese economy has lowered the demand for raw material/intermediate goods from countries like Pakistan.

The data reveals that the pattern of exports has not exhibited any significant change. In fact, the overall exports have increased with marginal access into the Chinese market. As per the Tariff Reduction Modality (TRM) of China, some of the Pakistani products having relatively greater export potential were facing high tariff rates, and were given no concession in China's offer list. For instance, Pakistani dried fruits facing tariff rate of around 25 percent, semi-milled or wholly milled rice/ broken rice (65 percent), footwear with wood base/ metal toe-cap (24 percent), and men's or boys' garments of cotton (16 percent). As against this, the items in which Pakistan lacks competitive advantage (such as, telephone sets, digital cameras, electrical machines, children toys, etc.) were included in the tariff elimination list of China.

It is worth noting that although China's imports from world are increasing, imports from Pakistan have not shown a matching rise. Particularly, the share of Pakistan's exports in China's imports from world stood low.[5] This requires that Pakistan should try to seek preferential concessions in areas where the country has consistently performed well with the world, and where China also trades in with other countries.

[4] China has provided Pakistan zero duty on 35 percent of the total tariff lines, compared with over 90 percent to Malaysia, Indonesia, Philippines and Thailand, provided under ACFTA (ASEAN-China Free Trade Area).

[5] The exports which have shown marginally better performance include cotton (9.8 percent), textile (5.8 percent) products and vegetable saps (24 percent).

III. Consumer Imports Hurting Non-competitive Local Industry

The influx of cheap imports from China might have some adverse effects, especially on domestic manufacturing sector. The anecdotal evidence suggests that local manufacturing of ceramics, electric machinery and equipments, chipboard, plywood, bicycles, etc., and a number of small scale industries have also been affected, among others, by low cost imports from China **(Table 3).**

Table 3: Declining Production of Pakistan's Manufacturing Industries

	Unit	FY06	FY17	CAGR *
Pig iron	Tones	767,956	0	-100.0
Coke	Tones	182,278	0	-100.0
Chipboard	MT	22,809	0	-100.0
Metal drums	MT	5,000	452	-21.4
Heavy machinery & equipment	MT	16,976	4,323	-12.8
Bicycles	Nos.	589,605	200,210	-10.2
Sewing machines	Nos.	39,064	18,291	-7.3
T.V. sets	Nos.	935,098	438,453	-7.3
Electric bulbs	000 Nos.	143,634	72,148	-6.7
Plywood	`000' Sq. feet	40,568	23,431	-5.3
Electric transformers	Nos.	44,782	28,802	-4.3
Electric meters	Nos.	2,855,542	1,855,744	-4.2
Deep freezers	Nos.	185,684	127,087	-3.7
Switch gears	Nos.	17,181	11,931	-3.6
Electric motors	Nos.	12,223	8,874	-3.2
Cycle tubes	000 Nos.	10,204	7,559	-3.0
Storage batteries	Nos.	143,587	106,473	-2.9

Data source: Pakistan Bureau of Statistics; *: Compound Annual Growth Rate (%)

Although adequate data is not available in support of the argument, the influx of imported consumer goods, and non-availability of their local substitutes, presents enough evidence that local SMEs are losing ground in the domestic market.[6] The increasing trade gap poses a potential risk that may also be a reflection of lowering or stagnancy in local production given the similar product composition of the two countries. Further, the non-competitive SMEs might also have been affected, as the Chinese imported goods get benefit of economies of scale. Moreover, some other factors also remained in play, such as relatively high cost production, poor law and order situation, and energy crisis severely impacted the production performance of local SEMs. All of these have affected the performance of SMEs and some large scale industries.

IV. Exploring the Untapped Trade Potential

Apparently, the low volume of bilateral trade between Pakistan and China is not reflective of the economic size of two neighboring countries. This also indicates the existence of huge untapped trade potential in both countries, which can be utilized mainly to enhance welfare of the masses.

The establishment of Special Economic Zones under the CPEC arrangements are expected to provide tremendous opportunities to develop and upgrade Pakistan's SME sectors, which have high export potential, such as, agriculture, food processing, marble & mining, light engineering, textile, garments & made-ups, and logistics sector.

Moreover, the continued restructuring in Chinese economy opens opportunities for countries like Pakistan, as there is possibility of relocation of Chinese low value added industries to other regional countries where they could establish their business with competitive edge. In this context, the continuity and consistency in investment and industrial polices can play an important role in attracting FDI in export-oriented sectors. The zero rated category and other preferential tariff concessions to China have enabled Pakistan to import

[6] The latest survey data for SMEs is available for 1995-96, while CMI for LSM is available for 2005-06. This mainly constraints an adequate analysis of pre and post CPFTA impact on local industry.

machinery and cheap raw material. In this way, China has provided support for Pakistan with modern technology, technical support, and lower production costs by providing cheaper raw material.

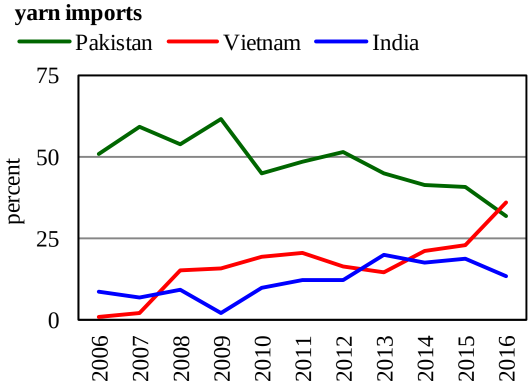
The Global Financial Crisis 2008 experience reveals that the reliance on regional trade can help countries minimize negative spillovers of adverse economic developments. In this backdrop, the shift of Pakistan's trade towards a stable regional partner like China is a better choice, as the role of China is gradually expanding in the world trade. This provides Pakistan an opportunity to diversify its exports as the concentration of exports in matured economies (USA and EU) could be affected in case of emergence of any economic shock with widespread spillover affects.

Agricultural Trade Potential

Due to shortage of arable land and freshwater resources in China, the country needs to import land-extensive crops (such as wheat and rice) to feed its population. Besides, with rising living standards, China's demand for agricultural imports is growing. China's leading suppliers of agricultural imports include United States, Brazil, Australia, Canada, New Zealand, and Argentina.[7] China mainly imports soybeans from the US, meat from Brazil, dairy produce from New Zealand, fish and other aquatic invertebrates from Russia. Further, with rising living standards, the Chinese demand for agricultural imports is gradually moving up, which is likely to create agro-based trade opportunities in countries having substantial potential in agricultural produced.

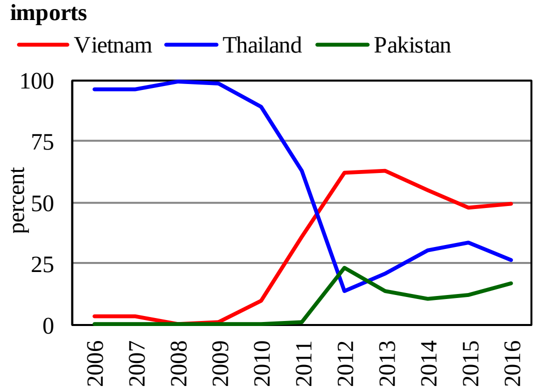
On the other hand, China's demand for cotton yarn and rice imports is met by the emerging economies of Asia, like Pakistan, Vietnam, Thailand and India. However, the relative share of China's import of these products has witnessed some changes recently. It is worth noting that while Pakistan remained the top supplier of cotton yarn to China (until 2015); Thailand dominated as leading rice exporter to China until 2009. However, Thailand's *rice pledging scheme* in 2011, leading to an increase in export price of Thai rice, created export opportunities for other rice producer countries.[8] Pakistan also took benefit of its low cost rice and emerged as the second largest supplier of rice to China, after Vietnam, as shown in **Figure 5.**

Figure 4: Share of major suppliers in China's cotton yarn imports



Source: International Trade Centre

Figure 5: Share of major suppliers in China's rice imports



Source: International Trade Centre

Keeping in view the fact that agriculture sector accounts for around 20 percent of Pakistan's GDP and employs over 40 percent of the country's labor force, both Pakistan and China have agreed to enhance cooperation on

[7] China's agricultural imports from the US jumped from US$ 6.7 billion in 2006 to US$ 21 billion in 2016. (Source: United States Department of Agriculture).

[8] In 2011, when rice prices were at record highs, Thailand's government started stockpiling with plan to sell the stockpiled rice at higher prices for profit.

agriculture under the CPEC arrangements. This is likely to help Pakistan utilize its vast untapped potential in agriculture, and develop the sector, which is currently lagging behind in terms of its productivity if compared with the other comparable countries. The usage of better varieties of agricultural crops together with bringing more area under utilization with the Chinese cooperation can enhance the country's agriculture production, which can be exported, among others, to China as its demand for agricultural products is increasing.

Particularly, unlike China's Western trading partners, Pakistan (having low transportation cost advantage) can maximize its agricultural exports to its neighboring country by improving production efficiency and quality. On a positive note, various agricultural projects have been initiated to get maximum benefit of CPEC, which include:

i. ***Setting up of a fruit processing industry in Gilgit-Baltistan:***
The climatic conditions and fertile soil of Gilgit-Baltistan offers ideal environment for the production of highly nutritious and tasty fruits, like apples, peach, cherries, almonds, apricot, etc. According to an article published by the Asian Development Bank, farmers in Gilgit-Baltistan produce over 100,000 metric tons of fresh apricots a year. Setting up of the fruit processing industry in the region would help boost the country's fruit exports.

ii. ***Setting-up of 'Sino-Pakistan Hybrid Rice Research Center' at Karachi University:***
Both the countries have recently initiated collaborative research for producing high yielding and high quality rice varieties. Setting up of the rice research centre is a right step towards achieving the objective.

iii. ***Setting up of meat production & processing facilities in KP:***
Setting up of meat production and processing facilities in KP would help increase Pakistan's meat exports to China, as well as, to Afghanistan and Central Asian market.

iv. ***KP-China Sustainable Donkey Development Program:***
Under the proposed KP-China Sustainable Donkey Development Program, it is planned to develop and enhance donkeys' population in Pakistan so as to ensure regular and interrupted backward supply for export of live animals and enhancing income of donkey breeders and traders in the country.

V. Concluding Remarks

The CPFTA is an important strategic link between China and Pakistan, which aims to further solidify the bilateral relations between the two countries. For Pakistan, this agreement is an opportunity to exploit the Chinese markets, as it addresses tariff/non-tariff barriers and augment comparative value of exports.

So far, the bilateral trade balance remains in favour of China. However, Pakistan can also reduce its overall trade deficit by diverting its exports from traditional destinations to China, which is a market of above one billion consumers. This can be done by encouraging Pakistan's private sector to modernize its business processes, invest in research and development, improve human capital, seek international certifications, and meet quality standards as expected by the consumers. Moreover, Pakistan's private sector also needs to get benefit of recent ease in supply-side bottlenecks, improved macroeconomic outlook, setting up of planned Special Economic Zones under the CPEC arrangements, and the expected relocation of labour intensive industries in the backdrop of continued restructuring in Chinese economy.

On one hand, the imports from China have benefitted Pakistan's economy by fixing the supply-side constraints, which have been affecting the country's productive potential severely. In this regard, the contribution of imports of machinery and raw material is worth mentioning due to having its positive spillover on growth-induced activities. On the other hand, the production of local industry with low competitive advantage has been affected, as the CPFTA provided the Chinese goods with an equal opportunity to compete with their Pakistani counterparts in the country’s local market.

Currently, the second phase of CPFTA is being negotiated, which is likely to further lower the tariffs and normalize the trade procedures. In these deliberations, attention may be paid on two important dimensions: (a) Pakistan should seek the same level of tariff concessions on its exports to China, as enjoyed by its competitors from East Asian countries on their products. This is likely to provide our exports an equal opportunity to compete with the competitors’ products in Chinese markets; and (b) the safeguard measures (as allowed under WTO rules) could also be sought in favour of Pakistan’s non-competitive industry (e.g. ceramics, footwear, leather goods, sports goods, fans industry, plastic and tyre, etc.) with mutually agreed timelines.[9] This could help the local industry to build-up enough capabilities over the time to compete with Chinese products.

[9] The WTO rules allow members to take a “safeguard” action (i.e., restrict imports of a product temporarily) to protect a specific domestic industry from an increase in imports of any product, which is causing, or which is threatening to cause, serious injury to the industry.

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